Competition in Underwriting of Government Debt Auction

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Abstract

We examine a novel two-stage mechanism for selling government securities. In Stage 1 (the \underwriting auction"), the aggregate amount of security to be auctioned in Stage 2 is underwritten by bidders via a discriminatory auction. All underwriting auction participants then join the second stage auction in which the security is sold via either a Discriminatory Auction (DA) or a Uniform Price Auction (UPA). Winning first-stage underwriters have dual roles in the second stage, as bidders and as insurers who must absorb any excess security supply.

Using proprietary data on Government securities auctions in India between 2006 and 2012, we find sharply different outcomes when the second-stage auctions are DAs compared to UPAs: Under DAs, (a) the Stage 1 underwriting commissions are higher and exhibit more volatility, (b) Stage 1 award concentrations are higher, and (c) Stage 2 bid-shading and the degree of underpricing are higher. We also show that the Stage 1 underwriting auction is informationally powerful in explaining Stage 2 auction outcomes including the likelihood of devolvement, the degree of bid shading, and post-auction secondary market price movements. The direct and indirect costs of underwriting appear to be higher for discriminatory auctions, triggering the auctioneer to devolve at a much higher devolvement price. We show that the winner's curse risk of unsold inventory is a driver of our results. We find evidence of this channel by exploiting a policy change that induced natural variations in inventory costs differentially across bidders.

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