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Municipal Finance Law Since 1971

The Missing Information That Municipal-Bond Investors Need.

Prior to the Great Recession, interest rates on municipal bonds were generally lower than Treasury rates. This relationship has reversed since 2008, imposing substantial extra costs on state and local government borrowers. Further, the municipal-bond market witnessed major interest-rate spikes in the aftermath of Wall Street analyst Meredith Whitney's dire (and errant) 2010 warning of widespread bond defaults and the Detroit bankruptcy.

High borrowing costs and volatility are the result of ignorance about the risk of municipal securities. A drumbeat of negative news headlines deters investors from buying municipal bonds, limiting liquidity and raising yields above levels necessary to compensate for the very limited risk of lending to most U.S. cities and counties.

By replacing fear and ignorance with data and insight, we can lower municipal borrowing costs and reduce the market's vulnerability to negative headlines. Much of the data needed for this task is buried in audited financial statements published each year by about 18,000 of the nation's local governments.

Unfortunately, municipal investors are less apt to perform financial statement analysis than their counterparts who invest in corporate securities, where discussion of such measurements as P/E ratios and EBITDA is common. Municipal-bond-market participants are largely ignorant of which government financial ratios presage bankruptcy or default and what levels signify danger.

There are many reasons why the municipal market lacks sophistication in this area, but a big part of the problem has been a lack of free (or even low-cost) financial-statement data. In this regard, some strides are being made. First, the 2009 launch by the Municipal Securities Rulemaking Board (MSRB) of its Electronic Municipal Market Access (EMMA) system gave investors a one-stop shop for municipal financial disclosure. But as the Securities and Exchange Commission (SEC) observed recently, a large number of municipal-bond issuers have been posting their statements late or not at all. The commission's Municipal Continuing Disclosure Cooperation Initiative has greatly increased the number of statements on EMMA. Finally, late this year the Census Bureau is expected to begin posting federal single-audit submissions online. These packages include the same basic financial statements typically found in municipal market disclosure.

But the simple publication of thousands of voluminous PDFs does not provide the degree of transparency needed to raise the level of municipal-bond-market financial literacy. The vast majority of investors and analysts lack the patience and/or technical skills needed to extract the valuable needles of insight from this haystack of disclosure.

Investors in corporate securities do not face these difficulties. For the last 20 years, company financial reports have been available in textual form on the SEC's Electronic Data Gathering, Analysis and Retrieval system. As a result, corporate financial-statement data is freely available in convenient forms around the Internet: Yahoo Finance, MarketWatch, Morningstar and your broker's

website are just a few of the places you can find this data.

So while corporate investors can readily compare the financial statistics of a safe company like Apple to an insolvent one like Radio Shack, municipal investors cannot easily perform the same exercise for Dallas and Detroit.

It wasn't always this way. Between 1909 and 1931, the Census Bureau published an annual volume entitled "Financial Statistics of Cities Having a Population of Over 30,000." The final edition — available at the St. Louis Federal Reserve's website — covered 311 American cities and included hundreds of revenue, expenditure, asset and liability data points for each municipality. Unfortunately, ever since 1931, Census financial data on local governments has become less comprehensive, less timely and less comprehensible to the lay user.

In the years after 1931, we lost the understanding that comparative local-government financial statistics were a public good. While we might look to the federal government to once again offer this information in today's era of heightened need, it may be challenged to take on this role in an era of sequesters.

But while we may need the private sector to provide this public good, the federal government can greatly reduce the cost of compiling a local-government financial-statement database. The SEC has required companies to file financial statements in text form — rather than via PDF — since the mid-1990s. In 2008, the SEC further standardized company financial reporting by requiring firms to file their statements in the form of eXtensible Business Reporting Language (XBRL), which imposes a consistent format on all filings. To date, neither the SEC nor the MSRB has pursued a similar course with respect to municipal financial disclosure.

Next week, the Data Transparency Coalition, a group that advocates for the use of XBRL, will hold a Financial Regulation Summit featuring numerous congressional representatives and regulators. Perhaps the extension of XBRL to the municipal-bond market can find its way onto the agenda.

Innovative financial regulation has done much to increase the liquidity and efficiency of equity markets. It is now time to extend these efficiencies to the municipal-bond market. Local government bond issuers and the taxpayers who ultimately service municipal debt stand to benefit.

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