Bond Case Briefs

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Improving Financial Disclosure by State and Local Government Borrowers.

State and local government financial reporting is regulated more lightly than that of corporations, but recent enforcement actions taken by the Securities Exchange Commission alleging fraud and other developments have sparked an effort to promote better financial disclosure by state and local government borrowers.

This has raised several questions. What benefits do better disclosures produce? And do these benefits outweigh the costs? Two papers to be presented at the sixth annual Municipal Finance Conference address these questions.

The first, "When transparency pays: The moderating effect of reporting quality on changes in the cost of debt," begins with a simple intuition: improved reporting on a municipal government's finances should reduce uncertainty about its ability to service its debts, which, in turn, should reduce the cost of borrowing. "Higher quality, timelier, more transparent reporting means less information asymmetry between the issuer and its bondholders and less uncertainty about the issuer's changing default risk," Christine Cuny and Svenja Dube from the Stern School of Business at New York University write. However, much empirical research on the subject doesn't adequately account for an important fact– risky issuers tend to have weak reporting quality. The authors address this concern. They ask: are issuers with stronger reporting quality less likely to be downgraded and more likely to be upgraded than similar issues with weaker reporting quality?

Cuny and Dube match issuers with the same beginning credit rating that are exposed to the same drop in house prices; house prices are used by rating agencies as an indicator of local economic conditions. They then examine how the issuers with stronger disclosure fared relative to those with weaker disclosure. They find that a one standard deviation improvement in reporting quality lowers the probability of a ratings downgrade by 46% and raises the probability of an upgrade by 31%, all else equal. The impact of reporting quality is greater when adverse local housing conditions persist for more than one year, supporting the notion that that reporting quality reduces uncertainty about default risk. Overall, these results suggest that reporting quality can indeed lower municipal borrowing costs.

The second paper, "Regulatory Disclosure interventions in Municipal Securities Secondary Markets: Market Price Effects and the Relative Impacts on Retail and Institutional Investors," examines the impact of steps the Municipal Securities Rulemaking Board, a self-regulatory agency that oversees the municipal bond market, has taken to require more disclosure by broker-dealers. In 2008, seeking to reduce concerns that institutional investors were getting better prices for municipal bonds than individual investors, the MSRB launched an online disclosure portal–the Electronic Municipal Market Access (EMMA). EMMA provides public access to municipal bond disclosure documents and near real-time data on market trade prices. Komla Dzigbede of the State University of New York at Binghamton uses the EMMA intervention to examine two questions: 1) What is the impact of the EMMA on secondary market pricing of municipal securities? and 2) has EMMA changed institutional investors' usual trade price advantage over retail investors?

Dzigbede compares daily price differentials and volatility in prices of California state general obligation bonds traded before and after the implementation of EMMA, accounting for factors relating to individual bond trade, bond characteristics underlying the trade, and market factors influencing the trade. He then compares these effects between individual and institutional investor segments. He finds that EMMA enhanced the efficiency of trade pricing – that is, the interventions decreased the average daily price differential and trade price volatility. But he also finds that the benefits effects of regulatory interventions were greater for institutional investors than for individual investors. Institutional investors' pricing advantages persist after the regulatory interventions. These results suggest that regulators should look for policies that more effectively counteract disparities in information flow to equalize opportunities for retail investors, he says. "Overall, regulatory policy in the municipal bond market contexts must stretch beyond interventions and enforcement of disclosure rules to emphasize, to a greater extent, other supportive mechanisms […]" to address the information disparity, Dzigbede concludes.

The Brookings Institute

Vivien Lee and David Wessel

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Editor's Note: The papers discussed in this post were presented at the 2017 Municipal Finance Conference on July 17 and 18 at Brookings.