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When Transparency Pays: The Moderating Effect of Disclosure Quality on Changes in the Cost of Debt.

Theoretically, disclosure quality reduces the cost of debt by reducing uncertainty about future cash flows (Lambert et al., 2007). However, cross-sectional studies that empirically link disclosure quality to the cost of debt are subject to the concern that risky issuers tend to exhibit weak disclosure quality. Similarly, studies that examine changes in disclosure quality suffer the criticism that changing issuer economics drive both the disclosure change and the cost of debt change.

The municipal bond setting provides an opportunity to address these concerns and strengthen the link between disclosure quality and the cost of debt for several reasons. First, even without issuer-provided disclosures, some economic information that is relevant to issuers' credit quality is publicly available. For example, changes in local house prices are observable and are correlated with the strength of the local economy (Campbell and Cocco, 2007; Standard & Poor's, 2012). Although property tax collections are the largest own-source of revenues for most local governments and are responsive to changes in house prices, house prices are largely outside the control of city and county officials. Therefore, conditioning on changes in local house prices helps to satisfy the ceteris paribus condition when comparing weak disclosers to strong disclosers.

Second, the municipal setting lends itself to the clean measurement of significant aspects of financial disclosure quality. These aspects include: the accessibility, comprehensiveness, reliability, timeliness, and regulatory compliance of financial information. Moreover, the municipal disclosure environment is lower quality and exhibits greater cross-sectional heterogeneity than does the corporate setting. Finally, municipal bond insurance and disclosure quality are substitute mechanisms to lower the cost of debt. Therefore, we use bond insurance as an instrument for disclosure quality to help attribute our results to financial reporting choices.

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