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Economists Find Underreporting of Municipalities' Private Debt Obligations.

The underreporting of bank debt remains a sizable risk for holders of municipal bonds two years after Securities and Exchange Commission rule changes designed to improve transparency.

That was the conclusion of scholarly research performed by three economists and presented Monday at the Brookings Municipal Finance Conference. The paper authored by Federal Reserve Board economists Ivan Ivanov and Nathan Heinrich, as well as by Tom Zimmermann of the University of Cologne, examined the effectiveness of regulations designed to improve the transparency of private debt and concluded the requirements have limited effectiveness.

“We need to worry about it,” Ivanov said during a webcast presentation of the research. “We need to be able as a market to observe these.”

Roughly 50% of issuers are now required to disclose private debt under the 2019 amendments to the SEC?s Rule 15c2-12, the researchers found. Those rules require disclosure of the incurrence of a financial obligation of the issuer or obligated person, if material, as well as any agreement to covenants, events of default, remedies, priority rights, or other similar terms of a financial obligation of the issuer or obligated person, if these are material.

Bond investors need to be aware of other obligations because such debts could potentially impair bondholders, particularly if the debt is explicitly senior to the outstanding bonds.

The authors used subscription services and confidential data, and also hand-collected information from over 2,300 filing documents. In each filing, they searched for the obligation amount, interest rate and maturity, noting whether the filing was new or amending an existing obligation, and whether the filing included a term sheet summarizing the obligation.

The authors found that private debt was significantly underreported, using their data to determine when a filing was required and whether an associated disclosure appeared on EMMA.

“In the vast majority of bank loan events where disclosure is required, the associated issuer makes no disclosure on the EMMA system,” the researchers discovered. “For example, out of the 4,813 such bank loan events, only 935 events corresponding to 156 entities are associated with mandatory disclosures filings on the EMMA system.”

Further, the authors found, there was a wide range in the quality of these disclosures, with most offering up the size of the obligation but many excluding important information about the terms of such obligations.

The economists suggested that low issuer sophistication and familiarity with 15c2-12 might partly explain the underreporting.

Emily Brock, the director of the federal liaison center at the Government Finance Officers

Association also noted during the conference that some issuers might not be aware of the rule. Brock said there is an opportunity for the whole muni market to improve the state of disclosure.

“We can use this opportunity to see what EMMA can be,” Brock said.

She also said it’s important to note that issuers lean heavily on counsel to help them make the determination about materiality, a concept that can be difficult to pin down. The SEC has generally declined to elaborate on when an obligation or event is material, not wanting to go beyond the Supreme Court?s ruling that something is material if there is “a substantial likelihood” that the disclosure would have been viewed by a “reasonable investor” as having significantly altered the “total mix of information” used to make an investment decision.

The Brookings conference continues through Wednesday.

By Kyle Glazier

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