Financial Disclosure and Municipal Market Dynamics: What the Research Tells Us

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Today’s Presentation

Our question: How does the municipal bond market respond to state/local financial disclosures?

The “question behind the question“: What might happen if the federal government regulates state/local financial disclosures?

Today’s focus: What does research tell us about three potential “policy interventions“?

1. Require compliance with generally accepted accounting principles (GAAP)
2. Reduce disclosure delay
3. Prescribe the content/format of financial reports

Our key take-away is a conundrum: The market responds, but do the benefits to issuers of that response pass the “cost-benefit“ test?
Today’s Disclosure Landscape

State and local government financial reporting is “unregulated"

- Per the Tower Amendment (1975), Securities and Exchange Commission (SEC) does not directly regulate government financial reports
- However, SEC has broad “indirect" authority:
  - Tower Amendment created the Municipal Securities Rulemaking Board (MSRB) to regulate municipal bond brokers/dealers; SEC approves all MSRB rules; FINRA enforces
  - Broker-dealers must ensure appropriate “continuing disclosure" of financial information to prevent securities fraud
  - SEC has pursued actions against financial institutions and state/local governments that have not complied with MSRB continuing disclosure rules
Today’s Disclosure Landscape

SEC has been active in the municipal bond market:

- Report (2012) on the municipal securities market highlighted concerns about timeliness and informativeness of state and local government financial reports
- High profile enforcement actions against broker/dealers - Municipalities Continuing Disclosure Cooperation (MCDC) Initiative;
- High profile enforcement actions against governments - City of Miami, FL convictions; major fine levied on PANYNJ; others

Congresswoman Gwen Moore (D-WI) introduced a bill that would hold governments responsible for disclosure, and mandate national accounting standards
Today’s Disclosure Landscape

The argument for unregulated disclosure:

- No single regulatory regime can treat every state/local government fairly
- Compliance costs of regulated disclosure are enormous, especially for smaller jurisdictions
- Market forces ensure investors get the information they need

The argument for regulated disclosure:

- New technology - namely “eXtensible business reporting language” (XBRL) - makes disclosure cheaper and easier than ever
- Silicon Valley’s “democratization of public finance” - OpenGov, Neighborly, Socrata, BondLink, others - demands comparable financial reports
- Without default insurance, municipal bonds are no longer “commoditized"
Policy Intervention: Require GAAP Compliance

State/local governments comply with GAAP to varying degrees:

- By 1996, virtually all 50 state governments had adopted GAAP
- In 15 states, state law requires local governments to comply with GAAP created by the Governmental Accounting Standards Board (GASB)
- In 10 states, local government compliance is “unregulated”
- In the other 25, local governments follow a state-wide “chart of accounts” that may or may not correspond to GASB standards

Potential advantages of required GAAP compliance: Better comparability across governments; (potentially) less emphasis on cash-basis budgeting and financial reporting

Potential disadvantage: implementation/maintenance costs for issuers
• Borrowing costs in GAAP-regulated states are, on average, 15-25 basis points less than in non GAAP-regulated states (Baber and Gore 2008).

• Governments substitute between disclosure and bond insurance (Gore, et. al. 2004).

• GAAP regulation induces additional disclosures for low-debt governments, but not for high-debt governments (Gore 2004).

• Ratings respond to accrual measures like net assets (Plummer, et. al. 2008; Kioko, et. al. 2012).

• However, buy side analysts still rely mostly on traditional fund-based measures like fund balance (Bloch 2016).
Policy Intervention: Improve Disclosure Timeliness

State/local governments typically release their financial statements 180 days after fiscal year close (Merritt Financial; GASB)

Potential policy interventions:
- Mandate audit reports by some "date certain"
- Encourage or require periodic unaudited reports
- Streamline the content of financial reports

Potential advantages of faster disclosure: Less uncertainty on pricing decisions; Better visibility into recent government policy

Potential disadvantages: Feasibility and costs of compliance for state/local governments
• Buy side analysts discount the value of “stale" financial information (Robbins and Simonsen 2010)
• Buy side analysts see disclosure delay as a sign of potential internal control weakness, management problems (Bloch 2016)
• Municipal borrowing costs increase by 6 basis points ($319,800 for a typical issue) for every 100 days of audit delay (Edmonds, et. al. 2016)
• Non-profit hospitals that produce quarterly, unaudited financial reports borrow at 10-12 basis points less than those that don’t (Marlowe 2016)
A key question: Do investors care about specific pieces of price-relevant information that are, or could be, included in government financial reports?

The policy question: Can regulators calibrate the content of financial reports to best meet investors’ needs?

Advantage: responding directly to key stakeholders’ financial needs;
Disadvantage: Adds complexity and cost to government financial reporting
• Unfunded pension liabilities and unfunded OPEB liabilities are strongly reflected in credit ratings (Benson, et. al. 2015; Martell, et. al. 2013; Marlowe 2010)

• Governments with sizeable unfunded ARC borrow at two or three basis points higher than those with fully funded pensions (around, but strongly related to credit ratings (Benson and Marks 2016; Burson, et. al. 2016)

• The “modified approach" to infrastructure reporting reduces secondary market price dispersion by up to 15% (Bloch, et. al. forthcoming)

• Governments with material weaknesses to internal controls borrow at 10-18 basis points higher than those without those weaknesses (Park, et. al. 2016)
Where We Need to Learn More

• Where disclosure does not matter - bias against "non-findings"
• Implementation costs for issuers of complying with new GASB standards
• Role and implications of state-level oversight bodies
• What about budgeting institutions and transparency?
• Benefits, costs, and implementation challenges of XBRL, other technology advances to expedite and drive down the cost of reporting
• What’s the value of disclosure as a "democratic principle" or accountability as a democratic value?
• How, if at all, does the market respond to "road shows" and state and local governments’ other enhanced investor outreach?


