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Voluntary disclosure incentives: Evidence from the municipal bond market

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ABSTRACT

I investigate the trade-off between capital market incentives, reputational concerns, and administrative costs in the public disclosure decisions of municipal bond issuers. After Ambac's bankruptcy, issuers of insured debt increase disclosure relative to issuers of uninsured debt. After local per capita income declines or expenditures increase, issuers, particularly those with strong electoral incentives and weak voter oversight, reduce disclosure. After the implementation of an online filing repository, issuers with few dissemination channels increase disclosure relative to other issuers. Overall, my findings support a positive relationship between voluntary disclosure, risk, and low-cost dissemination, to the extent reputational capital is not threatened.

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1. Introduction

Limited regulatory oversight and weak public financial disclosure in the municipal bond market provide a novel context for studying the conflicting roles of market and political forces in driving disclosure decisions. From a market perspective, low borrowing costs minimize resources consumed by interest payments and maximize resources that can be devoted to political priorities. Therefore, municipal officials are incented to use disclosure to reduce the cost of capital, to the extent the benefit exceeds the cost of publishing and disseminating the information. From a political perspective, municipal officials operate under a democratic system in which voters rely on the limited information available to them to make electoral decisions. Therefore, reputational damage from disclosing negative information to voters may inhibit disclosure.

To better understand the trade-off between minimizing the cost of capital through transparency, minimizing expected reputational costs by suppressing negative information, and minimizing administrative costs, I identify several events that alter the cost-benefit tradeoff. Because these events affect only a subset of municipal bond issues, unaffected issues create a natural control group.

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First, I identify a ubiquitous, externally imposed escalation of credit risk: the abatement of municipal bond insurance. Municipal bond insurance was historically prevalent in the municipal bond market because it reduces the cost of capital for issuers. During the financial crisis, municipal bond insurers suffered large losses related to subprime mortgage exposure, leading to credit downgrades for all of the bond insurers. By 2010, most insurers ceased writing new policies, several were forced to cease paying claims, and a few, including Ambac, sought bankruptcy protection. Despite the fact that exposure to municipal bonds did not precipitate the financial distress of the municipal bond insurers, the cost of capital for issuers of insured debt increased.

After controlling for unobservable issue-level heterogeneity, group-specific time trends, time fixed effects, new issuance, changes in credit quality, and changes in county-level demographics, I document that issuers of insured bonds respond to the diminution of bond insurance with increased disclosure, on average. Specifically, issuers of insured debt are 7 percent more likely to file financial statements and 60 percent more likely to file a budget after Ambac's bankruptcy than issuers of uninsured debt. This disclosure increase is particularly pronounced for issues insured by Ambac and issuers of insured debt that issue new bonds over the ensuing two-year period, suggesting these disclosures are motivated by a desire to reduce the cost of capital. By contrast, the countervailing reputational incentive to suppress negative information is particularly acute for issuers that were inordinately exposed to the nationwide drop in house prices that precipitated the distress of the bond insurers. I find that issuers of insured bonds located in counties that experience extreme house price depreciation are less likely than other issuers to increase disclosure following Ambac's bankruptcy, demonstrating the relative strength of reputational incentives.

Next, I examine the relationship between disclosure and heightened credit risk that stems endogenously from disclosing negative information. Because voters cannot directly observe the performance of county officials, they evaluate officials across a variety of indirect economic, fiscal, and social outcomes. I focus on two such outcomes that overlap with the dimensions on which the rating agencies evaluate credit risk. From an economic perspective, voters penalize incumbents for personal welfare loss, such as income abatement (Lewis-Beck and Stegmaier, 2000). From a fiscal perspective, voters penalize incumbents for wealth transfers in the form of increased governmental spending (Peltzman, 1990). These negative outcomes jointly heighten the cost of capital and decrease the probability of political success for incumbent officials.

I find that issuers that either suffer a decline in local per capita income or increase spending reduce the quantity and quality of public disclosure. Issuers in counties that experience a negative change in per capita income file 7 percent fewer financial statements and are 33 percent less likely to separately file a budget in the following year than issuers that do not experience a negative change in per capita income. Issuers that increase spending are 4 percent less likely to file financial statements, file 11 percent fewer financial statements and are 22 percent less likely to file a budget in the following year than issuers that do not increase spending. These reductions suggest that, on balance, the desire to capture personal political success tends to outweigh the capital market-based motive to provide transparency. Moreover, issuers with relatively strong ex-ante electoral incentives are particularly likely to suppress negative information. By contrast, issuers that are subject to relatively strong voter oversight are less likely to suppress negative information.

Finally, I examine the relationship between dissemination costs and disclosure. I capitalize on the introduction of a free, electronic, centralized repository for municipal disclosures (similar to the SEC's EDGAR system for corporate disclosures). The online system allows issuers to communicate information immediately and inexpensively to all stakeholders at once. I provide evidence that the ability to reach a broad audience at lower cost online is associated with enhanced disclosure. Issuers with few alternate dissemination channels are 9 percent more likely to disclose and file 28 percent more financial statements after the inception of the repository than large, general purpose issuers that are more likely to have web sites. By contrast, issuers of pre-refunded bonds file 20 percent fewer financial statements in the repository than issuers of bonds that are required to provide continuing disclosures.

Overall, this paper seeks to develop a richer understanding of municipal disclosure incentives, but it also contributes broadly to the disclosure choice literature. My findings demonstrate that the relationship between risk and disclosure depends on the nature of the risk. I provide novel evidence that to the extent reputational capital is not threatened, increased risk is associated with increased disclosure. This suggests that even in the municipal bond market, in which capital is relatively cheap, issuers believe there are benefits to transparency. However, municipal officials have powerful personal incentives to preserve reputational capital. When present, these short-term political incentives tend to outweigh the perceived capital market benefits of transparency.

The rest of the paper is organized as follows: Section 2 develops hypotheses. Section 3 describes the data, empirical proxies, and research design used to estimate the relation between disclosure incentives and disclosure outcomes. I present results demonstrating relationships between disclosure, cost of capital, reputational capital, and the cost of dissemination in Section 4. I offer concluding remarks in Section 5.

2. Disclosure incentives

As of 2015, state and local governments owe investors over $3.7 trillion, spanning 50 thousand different issuers and 1.5 million individual municipal bonds. These bonds finance general governmental operations and myriad projects, ranging from sewage to hospitals. Repayment sources are also diverse, ranging from property taxes to usage fees. Despite the

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