RSW's Take On Municipal Disclosure

In the business section of the Sunday New York Times and in today's Bond Buyer, there were two articles dealing with inadequate Municipal issuer disclosure. Using data compiled by DPC (firm that compiles municipal data), the New York Times article authored by Gretchen Morgenson set out to highlight the "spotty" nature by which municipal debt issuers released their annual financial statements. We agree that the degree, timing, and manner by which some municipal issuers report is sorely lacking, particularly when compared to their taxable brethren.

As in all boom times, standards become relaxed as issuers, investment banks, and investors, pay less attention to the timeliness of financial disclosure. AMBAC, FGIC, and MBIA are testament to this phenomenon. In the Times article, Gretchen points to the problems of poor municipal disclosure and cites two distressed municipal issuers as a sign of things to come. Namely, Orange County California and Jefferson County Alabama. This is where we depart from the thought process of the author. Ms. Morgenson seems to be sensationalizing the facts by implying that poor disclosure was a major contributor to bondholders being harmed. Both of the counties named above, engaged in derivative transactions and got burned. Interest rate swaps were the culprit, not a lack of disclosure. A lack of financial reporting exacerbates a deteriorating situation but didn't cause the problem. FYI, Orange County bondholders recouped 100 cents on the dollar, which was an important fact missing from the article. As far as Jefferson County bond holders are concerned, the situation is still developing. Here again, a misuse of derivatives is the 800-pound gorilla, and any lasting impact to debt holders is yet to be determined.

The second key fact that was barely mentioned in the Bond Buyer article and totally omitted in the Times article is the fact that the municipal bond market is virtually "two-tiered". According to the Bond Buyer, the reporting for the smaller, lower-rated issuers may be woefully inadequate while the financial disclosure for "larger revenue bonds and state obligation debt, was less alarming than DPC Data's study".

To my way of thinking, municipal issuers can do more to tighten the way that they report their financial results. In fact, the SEC is taking a lead role as they are considering changes in the way that issuers release financial information. Currently, borrowers must disclose material events, bond calls, adverse tax opinions, and financial results with four Nationally Recognized Municipal Securities Information Repositories (NRMSIRs). To streamline the process the SEC is proposing to have one central depository for the information, called EMMA (Electronic Municipal Market Access). As an aside, if this new mandate is approved the need for the four NRMSIRS is obviated, and yes that includes DPC, mentioned above. The topic is a good one. This market needs and deserves better disclosure. What we recoil from however, is the tendency to link less than ideal disclosure with a default that happened ten years ago. Analogies to subprime disclosure, references to ticking time bombs, and by combining high quality state general obligation bonds and revenue debt with lesser-rated housing and hospital securities also appear to be a over the top. For over a year RSW has taken the position that our financial system will remain under considerable stress. By seeking to acquire the "best credits" available in each state we are in essence building in a cushion to deteriorating financials, higher than average downgrades, and yes even reporting that is more lax than we would like.

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