Financial Disclosure and Bond Insurance*

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Abstract

Regulators typically assume that public financial disclosure is necessary for the efficient functioning of capital markets. Economists recognize that other mechanisms, such as insurance, can mitigate problems that occur when buyers have less information than sellers. We examine whether public financial disclosures and bond insurance are substitutes. Our data are from municipal issuers in Michigan, where financial disclosure is required by the state, and Pennsylvania, where disclosure is unregulated. We study municipal issuers because they are not covered by federal securities laws and state laws often allow issuers to choose the level of financial disclosure. Overall, we find that when disclosure is unregulated, issuers substitute between disclosure and insurance. When disclosure is required by state law, issuers use less insurance. Our results imply that required accounting disclosure is not necessarily optimal since rational issuers will trade off public disclosure and insurance when free to do so.

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