Testimony from Marc Joffe, Chair, XBRL US State & Local Government Working Group, Reason Foundation to the California State Committee on Governance and Finance

April 10, 2019

Thank you for the opportunity to share my thoughts about SB 598 today.

My name is Marc Joffe, and I am a Senior Policy Analyst at Reason Foundation. Before becoming a public policy analyst, I held a variety of management roles in the field of credit risk information technology at two investment banks and at Moody's Analytics.

Six years ago, the State Treasurer's Office commissioned myself and a co-author to study the feasibility of creating a quantitative model for assessing California city credit risk. We were hired in the aftermath of a string of Chapter 9 bankruptcies and bond defaults by cities such as Stockton and San Bernardino. One goal of this investigation was to determine whether the state could create an early warning system for local government fiscal distress.

Our clients at CDIAC asked us to consider using the State Controller's Cities Annual Report data for this purpose. But when I reviewed the data, I found large discrepancies with audited financial statements prepared by the cities. These financial reports, known as CAFRs, are prepared to satisfy municipal bond market continuing disclosure requirements and federal single audit requirements, and are published exclusively in PDF format. So rather than use the Cities Annual Report data, we undertook the daunting task of locating CAFRs and hand entering their data into a spreadsheet.

It was then that I realized the importance of the reform proposed in SB 598. If it was possible to automatically load data from CAFRs into financial models, it would be much easier to effectively monitor local government fiscal health.

This sort of monitoring is useful for municipal bond analysis as well as state oversight. In the absence of timely, high quality financial data municipal bond investors are compelled to rely on credit rating agencies and their own biases when assessing credit risk. Academic research finds that rating agencies are harsher in their analysis of municipal credit, than of corporate or asset-backed credit. Meanwhile a trickle of high-profile municipal bankruptcies, such as those in Detroit and Puerto Rico, reinforce unfounded fears that most municipalities are not creditworthy, potentially raising the cost of capital for crucial infrastructure projects.

So there is no substitute for hard, accurate numbers. Investors in corporate securities have virtually real time access to issuer financial statement data because the SEC has mandated that annual and quarterly reports be delivered in machine readable form. No one in the corporate securities market is hand entering balance sheet and income statement data from PDFs. Nor should anyone in the municipal bond market.

Returning to the issue of state oversight, much has changed since our 2013 project, but the core problem remains. At the State Controller's Office, the Cities Annual Report has been replaced by the very modern By the Numbers web site. State law was also modified to give cities more time to enter their financial data so that completed CAFRs could be consulted during the SCO submission process.

Unfortunately, discrepancies between ByTheNumbers and CAFR data remain. Further, ByTheNumbers is only available on a delayed basis. State law requires SCO to publish the data 16 months after the end of the fiscal year, but many government financial statements are available within just 6 months of the fiscal year end.

SB 589 offers a modern solution to the challenge of monitoring local government health – not only cities and counties, but various categories of special purpose governments as well. It will allow the state auditor, other state agencies, policy researchers and concerned citizens to more quickly identify at-risk governments, permitting interventions that might prevent the loss of vital community services.