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[A Cautionary Tale for the New Muni Bond Era.](#)

A decade after the Libor scandal, a new approach to interest rates could help U.S. states and cities – if they change their thinking.

There's a moment in Act II of Hamlet where his old college buddies are trying to convince him to look on the bright side. Sure, his dad died and his mom hooked up with his uncle, they argue, but Denmark could be worse off. Hamlet's response is one of William Shakespeare's great lines: "There is nothing either good or bad, but thinking makes it so."

Hamlet meant that our beliefs about our circumstances matter more than anything. In fact, they matter a lot more than what others tell us, even if everyone else might be right. Oddly enough, Hamlet's view offers a cautionary tale about the future of the municipal bond market.

A decade ago, two big developments rocked public finance: the Great Recession and the news that bankers in the Bard's beloved England had conspired to manipulate the ubiquitous London Interbank Offered Rate. Libor is the most common benchmark interest rate index used to make adjustments to variable rate loans. Unsurprisingly, public finance experts focused much more on the recession, but the Libor scandal may ultimately prove more important in the long run.

By early 2008, states and localities had borrowed billions of dollars at variable short-term interest rates. This made sense because short-term rates were far below the long-term rates governments were used to getting. By stringing along a series of short-term bonds, governments could borrow for the long run but pay less to service that long-term debt. Even better, with an insurance contract known as a floating-to-fixed swap, they could borrow at variable rates and pay lower long-term fixed rates. Prudent public debt managers around the country employed this strategy, especially when it saved money early in the Great Recession.

But they shortly found themselves dragged into scandal because much of that variable rate was pegged to Libor. When bankers held Libor artificially high, governments believed they paid higher short-term rates than they would have otherwise. When rates were held artificially low, floating-t--fixed swaps paid less and governments had to make extra debt service payments out of pocket. Before the dust settled, several big banks paid millions to settle state and local governments' claims of wrongdoing. State and local leaders across the country vowed to never again venture into the variable rate market, even for bonds tied to other short-term benchmarks.

In the decade since the Libor scandal, the finance industry has worked to develop a better, more transparent benchmark. Last year, it agreed to phase Libor out and instead go with the Secured Overnight Financing Rate (SOFR). Unlike Libor, which was run by the banks and was based on bankers' expected short-term interest rates, SOFR is administered by the New York Federal Reserve and is based on the market prices of very short-term investments. In concept, that makes variable rates less susceptible to manipulation. This is a major move, considering the estimated $200 trillion in mortgages, credit cards and other assets that are tied to variable interest rates.

It's still early for SOFR. Regulators, investors and academics have generally called it a move in the right direction. But so far just a few large governments and corporations have issued SOFR-referenced debt. That will change. As investors become more comfortable with it, they will look for more SOFR-related investment opportunities. That could mean a chance to revive the moribund market for variable rate municipal debt.

When that happens, states and localities will face a difficult choice. They could stick with beliefs based in Libor-era thinking and conclude that variable rate debt is too good to be true. Or they could bring their thinking into the SOFR era and reconsider the many potential benefits of a prudent variable rate debt management strategy. By then, things will have changed in Denmark.

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