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Muni Borrowing Costs Jump as Money Market Reforms Loom.

US local governments are facing a jump in short-term borrowing costs in the latest example of how the reform of Wall Street's $2.7tn money market industry is rippling through the financial system.

A key interest rate used to set the coupon payments on some short-dated municipal debt has moved up from what was in effect zero in March to 70 basis points this week.

"It's huge," said Jon Mondillo, portfolio manager at Alpine Funds, which invests in municipal bonds. "It's been a double barrelled shot in the face for issuers."

State governments and other public institutions that tap the municipal bond market in the US — which is tax exempt for domestic investors — have been beneficiaries of the long period of low interest rates.

The increase in the Securities Industry and Financial Markets Association (Sifma) rate catapults it above one week Libor, a global benchmark indicative of the cost of unsecured bank borrowing.

"It is a bit startling given where we have been the last seven or eights years," said Tim Schaefer, deputy treasurer for the state of California. "Not unexpected I might add . . . It creates concern. But by no means should it cause us to give up on the market."

The jump in Sifma's rate will hit the $175bn market for variable rate demand notes (VRDNs), or shorter-dated debt carrying a floating interest rate that resets weekly. New York, California and Texas are some of the largest state issuers, according to Sifma data.

The upward move in borrowing costs stems from US regulators' reform of money market funds, which invest in short-term debt sold by companies, banks as well as public borrowers such as states. The reforms allow fees to be imposed on investors pulling money out of funds during periods of financial stress and, in some instances, stop investors withdrawing money altogether.

Although the reforms do not take effect until next month, they have already prompted investors to move money out of so-called prime and tax-exempt funds, which buy debt sold by US municipalities.

Assets in tax exempt funds assets have fallen from $266bn at the start of 2016 to $143bn, according to data from the Investment Company Institute. That is the lowest level since the ICI began compiling records in 2002.

A drop in appetite to invest in such funds pushes up the cost of borrowing for municipal borrowers. Karen Mills, treasurer for the Town of Cary in North Carolina, said the sharp move was a concern but that 70bp was still a cheap rate to issue debt at. "We are looking into it, trying to understand if the market will settle back to normal or if we should move the issuance [of VRDNs] into fixed-rate money," she said.

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Joe Rennison in New York