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US Rates Strategy

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Tiering up: Reserve dieting

To shrink its balance sheet, the Fed must reduce bank demand for reserves. Tiering reserve remuneration, if carefully calibrated, might allow the Fed to slim down.

- **Banks' least comfortable level of reserves (LCLoR) includes precautionary liquidity buffers above their regulatory minimum**. But they also maintain an additional buffer or "surplus excess" over the LCLoR.

- **The size of these buffers reflects their concerns about the ability to monetize other forms of regulatory liquidity through the Fed's SRP and discount window**.

- To reduce bank demand for reserves without pressuring funding markets, the Fed must satisfy two conditions. **The reduction should come from banks' surplus excess reserves and it must be voluntary – that is, banks should not seek to replace their lower balances by borrowing in overnight markets**.

- **In a tiering regime, the Fed would pay a lower IORB rate on bank reserves above a threshold**. The threshold would be set below the current level of bank reserves, allowing the Fed to shrink through QT.

- **In theory, the lower IORB rate and remuneration cap would encourage banks to substitute Treasuries (bills) for their surplus excess reserves without reducing their overall demand for precautionary liquidity buffers**.

- We think banks would substitute bills for their reserves above the threshold as they are closest to providing the immediate liquidity that balances at the Fed provide. **This might initially pull bill yields lower until the reduction in the Fed's balance sheet or an increase in bill issuance renormalizes market rates**.

- **IORB tiering may be another channel for increased coordination as the Treasury could accommodate banks' bill demand through expanded issuance**

- Calibrating the exempt level and the surplus remuneration rate may require some experimentation as banks' demand for reserves changes with market conditions.

Bank liquidity demand

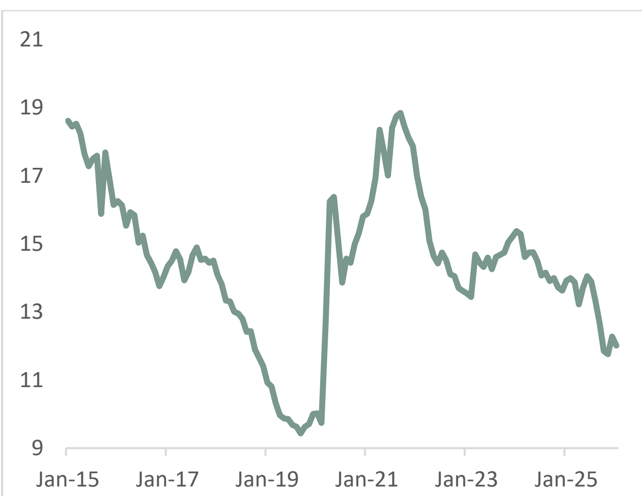
Large banks are required to hold a certain portion of high quality liquid assets (HQLA) that can be used to meet deposit withdrawals or financing demands. These are determined by post-financial crisis rules such as the LCR, NSFR, and Reg YY. Without digging too deeply into the structure of these regulations, their main purpose is to build up a pool of liquid resources that a bank can tap in periods of financial stress as well as limiting the scope of their potential asset/funding mismatches. The regulations are part of international agreements under Basel III. HQLA includes Treasuries and bank reserves. Other assets qualify as HQLA although they are included in the calculations at a discount.

Regulations only establish the bare minimum of bank reserve demand. Instead, banks seek to maintain a buffer above this amount. The cushion is designed to keep the bank from inadvertently coming close to the minimum threshold. Our sense is that this amount is roughly equal to their least comfortable level of reserves (LCLoR).

Banks also hold additional balances above this buffer. This “surplus excess” gives banks some flexibility in their liquidity management. Surplus excess balances are quite large – *total* bank reserves are \$2.9trn and 12% of aggregate bank assets (Figure 1). At the individual bank level, nearly 2/3 of banks surveyed last September, maintained buffers above their LCLoR of at least 11%.[1] But for 20% of banks, their buffers are substantially larger – more than 75% of their LCLoR (Figure 2).

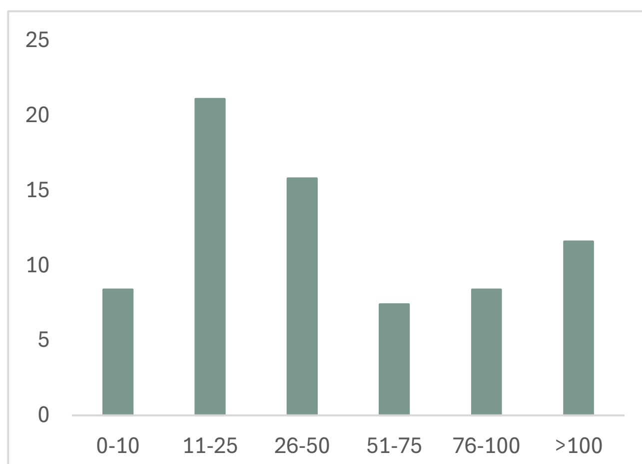
We think the high levels of surplus excess reflect two issues. First, banks determine the size of their buffers based on internal judgements about their daily (and intraday) liquidity needs as well as their expectations about liquidity outflows during periods of stress. These internal judgements are more conservative than the regulatory minimums**. As a result, even if the Fed and other bank regulators agreed to reduce liquidity requirements, it is unlikely that this would significantly reduce bank reserve demand**. Indeed, banks surveyed by the Bank Policy Institute were asked to scale the drivers of their demand from 1 (not important) to 5 (very important). They scored “institutional assessments” of liquidity risk and internal liquidity stress testing at high 4.6 and 3.8 readings, respectively.[2]

Figure 1: Bank reserves (% assets)



Source: Federal Reserve, SMBC Nikko

Figure 2: Surplus balances (% of banks)



Note: % of banks maintaining balances above their LCLoR as indicated by the x-axis. About 27% of banks surveyed maintain *no* surplus. Source: Federal Reserve, SMBC Nikko

Second, **banks are reluctant to use the Fed’s liquidity facilities such as the SRP and discount window**. They scored “aversion to discount window borrowing” in the same survey at a relatively high 3.8.

[1] See, Senior Financial Officer’s Survey”, September 2025, Federal Reserve Board

[2] See, “What Determines Banks’ Demand for Reserve Balances?”, B. Nelson, L. Bristow, B. Waxman, Bank Policy Institute, January 14, 2025.

This means that they are less likely to use either the discount window or SRPs to monetize their Treasuries. Our sense is that there is an "explanation effect" with respect to discount window/SRP borrowing. Because use in normal markets is rare, using either facility attracts attention along with requests for explanation from management and supervisors. The explanation effect extends to the Fed's mandatory public disclosure rules. In March 2025, the Fed surveyed senior bank financial officers who asked to rank explanations for their SRP aversion. Disclosure requirements had the lowest score (most significant negative factor). Moreover, bank reserves are always available at par unlike Treasuries which need to be monetized first. **Since bank reserves do not need to be monetized through the Fed's liquidity programs, banks prefer them to Treasuries in their liquidity pool**.

Tiering

Shrinking the Fed's balance sheet efficiently requires reducing banks' demand for reserves. To prevent funding rates from moving higher, we think the reduction in demand must satisfy two conditions. First, it needs to come from banks' surplus excess balances rather than their LCLoR. And second, it needs to be "voluntary" – that is, banks must be willing to part with them and not seek to replace them with balances raised in interbank markets. We think it is possible to satisfy both conditions by tiering the IORB rate. **The Fed would remunerate bank reserves at IORB up to a certain threshold; above that level, the remuneration rate would be less than IORB, *and potentially zero***. By lowering the return to reserves, the Fed could encourage banks to substitute Treasuries for their preferred – and unchanged - HQLA level. In turn, the Fed would be able to shrink its balance sheet through QT.

There is evidence that tiering changes banks' willingness to hold reserves – although, most recent use cases have involved countries with negative interest rates. Between 2014-22, the ECB kept its policy rate below zero. However, banks were unable to pass negative rates on to their retail depositors. As a result, their negative-yielding reserve balances were costly to hold and banks minimized these holdings. Lower profitability reduced their capacity to lend. When the ECB introduced tiering in October 2019, it set two rates for reserves: 0% and -0.50%.[3] Banks were paid the higher rate for balances below a threshold set equal to 6x the institution's required reserves. Balances above that amount earned the lower rate.

When adopted, European banks had an estimated 227bn EUR in unused reserve capacity under the 0% threshold. By the next reserve maintenance period, the unused allowance shrank to 37bn EUR. The extra balances that shifted into reserves came from other HQLA as well as interbank borrowing. The increase in reserves did not push market rates higher. Baldo et al attributes this to a "trade-off" effect. Banks increased their reserves by proportionally adjusting their other HQLA holdings and interbank borrowing rather than singling out a particular type of HQLA to make up the difference.

This raises two important points. First, although much reserve demand is determined by internal risk assessments, there is a portion of interest rate sensitive balances above banks' LCLoR. And second, banks prefer some diversification in their HQLA holdings – they, reacted proportionally to the change in the relative cost of reserves.

Given the interest rate sensitivity of surplus excess reserves, we think it is theoretically possible to reduce the demand for reserves by making them less attractive to hold. In practice, however, this is challenging because the Fed only has a rough snapshot of the demand for reserves and this changes with market conditions. As a result, there is some risk that the Fed sets the remuneration threshold too low and banks willingly accept the lower return on their surplus excess to avoid the Fed's liquidity

[3] See "How do Banks Manage Liquidity? Evidence from the ECB's Tiering Experiment", L Baldo, F. Heider, P. Hoffmann, J-D. Sigaux, and O. Vergote, European Central Bank, working paper, September 2022

programs. Put differently, the Fed needs to set the threshold high enough to accommodate some amount of flexibility in surplus excess demand. And it must set the surplus rate low enough to overcome banks' unwillingness to use its liquidity programs.[4] As a result, it might need to experiment with the threshold and remuneration rates to find the right combination that could reduce reserve demand.

Importantly, banks' demand for surplus excess liquidity would not decline – only its composition will change. The Fed is merely incentivizing banks to replace their reserves for Treasuries. Our sense is that banks might buy bills as these are closest to reserves with respect to immediate liquidity in stress periods. The demand for bills increased during the "dash for cash" in March 2020 and after the March 2023 bank failures.

Initially, the increase in demand might pull bill and repo rates lower. However, rates will normalize as the Fed's balance sheet shrinks or **if the Treasury increases bill issuance to accommodate the demand**. Previously, we noted that there was some scope for Treasury and Federal Reserve coordination in the bill market. The Treasury is looking to increase bill issuance as a substitute for higher cost term debt while the Fed is seeking to increase its bill holdings to the market neutral level. The Treasury agreed to issue supplemental financing bills to help the Fed drain excess liquidity before the introduction of the RRP program. **IORB tiering may be another channel for increased coordination as the Treasury could accommodate banks' bill demand through expanded issuance**. Indeed, ahead of the October 2016 money fund reform implementation date, the Treasury briefly increased bill issuance to ease the transition of balances from prime to gov-only money funds.

[4] Assuming no changes to the structure of the SRP or discount window.

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