US Rates Strategy

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Replacing the fed funds target

Is it time to replace the fed funds rate as the Fed's policy lever? This depends on how the Fed sees the role of the rate – as a signaling device or as a liquidity monitoring tool.

- **The fed funds rate trades in a narrow, idiosyncratic market that has become less important in an abundant reserves regime.** The market is vulnerable to changes in FHLB and non-US bank behavior.

- **In theory, the Fed might not need to use an interbank lending market like fed funds to distribute liquidity across banks.** Liquidity redistribution might instead occur through the discount window and standing repo facility (SRF) with the IORB rate used to communicate monetary policy. But this requires banks to be willing to borrow from these programs.

- **A recent G30 Group report suggests the Fed could change its policy target to IORB.[1] But as an untraded administered rate, IORB would provide no clues about the relative sufficiency of liquidity.**

- Alternatively, the Fed could consider the overnight bank funding rate (OBFR) as higher volume, traded, policy instrument. Like fed funds it is an unsecured rate more closely tied to funding liquidity than repo.

The Fed is probably not ready to abandon the fed funds rate and changing the policy rate is not part of this year's Policy Framework Review. That said, we wonder if the Fed's "otherwise basically forgotten rate" might warrant a closer look as a policy instrument.

A vestigial rate

The Fed uses the fed funds rate to both set policy and monitor liquidity conditions. But the rate is a leftover from the Fed's pre-2008 operating regime of scarce reserves. Several rounds of QE and the Fed's shift to an ample reserve operating regime have reduced the importance of fed funds trading. As banks are amply supplied with reserves they have little need to top up their liquidity balances by borrowing in this market. As a result, in the Fed's current operating regime, the rate should hardly ever move (Figure 1). Trading volume (currently ~ $100bn/day) is less than half its pre-crisis level and, provided reserves remain ample to abundant, such activity is arb-driven. The FHLBs account for nearly all the fed funds sold and borrowers are mostly non-US institutions seeking to earn the spread between IORB and fed funds (Figure 2).

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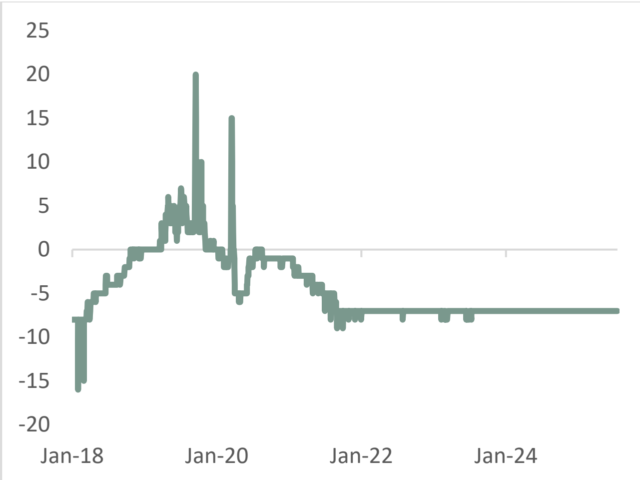
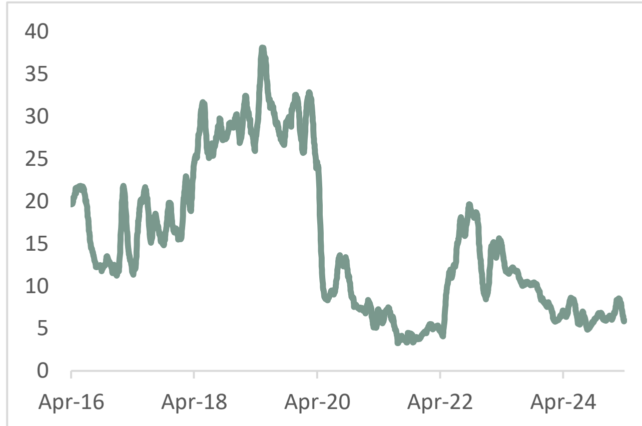
[1] See, "The Federal Reserve Monetary Policy Framework Review: A Comprehensive Approach to Improve Robustness", Group of Thirty Group, April 2025.

Figure 1: Fed funds less IORB (bp)



Source: Federal Reserve, SMBC Nikko

Figure 2: Domestic bank borrowing (% Fed funds volume)



Note: 20d average. Source: FHLB, SMBC Nikko

However, the narrowness of fed funds trading leaves the market vulnerable to changes in the behavior of either the FHLBs or non-US banks. FHLBs invest their liquidity buffers in fed funds, Treasury repo, and interbank deposit accounts (IBDAs). Fed funds trades unwind early the following morning and IBDAs are available to take in cash until late in the afternoon – past the RRP auction and the tri-party settlement windows. As a result, the FHLBs prefer fed funds and IBDAs to tri-party repo because these enable them to hold onto more of their cash throughout the day. This is important because the demand for advances is unpredictable both during the day and from one day to the next. More access to intraday cash helps the FHLBs from having to tap debt markets at awkward times or when liquidity is thin.

Two recent changes, however, might alter their supply of fed funds. First, we think it is possible that new developments in early-return tri-party could pull some of their cash from the fed funds market into repo if the FHLBs are able to secure their unwinding repo cash early enough in the morning. Interest in early return tri-party has so far been tepid and fed funds volumes are little changed. Second, recent regulatory changes to counterparty credit accounting could increase the attractiveness of IBDAs for the FHLBs. IBDAs typically have paid a couple of basis points more than fed funds, but until this year the FHLB's counterparty credit limits on IBDAs were more restrictive than those on fed funds.

Separately, it seems that non-US bank interest in using fed funds to arb IORB is somewhat *pro forma*. Early this year, the Fed lowered the RRP rate by 5bp so that it returned to the bottom of the fed funds target band. We had thought that this would lower where the fed funds rate traded relative to IORB. After all, with a 5bp increase in the RRP-IORB spread, wouldn't non-US banks push for a lower fed funds rate from the FHLBs? Instead, the funds rate has remained locked at IORB-7bp. Apparently, non-US banks do not feel strongly enough about the value of the arb to insist on better terms from the FHLBs. They are content to roll their overnight rates at the same spread from day-to-day. Even the interquartile spread (the difference between the 75th and 25th rate-volume quartiles remained as tight as before. **We think this raises some question about the usefulness of the rate as a market barometer – at least when reserves are ample**.

Two considerations

The Fed's choice of policy lever reflects two considerations. First, and most importantly, it is used as a monetary policy signal to define and guide market expectations in term markets. In this role, where the policy rate trades relative to the stated target from day-to-day matters less than its use as a communications instrument. Policy transmission is unaffected if the fed funds rate trades 7bp or 15bp below IORB; markets still "get the message" from the Fed's Survey of Economic Projections (SEP), policy statements and officials' speeches. Of course, this can also be accomplished by using an administered interest rate such as IORB or RRP; **the message matters more than the choice of communication instrument**.

The policy lever choice might matter more if trading around the target rate is a used to monitor the relative supply of bank reserves. In a scarce operating regime keeping banks sufficiently supplied with reserves required continuously adding small amounts of reserves to counter exogenous swings in bank balances such as those created by unpredictable tax flows. Determining how many reserves to add required a monitoring variable; one that reacted to both the supply and demand for balances. Since the "price" of bank reserves is the fed funds rate, that rate worked well to communicate policy *and* monitor liquidity.

But in an ample, or abundant reserve regime, the monitoring function is no longer as necessary. By design reserve balances are sufficiently large to smooth out any bumps created in their supply from exogenous shocks like swings in the Treasury's cash balance. Consequently, the fed funds rate hardly ever changes from day-to-day.

Is an active interbank market like fed funds necessary for implementing monetary policy? The fed funds (and repo) markets redistribute reserves from institutions long cash to those in need of intraday liquidity. **But the redistribution function can also be accomplished through the discount window or SRF**. Temporary shortfalls would still push these rates higher, but instead of borrowing from each other, banks would go directly to the Fed through either lending program. Fed funds, and indeed, *any* overnight funding rates would still be a monitoring device but only for determining when to borrow from the Fed. Assuming bank reserves remain ample, any use of the discount window or SRF would be infrequent reflecting an unexpected (and temporary) payment shock.

This assumes that the banks are willing to borrow directly from the Fed despite well-documented discount window reluctance. Recent quarter-end use of the SRF suggests that banks and dealers are somewhat more willing to use that program when balance sheet reporting constraints push repo rates above the top of the fed funds target band. But the willingness to use the program outside of reporting dates remains untested. And cash raised from the SRF still needs to be redistributed from banks and primary dealers to the broader market.

Time for change?

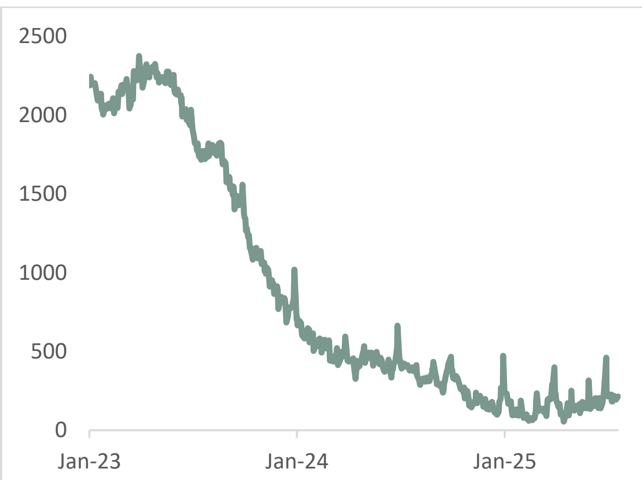
Despite the narrow, idiosyncratic nature of fed funds trading, there are no signs that this is affecting policy transmission. And while the Fed is currently reconsidering some of its communications tools, replacing fed funds is not on this year's framework review agenda. Nor has there been any indication that the Fed has questioned the volume or nature of fed funds activity.

Nevertheless, a recent report from the **G30 Group recommends that the Fed consider shifting to an IORB policy target** as "the excess reserves regime has made fed funds superfluous".[2] Using IORB as the policy instrument would meet the first consideration. An administered rate target would eliminate any message slippage caused by a market trading away from the level of the policy lever.

It would also mean there is no longer a need to floor trading in the policy rate with programs such as the RRP. Overnight rates would still find their own equilibria but where they traded would not alter the broader policy message.[3] As the G30 report argues, this would eliminate the need for the RRP (Figure 3). It would also remove the need to target an interest rate range which the Fed adopted in 2008 because it was unsure how or where the fed funds rate would trade in a post-QE world.

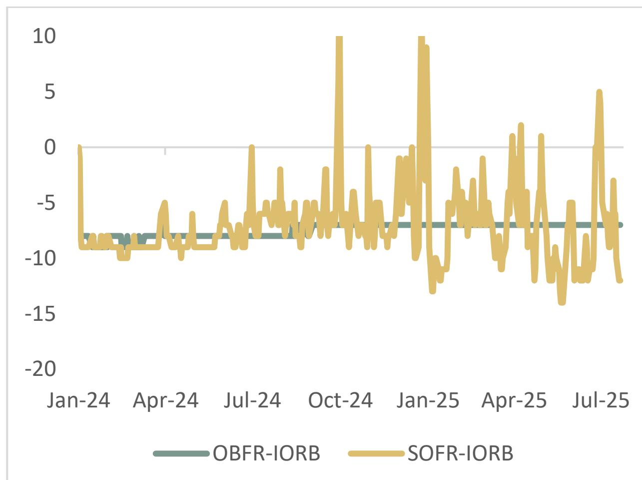
But a non-market target would also remove the ability to monitor reserve sufficiency *directly* via a market signal. This is not difficult to overcome. After all, the Fed has been monitoring a host of interest rates, market activity measures and surveys since 2022 for signs of reserve pressure. However these other measures often only indirectly reflect reserve adequacy. Repo and fed funds move together but the former is also affected by factors beyond the adequacy of bank reserves such as balance sheet capacity, bank regulation, and market positioning.

Figure 3: RRP balances ($bn)



Source: Federal Reserve, SMBC Nikko

Figure 4: SOFR and OBFR less IORB (bp)



Source: Federal Reserve, SMBC Nikko

As a result, the Fed might consider a compromise rate – one that can be used to signal policy *and* that trades in a robust market. The Fed's overnight bank funding rate (OBFR), like fed funds is an unsecured, overnight bank borrowing rate. OBFR adds overnight Eurodollar and time deposit transactions to fed funds transactions and calculates a volume-based median rate. This pushes daily trading volume to around $300bn/day. OBFR and fed funds are nearly identical – in the last year the two rates have been *identical* nearly 90% of the time. OBFR is less volatile than a repo rate target because it is less influenced by balance sheet reporting and market positioning (Figure 4). But since SOFR was chosen over OBFR as the Libor replacement, the rate has largely been forgotten.

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[2] See, G30 Group, April 2025.
[3] This is asymmetric. Rates trading above IORB indicate reserve scarcity. While this would not alter the *rate message* it would require some *balance sheet* response so that banks could satisfy their intraday and regulatory liquidity requirements.

While the Fed is unlikely to replace its fed funds target near-term, we wonder if OBFR could warrant a closer look. The replacement value of OBFR depends on how willing the Fed is to overlook the idiosyncrasies of the fed funds market to maintain its policy target.

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