

## US Rates Watch

## ON RRP tweaks won't stop bank stress

Clients continue to ask: is it possible the Fed might lower the ON RRP rate to support banks & their deposits? Our answer remains the same: possible = yes, likely = no. Detail below.

**ON RRP drop justification:** lowering the ON RRP rate or reducing its per counterparty cap (currently \$160b / counterparty) would place downward pressure on money market rates. This would make money market rates less attractive vs bank deposits & could help stem bank deposit outflows.

**Our pushback:** lowering ON RRP is unlikely because there is a much more effective policy tool = reducing the fed funds target range. If the Fed isn't willing to lower the target range, they won't be willing to lower ON RRP.

**Background:** ON RRP is a tool to keep money market rates within the Fed's target range. It provides an effective floor on money market rates because if you can invest risk free with the Fed, you're unlikely to invest at a rate lower than ON RRP. If the Fed wanted to lower money market rates & make bank deposits more attractive, the more direct approach would be to cut rates, lowering the fed funds target range & RRP along with it.

The only circumstance where the Fed is likely to adjust the ON RRP and IORB spread is if fed funds (FF) is too low or too high in the target range. The Fed has widened the spread between IORB & ON RRP in the past only when FF was 5bps from top or bottom end of the target range (Exhibit 1).

If the Fed were to only lower ON RRP then they would likely see fed funds & SOFR decline with it. If the Fed were to set ON RRP below the target range, then fed funds & SOFR would likely also set below it. To set ON RRP below the target range, the Fed would essentially have lost control of their key monetary policy targets.

**Wild hypothetical:** the Fed could theoretically subsidize banks by setting IORB very high & ON RRP very low. It would effectively abandon its target range framework & only target FF. We think this is extremely unlikely, but please indulge the thought experiment. Extremes often help prove points.

Recall, FF is a highly idiosyncratic policy target primarily determined by the balance of bargaining power between FHLBs (dominant lender) & foreign banks (dominant borrower); for more detail see: [Primer: Fed policy plumbing 16 June 2022](#).

The Fed could still have FF set in the current target range if it set ON RRP to zero & IORB to 16%. Our logic: FF currently trades in the 70th percentile of the 10bp IORB-ON RRP spread (FF = 4.83%, IORB = 4.9%, ON RRP = 4.8%). If the Fed set ON RRP to zero & IORB to 16%, the 70th percentile of this target range would be 4.8%. This is an unlikely extreme, but we are making a point.

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ON RRP: overnight reverse repo facility

IORB: interest on reserve balances

MMF: money market funds

FHLB: Federal Home Loan Bank

We believe FF is essentially determined by the balance of bargaining power between FHLB (lender) & foreign banks (borrower). We believe the 70th percentile of the FF target range is a function of the overall cash lending / borrowing demand dynamics that would still apply with extreme setting.

The Fed could likely still achieve a FF target of 4.8% if it set IORB & ON RRP at wild extremes. It would subsidize banks vs MMF or other money market alternatives. It would also likely result in a setting of UST repo & other UST rates well below FF.

**Back to real world:** the Fed is very unlikely to consider such an extreme setting of its monetary policy tools. It has historically not chosen to pick winners & losers in its monetary policy setting (in the extreme example above, winner = banks receiving IORB, loser = MMF & other money market alternatives).

The Fed has practically not chosen such extreme monetary policy setting because it wants to tighten lending standards. One of the primary ways monetary policy impacts the real economy is via lending standards. Tighter lending = slower economy, easier lending = faster economy.

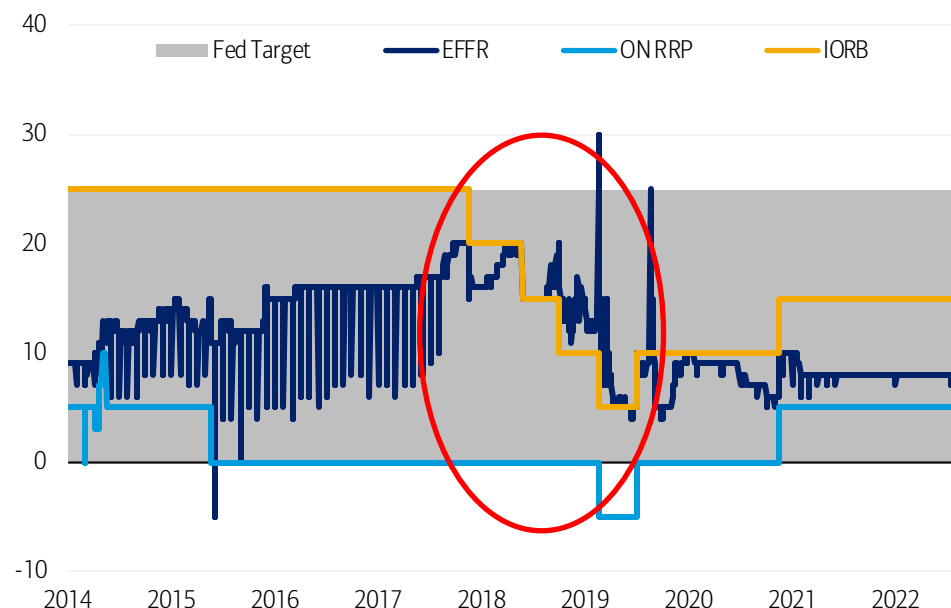
The Fed does not want to support banks over MMF or other money market alternatives because it wants banks to tighten lending standards. The Fed wants banks to compete more aggressively for funding (a point we have made many times over the past year).

Banks who compete more aggressively for deposits or other forms of funding will see NIM compress & be forced to pass along higher costs to borrowers. In essence, the economy will slow because banks are competing more aggressively for funding.

**Bottom line:** The Fed is very unlikely to lower ON RRP to support the banks. We think a more effective approach to tweaking ON RRP is to cut rates, lowering the target range. If the Fed isn't willing to lower the target range, then they likely will not be willing to lower ON RRP either.

#### Exhibit 1: Fed funds and administered rates within the Fed's target range (bps)

The Fed adjusted the IORB-ON RRP spread when the FF rate was within 5 bps of top or bottom of range



Source: BofA Global Research, Federal Reserve

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