FEDPOINT

Federal Funds

- **Federal funds, or fed funds, are unsecured loans of reserve balances at Federal Reserve Banks that depository institutions make to one another. The rate at which these transactions occur is called the fed funds rate.**
- **The most common duration or term for fed funds transaction is overnight, though longer-term deals are arranged.**
- **The Federal Open Market Committee (FOMC) sets a target level for the fed funds rate, which is its primary tool for implementing monetary policy.**

QUICK LINKS

Open Market Operations

EXTERNAL LINKS

Regulation D

FED EDUCATION

Open Market Operations

Fed Funds Transactions Redistribute Bank Reserves
Fed funds are unsecured loans of reserve balances at Federal Reserve Banks between depository institutions. Banks keep reserve balances at the Federal Reserve Banks to meet their reserve requirements and to clear financial transactions. Transactions in the fed funds market enable depository institutions with reserve balances in excess of reserve requirements to lend them, or "sell" as it is called by market participants, to institutions with reserve deficiencies. Fed funds transactions neither increase nor decrease total bank reserves. Instead, they redistribute bank reserves and enable otherwise idle funds to yield a return. Technical details on fed funds are described in Regulation D.

Participants in the fed funds market include commercial banks, thrift institutions, agencies and branches of foreign banks in the United States, federal agencies, and government securities dealers. Many relatively small institutions that accumulate reserves in excess of their requirements lend reserves overnight to money center and large regional banks, and to foreign banks operating in the United States. Federal agencies also lend idle funds in the fed funds market.

Other financial institutions serve as intermediaries in the market by borrowing and lending funds on the same day, usually channeling funds from relatively small to large depository institutions. Several broker firms that neither borrow nor lend funds arrange transactions between lenders and borrowers in order to earn commissions.
Fed Funds Transactions
Fed funds transactions can be initiated by either a funds lender or a funds borrower. An institution seeking to lend fed funds identifies a borrower directly, through an existing banking relationship, or indirectly, through a fed funds broker. The most commonly used method to transfer funds between depository institutions is for the lending institution to authorize its district Federal Reserve Bank to debit its reserve account and to credit the reserve account of the borrowing institution.

The most common type of fed funds transaction is a very short-run loan between two financial institutions; some transactions, however, have longer-term maturities. Most overnight loans are booked without a contract. The borrowing and lending institutions exchange verbal agreements based on various considerations, particularly their experience in doing business together, and limit the size of transactions to established credit lines in order to minimize the lender's exposure to default risk. Such arrangements facilitate speedy processing at the lowest possible transaction cost.

Overnight fed funds transactions under a continuing contract are renewed automatically until termination by either the lender or the borrower. This type of agreement is used most frequently by correspondent banks that borrow overnight fed funds from a respondent bank. Correspondent banks are typically larger institutions that provide services, such as managing funds, to smaller, respondent banks. Unless notified by the respondent to the contrary, the correspondent will continually roll the inter-bank deposit into fed funds, creating a longer-term instrument of open maturity.

Fed Funds in Monetary Policy

By facilitating the transfer of the most liquid funds among depository institutions, the fed funds market plays a major role in the execution of monetary policy. The interest rate on fed funds, the fed funds rate, is sensitive to Federal Reserve open market operations that influence the supply of reserves in the banking system. In fact, the directive for implementation of U.S. monetary policy from the FOMC to the Federal Reserve Bank of New York states that the trading desk should “create conditions in reserve markets” that will encourage fed funds to trade at a particular level. Fed open market operations change the supply of reserve balances in the system, and by affecting the supply of balances, the Fed can create upward or downward pressure on the fed funds rate.

In formulating monetary policy, the Federal Reserve sets a target level for the fed funds rate, and the Fed's announcements of changes in monetary policy specify the changes in the Fed's target for that rate. It is important to note that the fed funds rate is determined by market participants, and is not actually "set" by the Fed.

Movements in the fed funds rate have important implications for the loan and investment policies of all financial institutions, especially for commercial bank decisions concerning loans to businesses, individuals and foreign institutions. Financial managers compare the fed funds rate with yields on other investments before choosing the combinations of maturities of financial assets in which they will invest or the term over which they will borrow. Interest rates paid on other short-term financial securities—commercial paper and Treasury bills, for example—often move up or down roughly in parallel with the funds rate. Yields on long-term assets—corporate bonds and Treasury notes, for example—are determined in part by expectations for the fed funds rate in the future.

August 2007