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RESPONSE TO HUGHES AND YOUNGER REPORT ON FED'S AMPLE RESERVES FRAMEWORK

William English and Donald Kohn

AUTHOR NOTES AND ACKNOWLEDGEMENTS

English is the Eugene F. Williams, Jr. Professor of the Practice at the Yale School of Management. Donald Kohn holds the Robert V. Roosa Chair in International Economics and is a senior fellow in the Economic Studies program at the Brookings Institution.

DISCLOSURES

In their paper “The Price of the Floor: Quantifying the Cost of Ample Reserves in U.S. Policy Implementation,” Chris Hughes and Josh Younger address important issues related to the Fed’s adoption of an “ample reserves” policy implementation framework and the payment of interest on reserves. Their paper provides a detailed and useful history of the payment (or non-payment) of interest on reserves. They then take up two key questions regarding the impact of the new operating system on bank profits and risk relative to the previous scarce-reserve framework. This is an interesting paper on an important topic, but ultimately we do not find their arguments convincing.

Hughes and Younger discuss two possible ways that an ample reserves system could provide significant benefits to banks or the broader financial sector. First, the authors present simple counterfactuals that suggest that the payment of interest on a large stock of reserves provides banks with very substantial extra profits because the rate paid on the reserves is higher than the rate banks likely pay on the corresponding deposits. By their estimate, the cumulative extra bank profits resulting from the high level of reserves in recent years totals close to $200 billion dollars (p. 28), amounting to roughly two-thirds of a year’s profit for the aggregate banking sector. Second, they argue that the Fed’s larger holdings of longer-term securities in an ample reserves system protect financial firms from interest rate risk by taking that risk onto the Fed’s balance sheet. The authors note that they are not trying to estimate the value of this effect for banks, but they suggest that it could be positive on average over time (p. 24, footnote 33).

To calculate the possible effects of ample reserves on profits, Hughes and Younger construct a counterfactual balance sheet of the banking system, in which the increase in reserves is balanced by an increase in bank deposits. Then, based on assumptions about the pricing of deposits and deposit runoff rates, they calculate the cumulative effect of the higher reserves and deposits on bank profits. We see several problems with this approach.

First, it is not clear that a larger Fed balance sheet means a significant shift in the supply of deposits that banks face, as the authors assume (p. 18). The purchase of securities by the Fed boosts deposits as sellers deposit the proceeds of the sale, but the ultimate balance sheet configuration depends on subsequent adjustments by both sellers and banks. It seems likely that the strong growth in deposits in the COVID period reflected, importantly, the unprecedented government transfers to households and businesses, which were held, at least for a time, in the form of bank deposits. In addition, the uncertainty caused by the pandemic likely led households and businesses to desire larger deposit balances to address possible risks—consistent with the so-called dash for cash in the spring of 2020. But these reasons for increased deposit supply are not related to the ample reserves policy implementation framework.

Second, even if the ample reserves framework does lead to significantly higher deposits in the banking system, competition among banks should push up the rate paid on deposits and so sharply constrain the effects on bank profits (English and Kohn, 2025). The roughly $200 billion of additional profits available to banks—the estimate provided by Hughes and Younger—is surely enough to generate a competitive scramble to capture a larger share of the gains. And while the banking system as a whole cannot increase reserve balances (they can only be shifted among banks), any individual bank can increase its reserve balance by raising the rate it pays for wholesale funding and parking the new funds in its reserve account at the Fed. Hughes and Younger note that bank competition is imperfect (p. 27), and it does seem likely that retail banking markets suffer from imperfect competition. However, in large, wholesale markets (for Treasury bills, reserves, wholesale deposits, or other sources of wholesale funding) imperfect competition is much less likely to play a significant role. Indeed, as the authors note in their discussion of how the Fed's administered rates can be used to implement monetary policy, market rates follow the interest rate paid on reserve balances because of "arbitrage relationships" (p. 4). It is not clear why arbitrage is lacking in this case.

Third, if the banking system nonetheless did obtain profits of roughly the size suggested by Hughes and Younger as a result of increases in reserves, then we should see the effect in reported bank profits. However, as noted in English and Kohn (2025), the banking industry's return on assets has changed little on net from before the COVID crisis to last year, despite a doubling in the level of reserves over that period. Noting the lack of effect on profits, the authors suggest that those effects could have been masked by other influences, and so they turn to net interest income, which should strip out those other effects (pp. 28-29). They note that net interest income for the banking system rose sharply in 2022 and suggest that the increase reflected in large part the effect of ample reserves on profits. However, bank net interest margins declined by a comparable amount as rates tumbled in 2020, leaving net interest margins roughly unchanged in recent years relative to their level prior to the pandemic, again despite the huge increase in reserve balances since that time. In short, there is little in either aggregate bank profit measures or net interest margins to suggest that a large increase in reserve balances has a significant effect on bank profitability.

In addition to a possible direct effect on profits, Hughes and Younger argue that the Fed, by taking more duration risk on to its balance sheet in an ample reserves system, provides an indirect benefit to banks and other financial firms by reducing their interest rate risk. We see several problems with this argument. Most important, the Fed purchases Treasury securities in the secondary market, which is generally very deep and liquid. So long as arbitrage by investors pushes longer-term yields to roughly equal the expected average level of short-term rates over the term of the instrument, there is little in the way of anticipated profit or loss on such purchases (English and Kohn,

2025). Of course, ex post, there can be profits or losses if the actual path of short-term rates deviates significantly from the path that was anticipated in markets at the time of the security purchases. But those gains and losses should cancel out over time. And so long as the Fed's transactions are at market prices, there is no benefit for the sellers—the investors are choosing their portfolios given market prices, and they are getting what they paid for.

More broadly, this argument seems to be about profit or loss from QE, not from operating in steady state with an ample reserves system. (For our views on the possible profits and losses from QE, see English and Kohn, 2022.) For example, the authors emphasize that rates were low when the Fed bought securities in QE (p. 23) and suggest that the Fed could have used supervisory tools to force banks to purchase longer-term Treasuries as an alternative to buying Treasuries itself and taking on the risk of loss (p. 25). But these issues are simply not relevant for an assessment of the costs and benefits of the ample reserve framework in normal times. Moreover, taking duration risk out of the market is the point of QE—that is how it has its effects on yields. Forcing banks to purchase more longer-term securities instead of conducting QE (as the paper suggests, p. 7) would either make the banking system much riskier (remember Silicon Valley Bank) or lead banks to hedge their interest rate risk. In the latter case, there would be little point in the exercise, since the hedging would put the duration risk back into private hands, offsetting the effects of the purchases on longer-term yields.

The authors end with some suggestions about how the Fed could avoid conferring these benefits. For example, the Fed could go back to a scarce reserves framework. Alternatively, it could introduce a tiered system with market interest rates paid on only a portion of reserve balances. However, such approaches would effectively impose a tax on the banking system by forcing banks to lend to the government at a below-market rate. This would lead to efforts by banks to avoid holding reserves, which would be wasteful, and also make intermediation more costly, which would be a drag on economic activity.

References

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1775 Massachusetts Ave NW
Washington, DC 20036
(202) 797-6000
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