

Testimony before the Senate Committee on Homeland Security and Governmental Affairs

On Interest on Bank Reserves held at the Federal Reserve

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Thank you Chairman Paul and ranking member Peters for holding this hearing and inviting me to testify on this important topic.

The last time I testified on this subject was in 2004 when I testified as a member of the Board of Governors in favor of allowing the Federal Reserve to pay interest on the deposits that banks held at the Federal Reserve—their reserves.² I argued then, as I will argue today, that not paying interest on these deposits was, in effect, a tax on banks, forcing them to make interest free loans to the government. Naturally, banks tried to avoid that tax by reducing the amount of reserves they held by reducing customer deposits subject to reserve requirements. And to the extent they were still subject to this tax, they passed as much as possible along to their depositors and borrowers.

Congress ultimately agreed that the tax induced unnecessarily wasteful and harmful actions and it authorized the payment of interest on reserves in the Regulatory Relief Act of 2006; this legislation also included additional flexibility for the Board of Governors to reduce reserve requirements, which the Board had also requested. The authorization to pay interest was scheduled to take effect in 2011, but Congress sped up its implementation to 2008 to facilitate the Federal Reserve's actions to stabilize financial markets and the economy during and after the Global Financial Crisis of 2008-09.

In my view, the payment of interest on reserve balances (IORB) serves critical public policy purposes: It enables the Federal Reserve to meet its Congressional monetary policy mandates for stable prices and maximum employment in some circumstances, and it enhances financial stability. If Congress wishes to raise additional taxes from banks, it should do so directly, not by forcing them to make interest-free loans to the government.

¹ In addition to my position at Brookings, I have a consulting relationship with T Rowe Price focused on monetary policy and I am on the board of Forbright Bank—a \$7.7 billion institution (as of September 30) headquartered in Chevy Chase MD; on September 30, Forbright held \$ 576 million of deposits at the Federal Reserve.

² <https://www.federalreserve.gov/boarddocs/testimony/2004/20040622/default.htm>

In the remainder of my testimony, I will explain the positive benefits of IORB and address some of the criticisms that have been leveled against it.³

IORB is required to enable the Federal Reserve to take actions under some circumstances to meet its legislative monetary policy mandates for maximum employment and stable prices.

When the economy and employment are weak, the Federal Reserve normally reduces its target for short-term interest rates to stimulate spending. Twice in the past 20 years, the Fed has lowered its target interest rate to zero, but recovery from recession still has been slow or uncertain. In these circumstances, to reduce longer-term interest rates further to encourage spending and job creation and avoid persistent deflation the Fed has purchased longer-term government securities (known as quantitative easing, QE). Those purchases create a large volume of reserves. When it comes time to tighten policy—to raise interest rates—to combat actual or potential inflation, small adjustments in reserves will not suffice; inflation fighting depends on raising IORB, which puts a floor under market rates. We saw this be effective in 2015-19 and again in 2022-24.

Without IORB the Fed could be constrained from taking actions required to meet Congressional mandates. If it refrained from QE in weak economies when rates were already zero because it lacked the tools to tighten policy when appropriate, more people would be unemployed for longer; if it undertook QE without the ability to move against rising prices after the economy recovered, it would not be able to preserve price stability--inflation would be high and persistent. IORB and QE have contributed to economic and price stability over the past 20 years. I'm not arguing that the Fed has used these tools perfectly; I myself have been critical of some aspects of monetary policy in the post-Covid period.⁴ But the economy did better than it would have if the Fed wasn't able to take these actions, and they need to be available in the future.

IORB supports the Federal Reserve's ability to foster financial stability.

It enables the Federal Reserve to make purchases to stabilize Treasury, agency, and MBS markets when they are disrupted, threatening the flow of credit to public and private borrowers. Financial markets seized up in late 2008 and again in the spring of 2020 as lenders ran to the safest, most liquid instruments. That disfunction meant that

³ This testimony draws from a blog post I recently co-authored with William English.
<https://www.brookings.edu/articles/what-would-happen-if-congress-repealed-the-feds-authority-to-pay-interest-on-reserves/>

⁴ <https://www.brookings.edu/articles/the-inflation-surge-of-the-2020s-the-role-of-monetary-policy/>;
<https://www.brookings.edu/articles/fed-should-be-sure-to-include-monetary-policy-tools-in-forthcoming-framework-review/>.

households, businesses and governments were unable to borrow to finance the normal flow of spending; if those effects had persisted, the result would have been to make already very serious recessions even deeper and longer. Because of IORB the Federal Reserve was able to step in to make purchases of Treasury, agency and agency-guaranteed mortgage-backed securities to restore normal functioning in those foundational markets. I was on the FOMC in 2008-09; many policymakers were concerned that the securities purchases undertaken to stabilize markets and support the recovery not impede our ability to tighten policy to head off inflation when the time came. IORB gave us the confidence we needed to take the actions required to limit the damage to the economy from the financial crisis.

IORB means that the Fed can supply reserves to enhance the resilience of the banking system to unexpected adverse liquidity shocks such as deposit runs.

Reserves—deposits at the Fed—are the safest, most liquid assets banks can hold. IORB means that the banks see reserves as a viable source of liquidity to manage their risks and make interbank payments without harming their bottom line. And the Fed can meet their demands for this asset without sacrificing its ability to control short-term interest rates for monetary policy purposes. The “ample reserves” operating regime the Fed is now utilizing gives it the same control over money market interest rates it had in the pre-2008 scarce reserves operating system, but at the same time provides a much higher level of reserves—high-quality liquidity—to the banking system. Being able to use interest-bearing deposits at the Fed to manage liquidity is especially important for small and medium sized banks; larger banks have access to a much wider variety of instruments to meet unexpected outflows or generally to adjust their liquidity positions.

IORB does not result in a windfall for banks

Banks have to fund their holdings of reserves with deposits or borrowing, just as they do with other assets that they hold. And banks pay interest and face other costs associated with those sources of funding. The key issue, then, is how the interest on reserves compares to the banks’ cost of funding. There are three reasons to believe that the difference between the two is small. First, the rate paid on reserves is very close to the rates on a range of other short-term instruments with which banks and others can borrow and invest. Second, the Fed’s payments of interest on reserves have increased immensely in recent years, reflecting both a higher level of reserves and higher interest rates, but that increase does not appear to have affected bank profitability. Specifically, between 2021 and 2024, payments of interest on reserves increased by more than \$150 billion, but bank profits changed little, remaining near \$300 billion, suggesting that higher bank funding costs offset the rise in interest income on reserves. Finally, any individual bank can

increase its holdings of reserves by raising its deposit rates to attract new funds and leaving the funds in its reserve account at the Fed. If the rate paid on reserves offered banks an excessive profit, increased competition among banks for deposits would push up bank funding costs, offsetting that profit.

IORB will not result in a net cost to the Treasury over the long run

While a larger Fed balance sheet means that the Fed is supplying more reserves to banks on which it pays interest, it also means that the Fed is holding more government securities purchased with those reserves, and it earns interest on those. Thus, the implication for Fed profits (which are turned over to the Treasury after paying the Fed's expenses)—and so, the budget deficit—depends on the *net* interest earned or paid by the Fed.

The interest rate paid on reserves is a short-term rate—reserves are held overnight—while the rate on the Fed's securities holdings is a mix of short, intermediate, and long-term rates, depending on the particular portfolio of securities the Fed is holding. Thus, Fed interest income and expense (including interest payments to banks) can differ significantly in some periods. Indeed, the Fed had large profits and made large remittances to the Treasury for a number of years following the financial crisis and again in the immediate aftermath of the pandemic, but it has had substantial losses recently, reflecting the rapid rise in short-term rates put in place to combat the post-COVID inflation. But this is a temporary condition. Over time, yields on long-term securities have somewhat exceeded, on average, those on short-term debt as investors arbitrage across instruments with different maturities to achieve roughly equal risk-adjusted returns. As a result, the effects of a larger Fed balance sheet on interest payments to banks and interest receipts on securities should be roughly offsetting, leaving Fed income and the federal budget deficit about unchanged.

IORB and ample reserves do not crowd out consumer or business lending.

Deposits are the counterpart of those reserves. When a bank receives a deposit, it is credited to its account at the Federal Reserve. The bank then compares the risk-adjusted returns on various uses of the deposit, taking account of capital charges and other costs associated with each investment opportunity. Before IORB a bank might compare making a loan to lending to another bank in the federal funds market, reducing its (noninterest earning) deposit at the Fed. The key question facing the bank was whether it would earn a higher risk-adjusted return after costs on a loan to businesses and households or a loan to another bank. Today the bank would compare making the loan to

holding onto the deposit at the Fed. So the key question is whether it would earn a higher return in a loan to businesses and households or on reserves held at the Fed. The IORB rate is almost identical to the federal funds rate, so IORB hasn't altered the calculus behind the loan decision-- the incentives to make loan haven't changed materially.

Observers have been concerned that the ample reserves regime could crowd out other risk-free investments like Treasury securities at banks constrained by the leverage ratio. The leverage ratio imposes the same capital charge against both risky and safe assets. It's intended to be a backstop for risk-based capital regulation, but the provision of ample reserves has pushed banks closer to leverage ratio limits. To be clear, the problem is not ample reserves or IORB, it's the leverage ratio. The regulatory authorities have recognized the problem and proposed reforms to the calculation of the leverage ratio to make it more of a backstop for risk-based capital requirements, as intended, not the binding constraint. They are also looking at aspects of the special capital requirements for too-big-to-fail banks—the GSIB requirements--that might also have the effect of discouraging purchase and market making in Treasuries and are moving to address this problem too. I have supported these efforts.⁵ Once they take effect, ample reserves should not have a significant effect on bank support of a wide variety of security and loan markets.

While not allowing the Fed to pay interest on reserve balances would have little effect on Treasury income over time or on bank profits, it would handicap the Fed's ability to promote economic and financial stability.

If Congress repealed the Fed's authority to pay interest on reserves, the Fed would turn to other tools to implement monetary policy. In the short run, the Fed probably would make greater use of reverse repurchase agreements to provide a floor for short-term interest rates. In a reverse repurchase agreement, the Fed essentially borrows short-term in financial markets; counterparties will not lend to anyone else at a rate lower than the Fed is offering. Reverse repurchase agreements have effects—and costs—similar to those of the payment of interest on reserves. Thus, ending interest on reserves would leave Fed interest payments little changed in the short run, and so would have little effect on Fed profits and so on the federal budget.

If the Fed were unable to pay interest on reserves, it might reconsider its decision to implement monetary policy with a large balance sheet, and so move, over time, back to a smaller balance sheet and policy implementation using a scarce reserves framework.

⁵ <https://www.brookings.edu/articles/donald-kohns-thoughts-on-supplementary-leverage-ratio-reform/>

(Shifting back to a scarce reserves system quickly would not be feasible because the huge sales of Treasuries required would disrupt the Treasury market.) Such a shift would lead the Fed to decrease its holdings of securities, reducing interest income and largely offsetting, on average, the savings from not paying interest on reserve balances, as discussed above. The net effect on Fed income, and so on the federal budget, would depend on banks' residual demand for non-interest-bearing reserves. That demand would surely be small—vastly smaller than the level of reserves today. Moreover, the lack of interest on the reserves that banks chose to continue holding—or were required to hold because the Fed had to revive reserve requirements to induce a stable predictable demand for reserves--would still be an implicit tax on bank intermediation, falling on bank customers and inducing wasteful avoidance efforts. Such a change in policy implementation would also require the Fed to give up the benefits it saw to operating with an ample reserves framework, including potential improvements in financial stability from more liquid bank balance sheets.

Perhaps most importantly, under some critical circumstances the repeal of IORB would constrain the Fed's ability to meet its goals for maximum employment, stable prices, and a well-functioning financial system. In a future economic or financial crisis, it would be forced to choose between a longer period of higher unemployment because it foreswore asset purchases; or if it made those purchases it would risk saddling the US economy with higher inflation as it undertook the reduction in its balance sheet.

In sum, IORB has been a critical aspect of bank deregulation that reduces inefficient and distortive behavior by banks and benefits depositors and borrowers. It strengthens the safety and soundness of banks, and it enables the Federal Reserve use all its tools to stabilize the economy and financial system in an emergency without losing control of monetary policy. It should be left in place.