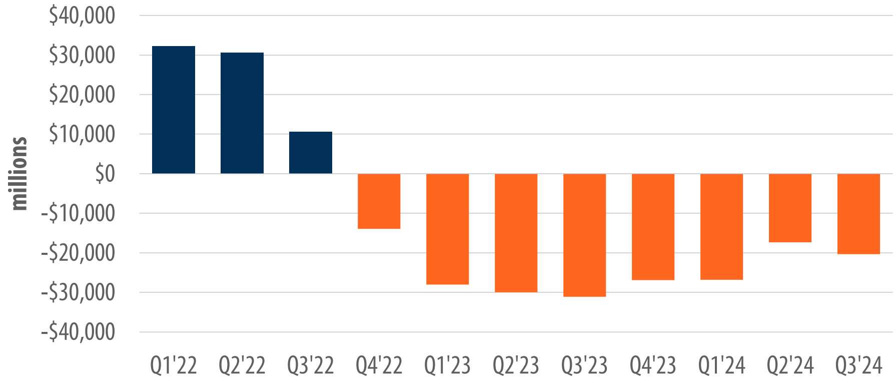
December 12, 2024

Abundant Reserves, Abundant Losses: Fed's Financials in Q3

In this week's edition of "Three on Thursday," we look at the Federal Reserve's financials through the third quarter of 2024. Back in 2008, the Federal Reserve (the "Fed") embarked on a novel experiment in monetary policy by transitioning from a "scarce reserve" system to one characterized by "abundant reserves." In addition to inflation, this experiment has resulted in some other developments that are worrisome. Higher interest rates have resulted in substantial unrealized losses on the Fed's securities portfolio. Simultaneously, they have caused the Fed to pay out more in interest to banks than it is earning, resulting in sizable and ongoing operating losses. To offer deeper insights into where things stood through the third quarter of this year, we have included the two charts and table below.

Net Earnings Remittances to the Treasury



Source: Federal Reserve Board, First Trust Advisors. Data from first quarter 2022 through third quarter of 2024.

Before 2022, the Fed earned more from its Treasury and mortgage-backed securities (MBS) than it paid banks. At the peak a few months ago, the Fed was paying an annualized 5.40% on reserves. Today, it pays banks 4.65% annually to hold reserves, exceeding its income from these assets, leading to significant quarterly operating losses for eight consecutive quarters. While losses will persist, they should lessen as the Fed continues to cut rates. The Fed plays fast and loose with accounting and labels these losses as a **deferred asset** on its balance sheet. It appears that the Treasury is lending the Fed money against this deferred asset, plus enough to cover its operating expenses. This is all based on the Fed's promise to repay the Treasury when it returns to profitability. In Q3 2024, net earnings remittances to the Treasury were -$20.3 billion, with the deferred asset now sitting over $200 billion.

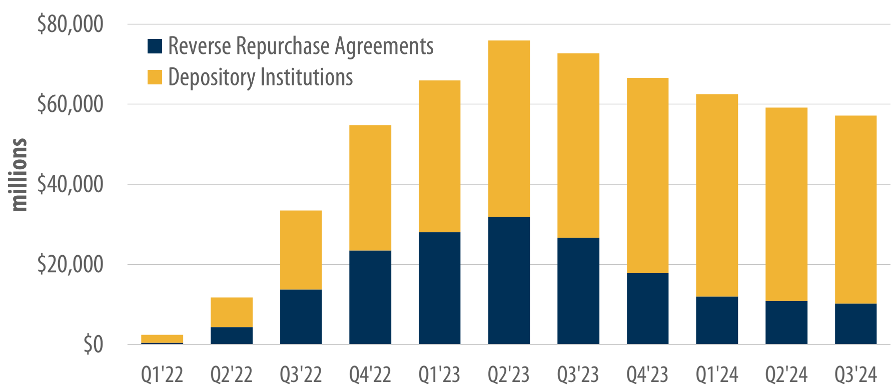
Federal Reserve's Portfolio Holdings (in millions)

Treasury Securities	Amortized Cost	Fair Value	Cumulative Unrealized Losses
Bills	$193,213	$193,452	$239
Notes	$2,459,544	$2,331,239	-$128,305
Bonds	$1,898,936	$1,523,343	-$375,593
Total Treasury Securities	**$4,551,693**	**$4,048,034**	**-$503,659**
Federal Agency and GSE MBS			
Residential	$2,318,606	$2,004,767	-$313,839
Commercial	$8,715	$7,621	-$1,094
Total Federal Agency and GSE MBS	**$2,327,321**	**$2,012,388**	**-$314,933**
GSE Debt Securities	$2,536	$2,711	$175
Total Domestic SOMA Portfolio Securities Holdings	**$6,881,550**	**$6,063,133**	**-$818,417**

Source: Federal Reserve Board, First Trust Advisors. Data as of third quarter of 2024. The domestic portfolio holdings of the Federal Reserve's System Open Market Account (SOMA). GSE stands for Government Sponsored Entity.

The Fed has over $800 billion in unrealized losses on its balance sheet, but it's important to note the unique position it's in. Unlike many financial institutions, the Fed doesn't face solvency concerns because it's not required to mark its portfolio to market values. The Fed has the option to hold its securities until they mature, and there's no regulatory agency that can intervene and force it to shut down due to accounting losses. With total reported capital of just $43.4 billion in Q3 of 2024, the Fed's unrealized loss of $818.4 billion represents more than 18 times its capital.

Interest Paid to Banks and Institutions by the Federal Reserve



Source: Federal Reserve Board, First Trust Advisors. Data from first quarter 2022 through third quarter of 2024.

The real beneficiaries in recent years have been banks and financial institutions, which earned $57.2 billion in Q3 alone from just holding reserves and reverse repurchase agreements. As the Fed continues to cut rates and shrink its balance sheet, interest payments to these institutions will decline. However, costs are still projected to remain high, we estimate at over $200 billion for 2024. These expenses are ultimately borne by taxpayers.