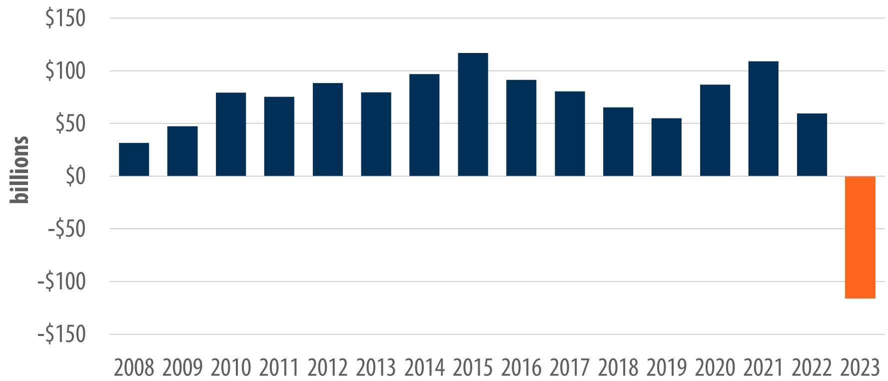
April 11, 2024

In this week's edition of "Three on Thursday," we look at the Federal Reserve's financials through year-end 2023. 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 losses. To offer deeper insights into where things stood at the end of last year, we have included the two charts and table below.

Net Earnings Remittances to the Treasury



Source: Federal Reserve Board, First Trust Advisors. Annual data 2008-2023.

Before 2022, the Fed was able to buy Treasury and mortgage-backed securities (MBS) that generated higher yields than what they were paying banks. Consequently, the Fed consistently earned substantial operating surpluses, which were then remitted to the Treasury Department on a weekly basis. Over a span of 15 years, the Federal Reserve contributed an average of over $75 billion annually to government revenue through this mechanism. But now, after the equivalent of 21 quarter-point rate hikes over the last two years, it pays banks 5.4% per annum to hold reserves – much more than what it earns from its portfolio of Treasury bonds and MBS, leading to $116 billion in losses over 2023. These accumulated losses are called a deferred asset on the Fed's balance sheet and will only be paid off if/when the Fed starts to make a profit again down the road.

Domestic SOMA Portfolio Holdings

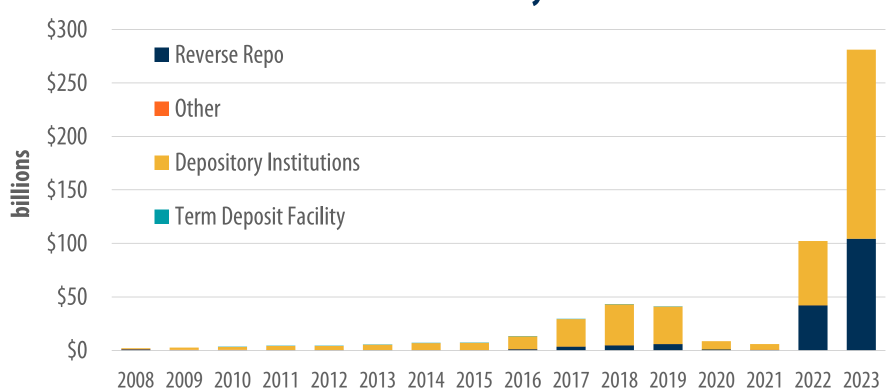
(millions)

Treasury Securities	Amortized Cost	Fair Value	Cumulative Unrealized Losses
Bills	$214,231	$214,361	$130
Notes	$2,891,337	$2,695,476	-$195,861
Bonds	$1,882,759	$1,493,246	-$389,513
Total Treasury Securities	**$4,988,327**	**$4,403,083**	**-$585,244**
Federal Agency and GSE MBS			
Residential	$2,472,419	$2,110,439	-$361,980
Commercial	$8,917	$7,552	-$1,365
Total Federal Agency and GSE MBS	**$2,481,336**	**$2,117,991**	**-$363,345**
GSE Debt Securities			
Total Domestic SOMA Portfolio Securities Holdings	**$7,472,220**	**$6,523,777**	**-$948,443**

Source: Federal Reserve Board, First Trust Advisors. Data as of 12/31/2023. SOMA: System Open Market Account Holdings. GSE: Government Sponsored Entity.

The Federal Reserve has $948 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 billion at the end of 2023, the Fed's unrealized loss of $948 billion represents a staggering 22 times its capital.

Interest Paid to Banks and Institutions by the Federal Reserve



Source: Federal Reserve Board, First Trust Advisors. Annual data 2008 - 2023.

In 2023, the Federal Reserve compensated banks and financial institutions a total of $281 billion for holding reserves, marking a significant increase of 175% from the $102 billion paid out in risk-free income in 2022—a sum that ultimately is borne by taxpayers. Market analysts and the Federal Reserve anticipate a reduction in the federal funds rate by a total of 75 basis points through three cuts in 2024. This adjustment, coupled with a reduction in the Fed's balance sheet throughout the year, is expected to decrease the Fed's expenditure on interest payments to banks and financial institutions. However, the projected expenses remain remarkably high, we estimate to be between $200 billion and $250 billion, indicating a continuation of significant payouts in 2024.