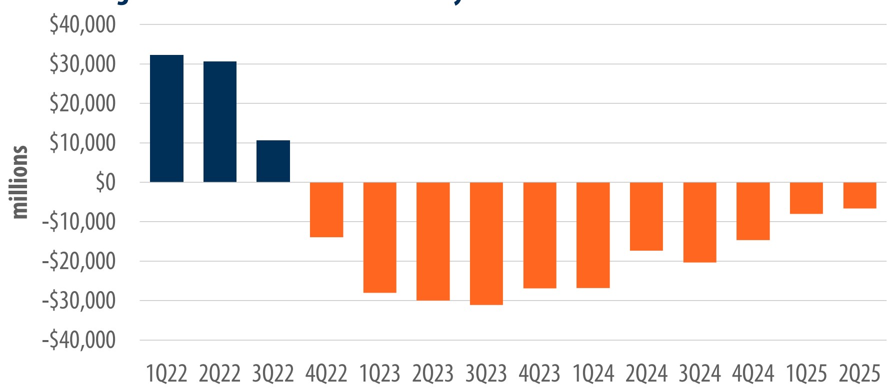
August 28, 2025

Q2 Look at Fed Reserve Financials Not Pretty

Back in 2008, the Federal Reserve (the "Fed") launched a new experiment in monetary policy, shifting from a "scarce reserve" system to one built on "abundant reserves." Beyond its contribution to inflation, this shift has created other, less-discussed problems. Rising interest rates have inflicted heavy unrealized losses on the Fed's securities portfolio. At the same time, higher rates have forced the Fed to pay banks more in interest on reserves than it earns from its assets, leading to ongoing losses. After years of mounting red ink, some members of Congress are finally beginning to notice—and they're not pleased. Last week the Fed released their latest quarterly financial report of the combined financial position of the 12 Reserve Banks through the second quarter. In this week's edition of "Three on Thursday," we dive into that report. For a deeper understanding, view 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 second quarter of 2025.

Before 2022, the Fed consistently earned more on its Treasury and mortgage-backed securities (MBS) than it paid banks on reserves. That flipped once rates rose. Today, the Fed pays banks 4.4% annually to hold reserves—more than it earns on its asset portfolio—driving losses for 11 straight quarters. These losses are expected to continue, though will narrow if, as many expect, the Fed cuts rates in September. For now, the shortfall is booked as a "deferred asset" on the Fed's balance sheet, to be repaid only when the Fed returns to profitability. In the second quarter of 2025 alone, net remittances to the Treasury were negative $6.7 billion, while the cumulative deferred asset grew to $233.8 billion.

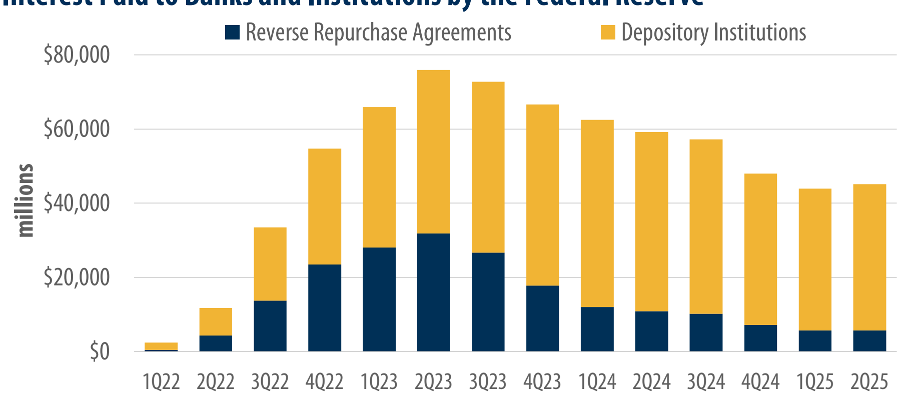
Federal Reserve's Portfolio Holdings (in millions)

Treasury Securities	Amortized Cost	Fair Value	Cumulative Unrealized Losses
Bills	$193,653	$193,660	$7
Notes	$2,282,915	$2,180,304	-$102,611
Bonds	$1,903,379	$1,437,061	-$466,318
Total Treasury Securities	**$4,379,947**	**$3,811,025**	**-$568,922**
Federal Agency and GSE MBS			
Residential	$2,171,282	$1,813,634	-$357,648
Commercial	$8,457	$7,402	-$1,055
Total Federal Agency and GSE MBS	**$2,179,739**	**$1,821,036**	**-$358,703**
GSE Debt Securities	$2,514	$2,647	$133
Total Domestic SOMA Portfolio Securities Holdings	**$6,562,200**	**$5,634,708**	**-$927,492**

Source: Federal Reserve Board, First Trust Advisors. Data as of second quarter of 2025. The domestic portfolio holdings of the Federal Reserve's System Open Market Account (SOMA). GSE stands for Government Sponsored Entity.

As of the second quarter of 2025, the Federal Reserve carried $927.5 billion in unrealized losses on its balance sheet. While striking, these losses do not raise solvency concerns for the Fed in the way they would for private institutions. Unlike commercial banks, the Fed is not required to mark its securities to market, nor is it subject to regulatory capital requirements. Instead, it can hold securities to maturity and operate independently of outside intervention. Even so, the scale is impressive: with reported capital of just $45.5 billion, the unrealized losses are roughly 20 times the Fed's capital, underscoring the unusual nature of its balance sheet.

Interest Paid to Banks and Institutions by the Federal Reserve



Source: Federal Reserve Board, First Trust Advisors. Data from first quarter 2022 through second quarter of 2025.

It has taken Congress years to grasp the scale of what's happening, but they may finally be catching on. The real beneficiaries of the "abundant reserve" system have been banks and financial institutions, which earned $45.1 billion in Q2 alone from holding reserves and reverse repos. The market currently expects the federal funds rate to drop by 50 basis points by year-end. This, along with a shrinking Fed balance sheet, will reduce the Fed's interest payments to these institutions. However, costs are still projected to remain high, we estimate between $150 billion and $200 billion for 2025, signaling continued significant payouts in the second half of the year— expenses ultimately borne by taxpayers.