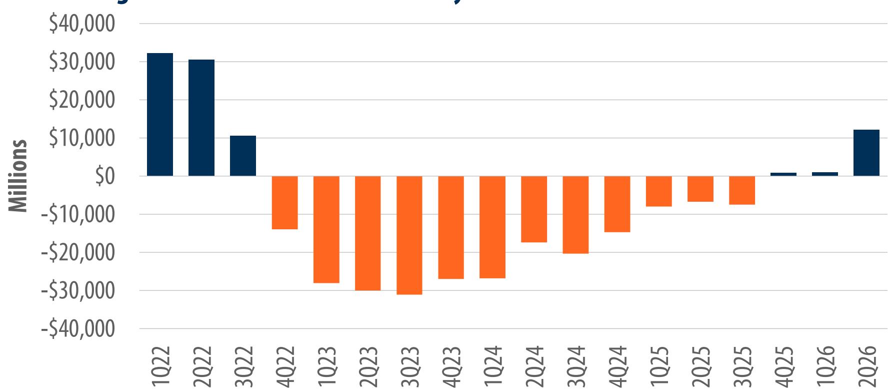
September 3, 2026

Q2 Fed Financials: Slow Progress

Last week, the Federal Reserve (the "Fed") released its Q2 quarterly financial report, detailing the combined financial position of the 12 Federal Reserve Banks. In this week's "Three on Thursday," we take a closer look at what the report reveals. Since 2008, the Fed has operated under an "abundant reserves" framework — a significant departure from its prior operating approach. While the Fed believes this framework has helped support financial markets and economic activity, it has also produced notable side effects. Higher interest rates have generated substantial unrealized losses on the Fed's securities portfolio and, for a period, caused the Fed to pay more in interest on reserves than it earned on its assets — resulting in sizable operating losses. There are, however, signs of improvement. Even as rates have stayed elevated, the Fed's balance sheet has continued to shrink, narrowing losses and returning the Fed to profitability over the past three quarters. For more, see the table and two charts below.

Net Earnings Remittances to the Treasury



Source: Federal Reserve Board, First Trust Advisors. Data from first quarter 2022 through second quarter 2026.

Before Q4 2022, the Fed consistently earned more on its Treasury and mortgage-backed securities ("MBS") portfolio than it paid banks on reserve balances. That changed as interest rates rose. After 12 consecutive quarterly losses, recorded as a deferred asset on the Fed's balance sheet, the past three quarters have returned to positive net income. In Q2 2026, the Fed reported net remittances to the Treasury of $12.2 billion, the largest quarterly gain since Q2 2022, while the deferred asset declined to $235.5 billion. That balance remains substantial, but the recent trend marks progress.

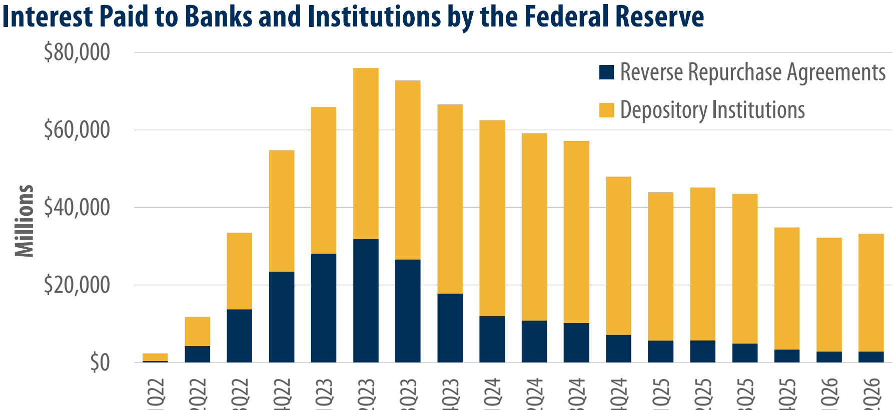
Federal Reserve's Portfolio Holdings (in millions)

Treasury Securities	Amortized Cost	Fair Value	Cumulative Unrealized Losses
Bills	$485,413	$485,300	-$113
Notes	$2,233,151	$2,144,151	-$89,000
Bonds	$1,925,678	$1,453,247	-$472,431
Total Treasury Securities	**$4,644,242**	**$4,082,698**	**-$561,544**
Federal Agency and GSE MBS			
Residential	$1,976,645	$1,660,988	-$315,657
Commercial	$7,950	$7,047	-$903
Total Federal Agency and GSE MBS	**$1,984,595**	**$1,668,035**	**-$316,560**
GSE Debt Securities	$2,483	$2,559	$76
Total Domestic SOMA Portfolio Securities Holdings	**$6,631,320**	**$5,753,292**	**-$878,028**

Source: Federal Reserve Board, First Trust Advisors. Data as of second quarter 2026. The domestic portfolio holdings of the Federal Reserve's System Open Market Account (SOMA). GSE stands for Government Sponsored Enterprise.

As of Q2 2026, the Federal Reserve carried $878 billion in unrealized losses on its balance sheet. While striking, these losses don't raise solvency concerns for the Fed the way they would for private institutions. Unlike commercial banks, the Fed isn't required to mark its securities to market and isn't subject to regulatory capital requirements. It can hold its securities to maturity, and no regulatory agency has the authority to force it to shut down over accounting losses. With reported capital of just $47.7 billion, the unrealized losses are roughly 18 times the Fed's capital. That ratio is still extreme, but it's an improvement from a few years ago, when unrealized losses approached $1.1 trillion. That said, long-term interest rates have risen since this data was released. The 10-year Treasury yield has increased from 4.47% on 6/30/26 to 4.80% on 9/2/26, which is likely to expand unrealized losses for the Fed in the third quarter.

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 2026.

In Q2 2026, the Federal Reserve paid banks and other financial institutions $33.2 billion in interest on reserve balances, up $1 billion from last quarter, but down from $45.1 billion a year earlier. While interest expenses have been moving in the right direction over the past year, they remain extraordinarily high. Market pricing currently suggests the Fed funds rate could rise by 50 basis points by year-end, while the Fed itself projects a 25 basis point hike. Regardless, continued balance sheet runoff should help reduce interest expenses further. Even so, we estimate the Fed will pay between $100 billion and $150 billion in interest on reserves in 2026, highlighting that these large, risk-free transfers to the banking system are likely to persist for years to come.