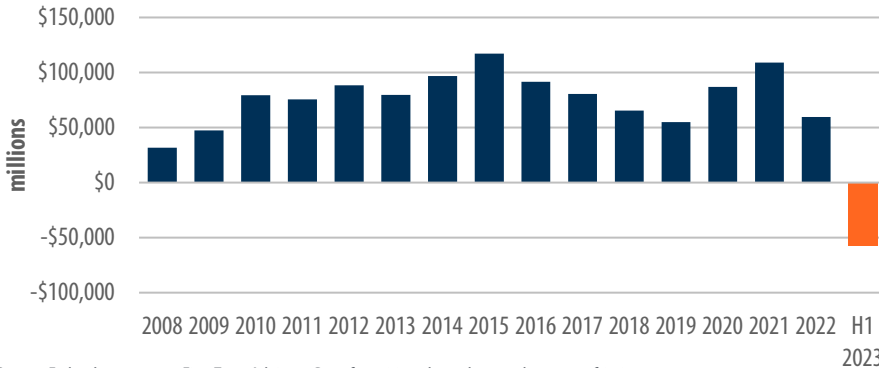


In this week's edition of "Three on Thursday," we delve into the current financial challenges facing the Federal Reserve. Back in 2008, the Federal Reserve embarked on a novel experiment in monetary policy by transitioning from a "scarce reserve" system to one characterized by "abundant reserves." In 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 this matter, we have included the two charts and table below.

### Net Earnings Remittances to the Treasury



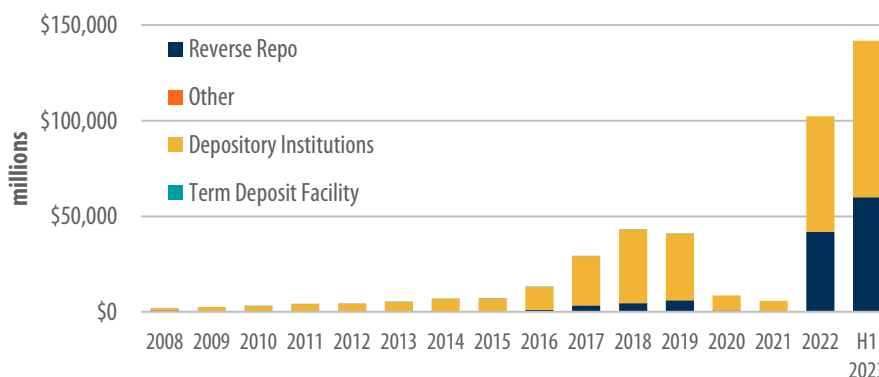
Source: Federalreserve.gov, First Trust Advisors. Data from 2008 through second quarter of 2023.

### Domestic SOMA Portfolio Holdings

Treasury Securities	Amortized Cost	Fair Value	Cumulative Unrealized Losses
Bills	\$266,167	\$266,055	-\$112
Notes	\$3,166,568	\$2,912,378	-\$254,190
Bonds	\$1,889,445	\$1,524,433	-\$365,012
<b>Total Treasury Securities</b>	<b>\$5,322,180</b>	<b>\$4,702,866</b>	<b>-\$619,314</b>
<b>Federal Agency and GSE MBX</b>			
Residential	\$2,581,779	\$2,118,922	-\$392,857
Commercial	\$9,137	\$7,611	-\$1,526
<b>Total Federal Agency and GSE MBS</b>	<b>\$2,590,916</b>	<b>\$2,196,533</b>	<b>-\$394,383</b>
<b>GSE Debt Securities</b>			
<b>Total Domestic SOMA Portfolio Securities Holdings</b>	<b>\$7,915,667</b>	<b>\$6,902,112</b>	<b>-\$1,013,555</b>

Source: Federalreserve.gov, First Trust Advisors. Data as of second quarter of 2023.

### Interest Paid to Banks and Institutions by the Federal Reserve



Source: Federalreserve.gov, First Trust Advisors. Data from 2008 through second quarter of 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 fifteen 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 in about a year and a half, 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 \$58.1 billion in losses over the first half of 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.

The Federal Reserve has \$1.0 trillion 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 \$42 billion in Q2 of 2023, the Fed's unrealized loss of \$1.0 trillion represents a staggering 24 times its capital.

Meanwhile, the Fed is set to pay banks and other institutions close to \$300 billion this year at current interest rates to just hold reserves, money that must ultimately come from taxpayers. So far through just the first half of this calendar year, banks and other institutions have already received \$141.8 billion in risk-free income, more than the \$102.3 billion they received for all of 2022.

This report was prepared by First Trust Advisors L.P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.