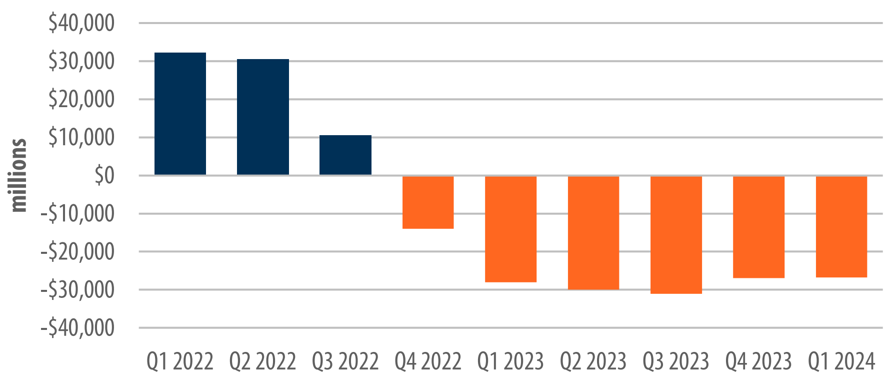
May 30, 2024

In this week's edition of "Three on Thursday," we look at the Federal Reserve's financials through the first 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 losses. To offer deeper insights into where things stood through the first 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 first quarter of 2024.

Before 2022, the Fed was able to buy Treasury and mortgage-backed securities (MBS) that generated higher yields than what they were paying banks. 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, which has led to large losses each quarter over the past six quarters and is set to continue. These 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. In the first quarter of 2024 alone, net earnings remittances to the Treasury were -$26.8 billion, with the deferred asset now sitting at $160.4 billion.

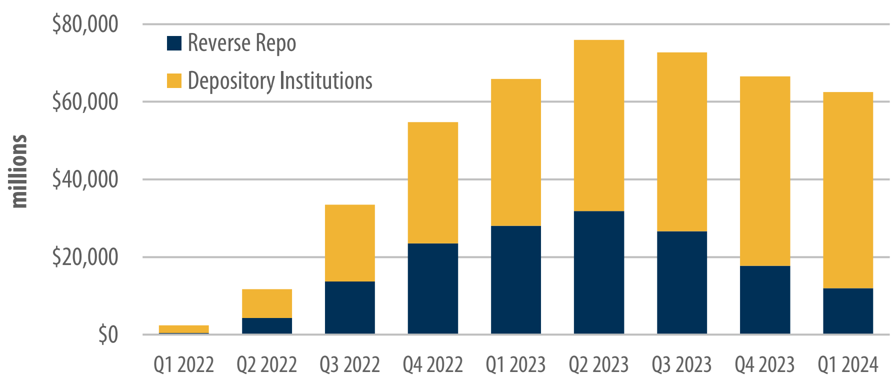
Domestic SOMA Portfolio Holdings (in millions)

Treasury Securities	Amortized Cost	Fair Value	Cumulative Unrealized Losses
Bills	$192,881	$192,883	$2
Notes	$2,735,835	$2,533,202	-$202,633
Bonds	$1,883,375	$1,450,175	-$433,200
Total Treasury Securities	**$4,812,091**	**$4,176,260**	**-$635,831**
Federal Agency and GSE MBX			
Residential	$2,427,812	$2,018,416	-$409,396
Commercial	$8,857	$7,437	-$1,420
Total Federal Agency and GSE MBS	**$2,436,669**	**$2,025,853**	**-$410,816**
GSE Debt Securities			
Total Domestic SOMA Portfolio Securities Holdings	**$7,251,310**	**$6,204,769**	**-$1,046,541**

Source: Federal Reserve Board, First Trust Advisors. Data as of first quarter of 2024.

The Federal Reserve has over $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 $43 billion in Q1 of 2024, the Fed's unrealized loss of $1.05 trillion represents a staggering 24 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 first quarter of 2024.

In the first quarter of 2024, banks and other institutions received $62.5 billion in risk-free income, just for holding reserves and reverse repos. Market analysts currently anticipate a reduction in the federal funds rate by 25 basis points through one cut in November of this year. 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. This sum is ultimately borne by taxpayers.