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Is Fedwire Still a Subsidy That Fully Recovers Its Cost?

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Working Paper No. 237

July 30th, 2025

ABSTRACT

This paper examines the Federal Reserve's current financial losses—unprecedented in scale—and the questionable accounting practices it uses to downplay their impact. It argues that the Fed's self-defined accounting standards, particularly the creation of a "deferred asset" to mask negative equity, obscure the fiscal consequences for the U.S. government and taxpayers. The analysis connects today's losses to longstanding institutional practices, notably the Fed's flawed cost-recovery accounting for its Fedwire payment system. These issues first emerged in the late 1990s and early 2000s, when the author, then a Fed staffer, challenged the internal logic used to claim that Fedwire guaranteed payments and still avoided subsidies. The paper includes as an appendix the original 2002 draft, "Fedwire: A Subsidy That Fully Recovers Its Cost?", which helped reveal the moral hazard and accounting inconsistencies that contributed to the 2008 crisis and continue to shape central bank risk and governance today.

https://doi.org/10.36687/inetwp237

JEL codes: E58, E42, G28, H83, L50

Keywords: Federal Reserve, Central bank accounting, Fedwire, daylight overdrafts, Payment systems, financial crisis, monetary policy, financial regulation

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Lately the Federal Reserve has been doing something it has never done before. It is losing lots of money. These losses have consequences for the already-poor financial condition of our federal government. The Fed has also been behaving badly while accounting for itself, employing deceptive accounting practices that downplay its deteriorating financial condition. Deceptive accounting at the Fed is not a new thing, however. Current Fed accounting issues and massive financial losses have roots in questions I raised about Federal Reserve payment systems while working at the Fed in the late 1990s and early 2000s.

A central bank does three main things, at least in the United States. It conducts monetary policy, it regulates (and supervises) banks, and it provides payment services. Monetary policy involves buying and selling securities and lending to banks to manage benchmark interest rates and the overall flow of money and credit. In the US, Congress has directed the Fed to do so with a statutory mandate to achieve "maximum employment," "stable prices" and "moderate long-term interest rates." The Federal Reserve also regulates and supervises banks and other financial institutions to promote banking stability and consumer protection. Together, the Fed advertises that it conducts monetary policy and financial regulation to provide a "safe, flexible and stable monetary and financial system."

A central bank need not conduct monetary policy as well as financial regulation. In fact, there are strong arguments against combining those two elements, as they can undermine the stated goals when conducted by the same institution. The Fed statement that it provides a "safe, flexible and stable monetary and financial system" appeared at the top of the Federal Reserve Board's website before, during, and after the massive 2008-2009 financial crisis. It still appears there today, helping us all rest easy – at least, most of us.

Monetary policy and bank regulation are relatively well known. There is a third leg of the stool, however, and one that receives far less attention than it should. Banking system stability depends on interconnections between banks, and banks are importantly linked to one another through the third leg of the stool at the Fed – its payment system services.

You can put money in two main buckets. There is "money at rest," and there is "money in motion." Money at rest, much of it, is in bank accounts. Central banking and deposit insurance help secure a feeling of safety in cash, and our accounting principles put cash at the top of the balance sheet to advertise its primary liquidity role. But these accounting practices put two very different things into "cash." There is "cash on hand" (currency, Federal Reserve Notes) and there is "cash in bank" (bank deposits).

Uninsured cash can be very risky, and many financial professionals got a reminder that cash management is never to be taken for granted in the 2023 banking crisis that led to the failure of Silicon Valley Bank. As "money at rest" includes bank account balances, it is also worth remembering a memorable line from a banking attorney who defined "money in the bank" as a "lawsuit in embryo."

How about "money in motion?" We can pay each other money through banks. Banks also pay each other money, however. The Fed provides massive wholesale payment services for banks that want to move money to each other, on their own behalf and on behalf of their customers.

The Federal Reserve's "Fedwire" payment system moves trillions of dollars in payments between banks every day. It is popular for a few reasons, including the fact that the Fed has guaranteed every payment that it processes to the receiving bank – even if the sending bank didn't have the money in its reserve account at the Fed when it sent the payment. These "unfunded" payments can lead to "daylight overdrafts," exposing the Reserve Banks to risk if the sending banks aren't able to make good on their intraday borrowings at the end of the day.

So how is the Fed losing historically unprecedented amounts of money today, and how do those losses relate to its conduct of monetary policy, regulation of banks, and accounting for its payment systems?

Like any bank, the Fed (and here I'm referring to the consolidated system of 12 Federal Reserve Banks) is exposed to interest rate risk. If a bank pays more in interest than it receives, it has negative net interest. Back in the old days, when savings and loan associations were still with us (before they imploded in the 1980s), there was something called a "3-6-3" rule in banking. Banks paid 3% to get money in the door, they earned 6% on their loans, and by 3pm they were on the golf course.

Banking was easy -- until it wasn't. After letting inflation get out of hand in the 1970s, the Fed drove targeted short-term interest rates sharply higher in the early 1980s, well above long-term rates as well as the rates many S&LS and banks had booked on longer-term loans on their books. The sad history of the S&L crisis remains relevant today. Readers are encouraged to get to know the work of past INET contributor Edward Kane, who wrote two books about the S&L crisis before we knew what hit us. Kane coined the term "zombie bank" to identify failed but still-walking institutions with incentives to "gamble for resurrection," given that those who controlled risky bets could gather any upside while losses would be socialized. The latter outcome is what we received with the S&L crisis, and we may be facing the same harrowing set of incentives with our central bank today.

The main driver for the Fed's recent operating losses has been its practice of paying interest on reserves. Reserves are the money banks have in their accounts at the Fed. After inflation accelerated in recent years, the Fed raised its targeted short-term interest rates (including the interest rate it pays banks for their reserves) sharply, from near-zero to near 5%. The Fed's net interest earnings have turned sharply negative, now running at an annualized basis north of a hundred billion dollars a year. And the Fed has also suffered much larger but "unrealized" losses on longer-term securities in its massive portfolio of Treasury and other government securities purchased as part of its quantitative easing program.

So how does the Fed account for itself, and for these recent losses? I don't use the term "account for itself" loosely.

Financial accounting in the US for external reporting purposes is largely based on "GAAP" – "Generally Accepted Accounting Principles." The name is a misnomer, however. These principles aren't so freely and generally accepted. They effectively have the force of law, through securities law and regulation. And while "GAAP" may sound like there is only one generally accepted set of principles, there are actually three different types of GAAP.

In much of the "private" sector, GAAP is set by the Financial Accounting Standards Board, a nonprofit organization sanctioned (and overseen) by the SEC and in turn, the US Congress. That is the main GAAP that people think of when they refer to GAAP. But there are two other GAAPs. One is GAAP for state and local governments, set by the FASB's "sister" organization GASB – the Governmental Accounting Standards Board. And the federal government's GAAP is set by a federal government entity called FASAB – the Federal Accounting Standards Advisory Board. Together, FASAB and GASB accounting principles for government entities serve as the informational foundation for our massive government securities markets.

So, which standards govern accounting at the Federal Reserve Banks and their multi-trillion-dollar balance sheet(s)? Who sets those standards? Does the Fed follow FASB, GASB, or FASAB?

The Fed doesn't follow any of those three standards. It sets its own accounting standards and changes them when it sees fit. The Fed truly "accounts for itself." And back in 2010, on the immediate heels of the financial crisis, the Fed changed its own accounting to allow for the accumulation of a dubious "deferred asset" in the event of losses such as it has more recently been accumulating.

Accounting has "debits" and "credits." In double-entry accounting, debits increase assets and expenses, and credits increase liabilities and revenues. Normally, when you have a loss, it negatively impacts reported capital (or net position) – the net amount remaining after liabilities are subtracted from assets. However, the Fed now effectively transforms losses into reported assets, with a "deferred asset" account that accumulates losses in an *asset* debited to insulate the reported net position from turning negative. (For further study, see this recent article at Law & Liberty titled "Duplicity at the Fed" by Paul Kupiec and Alex Pollock.)

The Fed also insulates its reported capital position from turning red by accounting for its massive bond portfolio not on current market prices, but on the cost it paid for those securities. With large relative increases in long-term interest rates in recent years, the Fed's balance sheet amounts for government securities do not reflect hundreds of billions of losses for securities purchased at lower rates (and higher prices) several years ago – securities that have significantly lower market prices today. The Fed's practice of accounting for its securities portfolio at cost resembles the

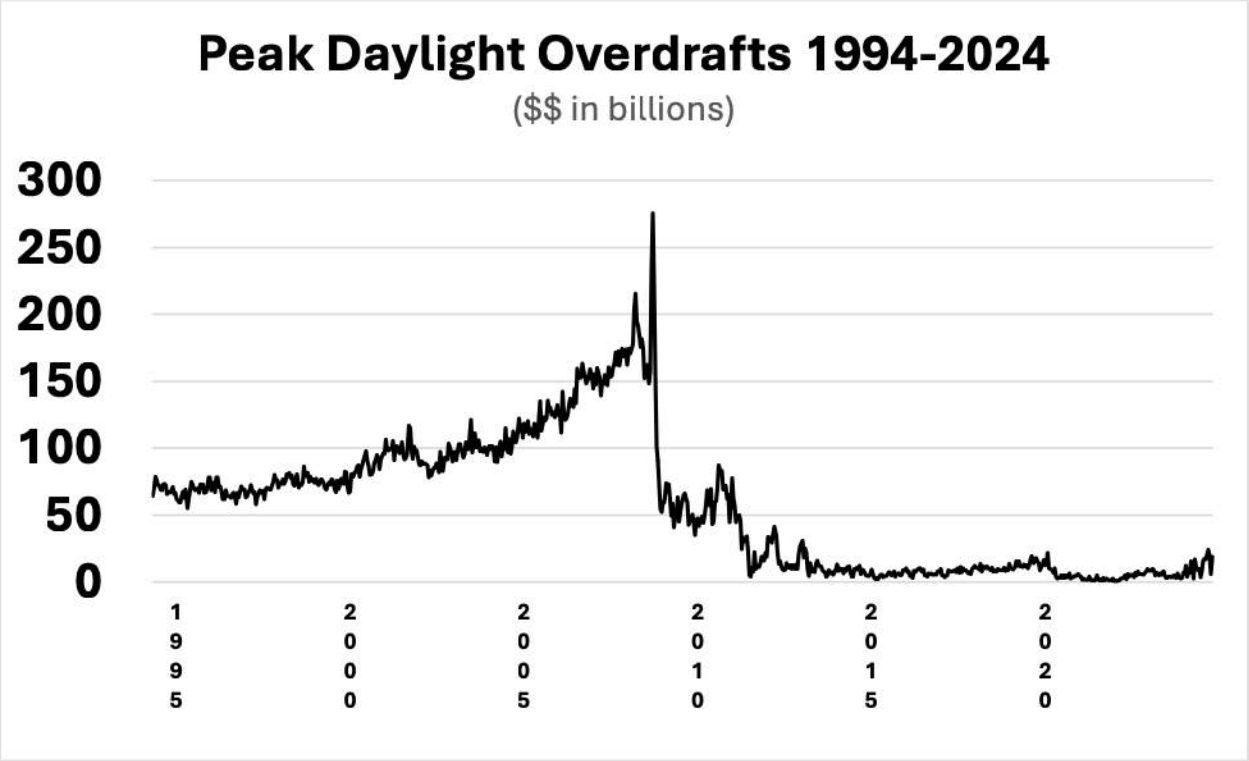
"held-to-maturity" accounting that has been identified as an element in the failure of Silicon Valley Bank and broader banking crisis in 2023.

A couple of years ago, a former senior regulatory official gave an address about that 2023 crisis. After the talk, in the Q&A, I asked "Do we need to revisit held-to-maturity accounting – in general, in banks, and for Reserve Banks in particular?" Her answer ended with "I'm not going to touch the Reserve Bank question."

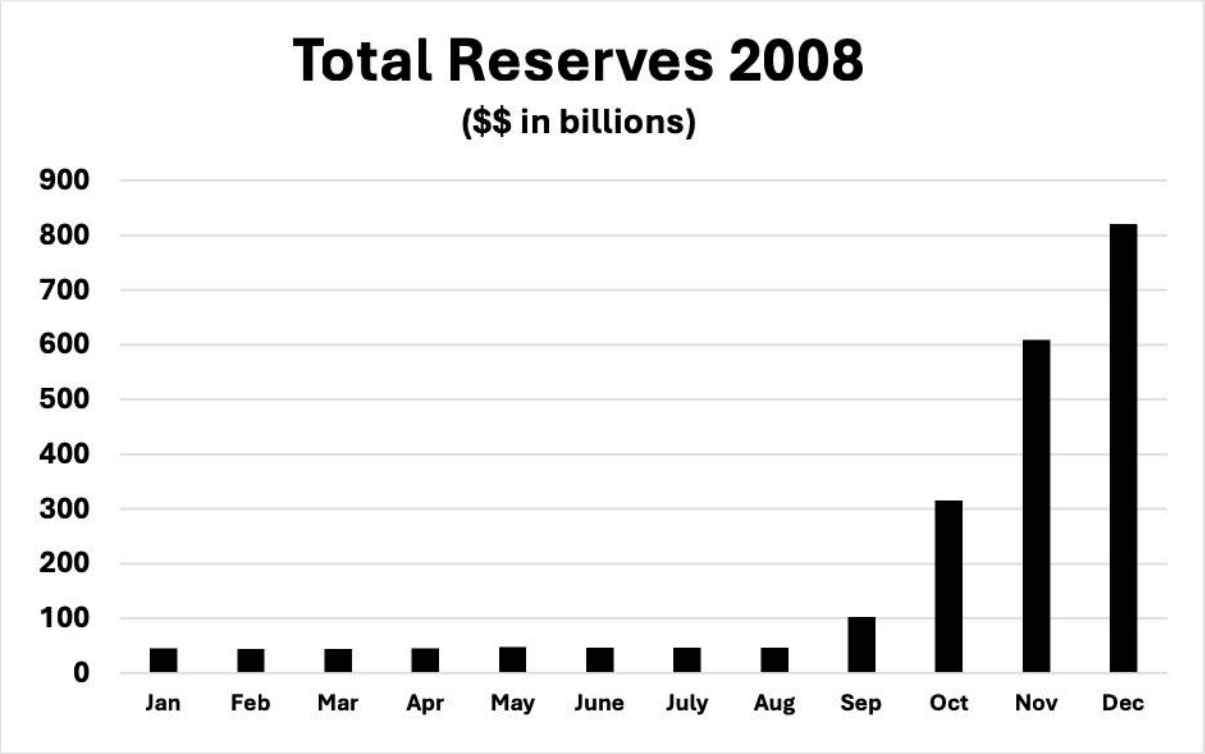
Together, the "deferred asset" and securities portfolio accounting have kept the Fed afloat, on its own books, anyway. These recent developments have important historical precedent, however. The Fed's strategic and/or deceptive accounting for its Fedwire system helped set the stage for today's large-scale losses.

The Fed hasn't always paid interest on reserves. The Fed began the practice in early October 2008, amidst arguably the worst financial crisis in US history. Congress originally granted the Fed the authority to pay interest on reserves in 2006, with implementation planned for 2011. However, Congress accelerated the timeline in 2008. On October 3, 2008, Congress passed the Emergency Economic Stabilization Act, and it was signed by the President that same day. This law allowed the Fed to begin paying interest on reserves immediately.

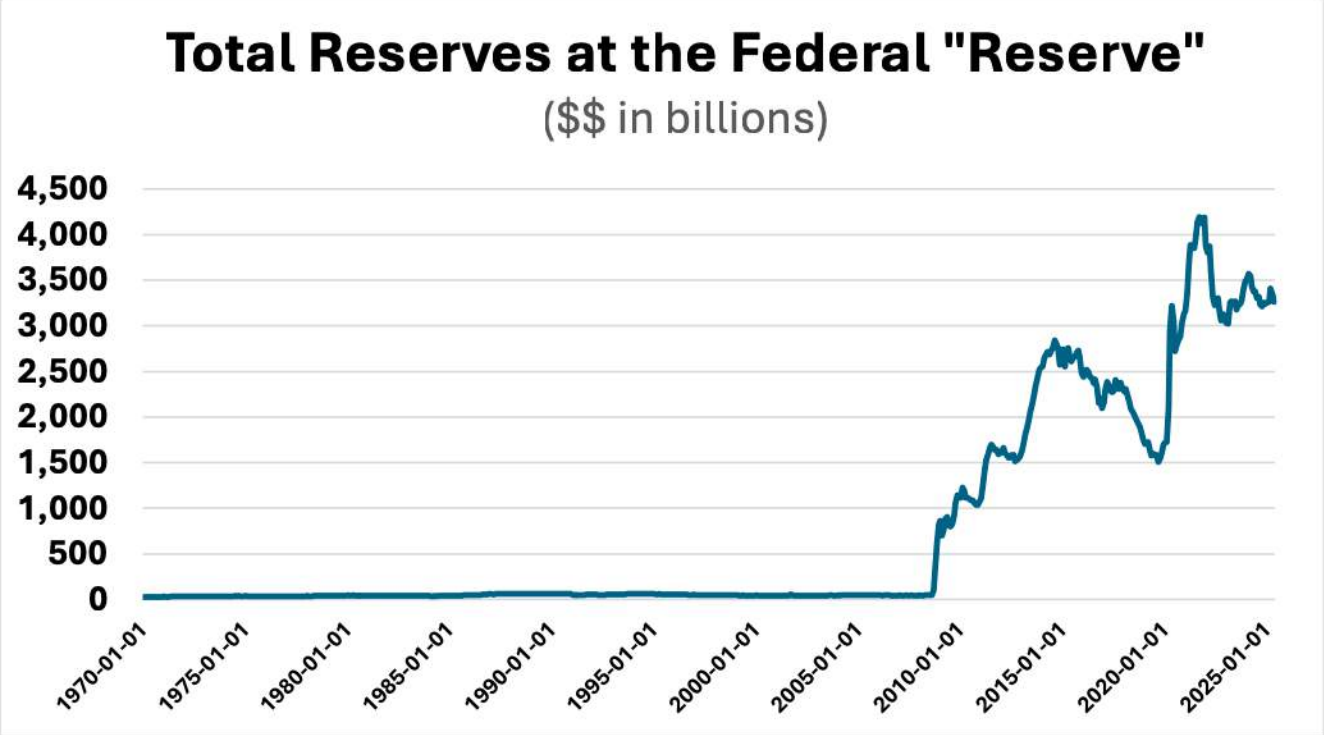
Here's a look at daylight overdraft credit from 1994 to 2024. The amounts shown are peak daily amounts, calculated for two-week intervals. The massive spike in the middle of the chart, to an amount reported at $275 billion, arrived in the two-week period ended October 8, 2008 – when the Fed started paying interest on reserves. (Note that these amounts are two-week averages of peak daily amounts).



Daylight overdrafts mushroomed in 2008 as Fed failures in the supervision-and-regulation led to a crisis in money markets. Daylight overdrafts then fell dramatically in late 2008, as reserve balances galloped higher with QE and the incentive banks had to maintain high reserve balances with the new October 2008 practice of paying interest on reserves. Reserve balances averaged around $50 billion in the first eight months of 2008, and then rose dramatically to more than $800 billion by the end of the year.



These interest-bearing balances (and interest paying balances, for the Fed) have since risen north of $3 trillion.



Back in late 2008, when the interest rate paid on reserves fell from 1% to 0.25%, the implied annualized interest expense for the Fed was under $5 billion. However, at today's levels, with reserves north of $3 trillion and the interest rate paid on reserves at about 4.5%, well, things add up in a hurry. This is the key factor leading to the large cash operating losses now accumulating in the Federal Reserve Banks.

How are these losses related to Fedwire accounting and the issues I raised in the early 2000s? Back in 1999, Congress passed the "Gramm-Leach-Bliley" law, formally the Financial Services Modernization Act of 1999. This law allowed banks, securities firms and insurance companies to effectively consolidate under the umbrella of a "financial services holding company." The Fed was pressing its case for taking lead regulatory responsibility for these new holding companies. That case included expression of apparently heartfelt concern the Fed's leaders had for the moral hazard implications of the "safety net" provided to the financial system. The Fed's leaders, including its then-chairman Alan Greenspan, testified to Congress that access to Fedwire-guaranteed payments provided a subsidy given the Fed's assumption of risk on the system.

Trouble is, the Federal Reserve had been accounting for its payment services, including Fedwire, to measure its compliance with cost-recovery mandates for its priced payment services like Fedwire. In the Monetary Control Act of 1980, the Congress first directed the Fed to fully recover all direct and indirect costs of its payment services, and thereby refrain from subsidizing banks on Fedwire. And every year since 1980, the Fed produced accounting statements "proving" that its revenues were exceeding expenses on its payment services, and therefore, the Fed was faithfully living up to Congressional directive not to subsidize banks.

How could we say that we are subsidizing banks when we are also saying we are not subsidizing banks? That's the question I posed to my favorite economics professor at the University of Chicago when I was working as a financial markets policy analyst at the Federal Reserve Bank of Chicago in the late 1990s/early 2000s. He responded "It sounds like you are talking out of both sides of your mouth." I asked the same question to a senior Chicago Fed officer, after I was summoned to his office to discuss how I was invited to present the paper in Washington by the former White House Counsel to President Ronald Reagan. That Fed officer responded "You are calling the chairman a two-talking criminal! … You can drop this and move on, or do this, and really move on."

In more recent years, defending the practice of paying interest on reserves, some Fed economists have argued how the new "ample reserves" regime -- incentivized importantly by the Fed paying interest on risk-free balances – helps to insulate the Reserve Banks from the risk of loss on daylight overdrafts. Those were the amounts flowing north of $200 billion a day at peak amounts in the 2008 financial crisis, right before the Fed started paying interest on reserves.

So, today, we have the Fed incurring massive losses driven by the Fed paying interest to banks for the privilege of reducing the risk they pose to the Fed, instead of charging banks to

fully recover the cost of guaranteeing daylight-overdraft funded Fedwire payments. And the Fed is accumulating losses in a dubious asset that helps it keep from reporting a negative capital position on its balance sheet. Yet the Fed's balance sheet has significant consequences for the federal government's fiscal condition, and in turn, taxpayers. The Fed is effectively masking its true net position, keeping it from showing a negative number like the "zombie banks" that Edward Kane identified. Ironically, the Fed is able to do so using accounting policies it drafts for itself while asserting the value of central bank "independence."

The Fed asserts that its losses need not impair its ability to conduct monetary policy. If they are indeed irrelevant, however, why does the Fed choose to implement strange accounting policies that keep it from reporting red numbers in the net position for the Reserve Banks? The Fed and its defenders have stressed a broader related theme that central bank profitability need not necessarily matter for central bank operations. Central bank profitability certainly matters for the deep pockets – taxpayers – that effectively stand behind the central bank, however. Taxpayers may have to provide higher future resources explicitly, or implicitly through taxes imposed by inflation.

Quantitative easing and payment of interest on reserves have generated large, continuing and hard-to-forecast future Fed losses, but the Fed's accounting currently helps to ensure that it will not show a negative net financial position. The Fed's dubious accounting is not without precedent. In fact, the Fed's accounting for cost recovery on Fedwire back in the 1990s and early 2000s arguably erected a moral-hazard-driven "pay no attention to the man behind the curtain" dynamic responsible in part for the 2008-2009 financial crisis and today's large Fed losses. I share below the draft paper I was invited to present at in Washington D.C. in early 2002 by the former White House Counsel mentioned above. This is the paper I was told "You can drop this and move on, or do this, and really move on." It is titled "Fedwire: A Subsidy That Fully Recovers Its Cost?"

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Fedwire®:

A Subsidy That

Fully Recovers its Costs?

Bill Bergman

ABSTRACT

The Federal Reserve provides payments services to depository institutions. The Fedwire® system is the largest such service in terms of dollar volume. Total volume on Fedwire regularly exceeds $1 trillion on a daily basis.

In recent years, the Board of Governors of the Federal Reserve System has regularly affirmed that fee revenue fully recovers the costs of providing payments services, including Fedwire, as required by the law. Over the same interval, however, speeches and testimony by members of the Board of Governors have identified Fedwire as a source of subsidy for depository institutions.

Fedwire is indeed a source of significant subsidy. Pricing, payments system risk and accounting policies prevent the Federal Reserve from meeting cost recovery requirements identified by the Board of Governors as flowing from federal law. The Federal Reserve should implement a new credit measurement and cost accounting system in order to set a new price schedule achieving full cost recovery.