Warsh & Fed B/S: more bark than bite

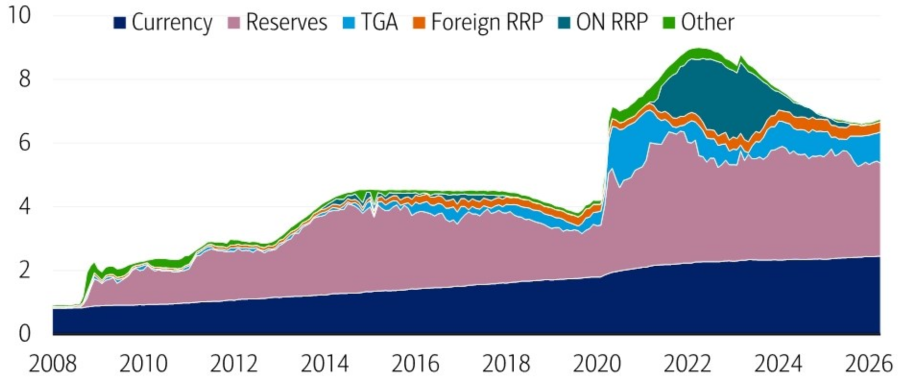
Key takeaways

- Warsh is Fed B/S critic; he won't change much. Focus on (1) size (2) composition
- Size = big drop unlikely. Composition = Fed UST WAM shorter but won't matter much
- Blue sky: bank SRP at IOR + reporting changes = reserve buffer drop. Blue sky may be more impactful vs conventional views

By Mark Cabana & Katie Craig

Exhibit 1: Fed balance sheet liabilities ($tn)

Currency, reserves, and TGA make up the largest shares of the Fed's liabilities



Source: Bloomberg

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Warsh & Fed balance sheet: all hat, almost no cattle

Kevin Warsh is now Senate confirmed as the new Fed Chair. A frequent client Q: "what will Warsh do on the Fed balance sheet?" Our A: "not much". We elaborate below.

Clients should focus on 2 aspects of Fed sheet: (1) size (2) composition. Size likely won't change much, composition will. We expect neither to matter much for markets.

Size: after Fed sheet normalized in Q4 '25, total size now determined by liabilities (Exhibit 1). The Fed has 3 big liabilities: (1) currency (2) TGA (3) reserves. Warsh will likely only be able to marginally move needle on reserve demand via liquidity de-reg.

Composition: Warsh will keep letting MBS reinvest in UST bills. He will likely accelerate Fed UST WAM reduction. UST unlikely to offset WAM impact, so market impact = nil.

Most important Q: Warsh reserve regime preference: ample or scarce? Our A: ample.

Blue sky: we propose new Fed regime with bank SRP=IOR. It could move needle.

Bottom line: Warsh impact on Fed B/S will be small & have minimal impact on markets.

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Warsh & Fed B/S: size & composition

Incoming Fed Chair Warsh is a longstanding critic of the Fed balance sheet. We expect he would quickly establish "working groups" to examine ways to shrink Fed sheet. Warsh will try to impact 2 parts of Fed B/S: (1) size (2) composition. Market impact likely small.

Fed balance sheet size

Central bank balance sheet sizes, once right sized, are determined by their liabilities. The Fed right sized its sheet via QT until money markets reflected tightness in Q4 '25.

To reduce sheet further the Fed needs to shrink one of its key 3 liabilities: (1) currency (2) TGA (3) reserves. We offer thoughts (TL;DR: reserves are the only shot; Exhibit 2).

Exhibit 2: Fed balance sheet composition ($bn)

Fed assets = mostly UST assets, Fed liabilities = mostly reserves + currency

	Assets			Liabilities					
Total	USTs	Agy MBS	Other	Reserves	Currency	UST Cash Balance	Foreign RRP	ON RRP	Other
6779.9	4450.2	1981.1	348.6	3117.4	2458.0	807.4	322.6	3.7	70.7
%	66%	29%	5%	46%	36%	12%	5%	0%	1%

Source: Bloomberg

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Currency: central banks believe currency is an "exogenous" liability. Exogenous liabilities are beyond the central banks control. To reduce currency the Fed could tax or eliminate currency / large denomination bills (ECB cut EUR500 notes). It won't happen in the US.

TGA: UST cash balance could be reduced. UST has signaled minimal interest or desire to reduce TGA (TGA expected to rise: end Q2 $900b, end Q3 $950b). UST could consider marginal adjustments, such as excess cash investment in repo or TT&L (see: TGA repo investment & TT&L). TGA repo may happen but impact small. TT&L very unlikely.

Reserves: lower reserves are Warsh best shot to reduce sheet. There are 2 conventional ways for Warsh to reduce reserves (1) bank unfriendly (2) bank friendly.

Bank unfriendly: Warsh can tell banks that reserves are capped or tiered (tier = some reserves not fully paid IOR). Reserve caps or tiers would make banks sub-optimally liquid. Sub-optimally liquid banks likely less willing to take risk (i.e. less market making, less loan growth willingness). Less bank risk = slower economy. Warsh unlikely to do it.

Bank friendly: Warsh likely to pursue bank friendly ways to reduce reserve demand via de-reg. This will include allowing banks to pre-pledge collateral to Fed discount window for instant monetization. Pre-pledging collateral will expand bank HQLA. More HQLA = fewer reserves needed. We estimate reserve drop of $200-500b (~10% total) & slow.

Bank friendly approach will shift the "reserve demand curve". Lower reserve demand will first put downward pressure on funding (Exhibit 3). Fed can later grow sheet slower / reduce sheet to normalize funding (Exhibit 4). Importantly, bank de-reg reserve demand drop will not tighten fin conditions (FCI). If no FCI tightening, no need for rate cuts.

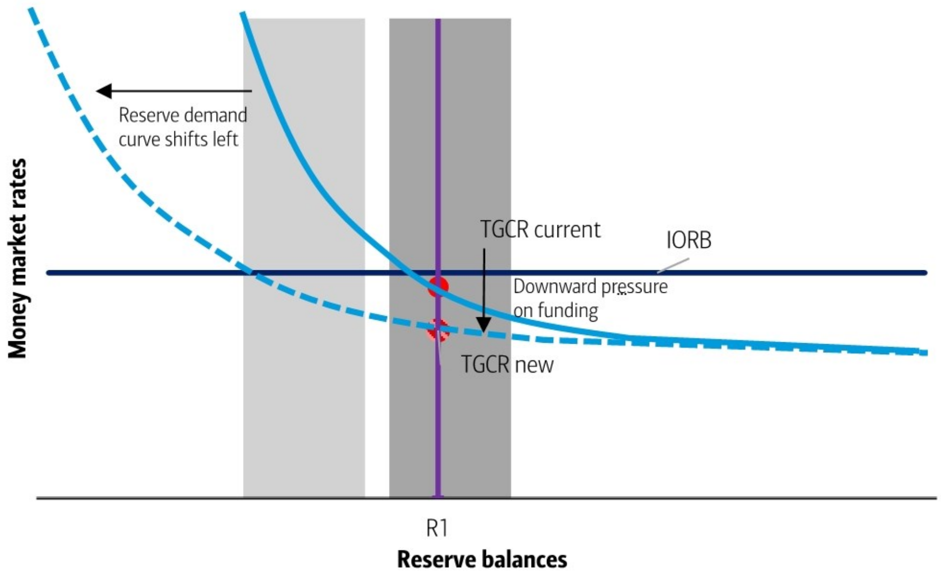
Other: foreign repo pool adjustment is possible but small peas. Warsh could lower or cap foreign RRP rate to push cash out of Fed into repo or bills. We have long argued this would diminish USD reserve currency status & hurt national interest (see: RRP & national interest). Warsh may see smaller sheet > national interest. We advise otherwise.

Warsh will also likely have a high bar to intervene in disorderly markets. His initial intuition is likely to remain out of markets but could be forced to act depending on extent of market dysfunction (he did support Fed emergency actions post GFC). Warsh market invention bar will be high but not insurmountable depending on shock extent.

Size summary: Warsh likely to find Fed B/S reduction hard via conventional means. Best shot is via bank liquidity de-reg, impact modest & slow. Liquidity de-reg & initial funding ease will not justify Fed rate cuts. Blue sky may be more impactful or Fed B/S reduction.

Exhibit 3: Stylized Fed reserve demand and supply curves if reserve demand curve shifts left

If reserve demand curve shifts left due to de-reg, it will place downward pressure on funding rates



Source: BofA Global Research. Note: Dark gray shaded area signifies "ample" reserves in current reserve demand environment, light gray in new reserve demand environment.

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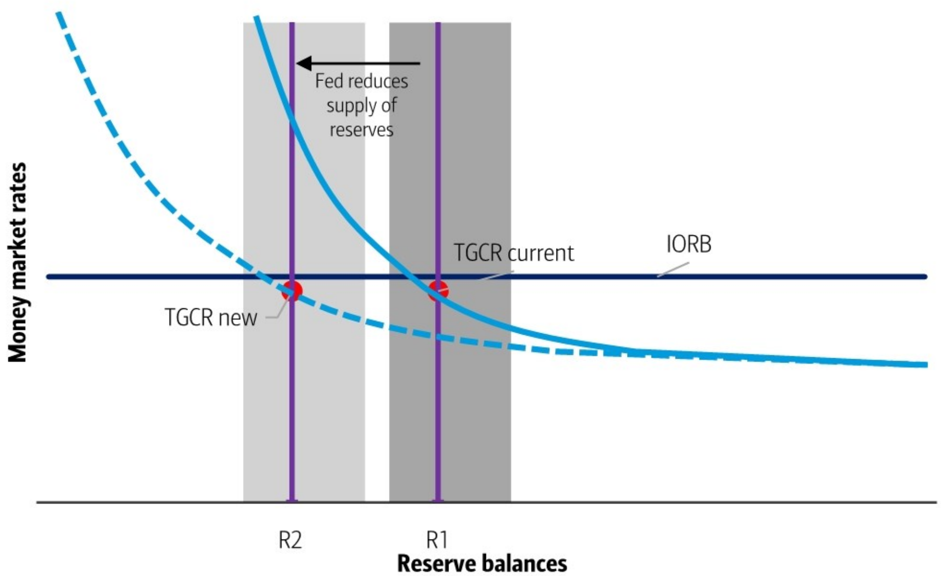
Exhibit 4: Stylized Fed reserve demand and supply curves if reserve demand curve shifts left and Fed reduces supply of reserves

If funding rates decline, the Fed can reduce the supply of reserves and bring money market rates back up to IORB but maintain "ample" reserves



Source: BofA Global Research. Note: Dark gray shaded area signifies "ample" reserves in current reserve demand environment, light gray in new reserve demand environment.

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Fed balance sheet composition

Warsh will also likely further adjust the composition of Fed assets in two ways (1) return to mostly Treasury portfolio (2) shorten WAM of Fed's UST holdings. Both are happening now. Warsh likely to speed WAM shortening, but it won't impact markets b/c mechanics.

Mostly UST portfolio: Fed is slowly reducing their $2tn in MBS at a pace of $10-$20b/m by allowing maturing and prepaid MBS to roll-off & reinvest in T-bills. Fed unlikely to sell MBS (unless they were bought directly by Fannie or Freddie, which we see as low likelihood). Fed MBS roll-off practice to remain & is well priced by markets.

WAM: Fed is shortening WAM by purchasing T-bills via RMPs and MBS reinvestment (Exhibit 5). Warsh can speed Fed UST WAM reduction by shifting maturing coupon reinvestments into shorter-dated tenors (we assume 2-3y coupons in Exhibit 5). Warsh WAM shortening highly unlikely to see Fed asset sales. Market impact = small.

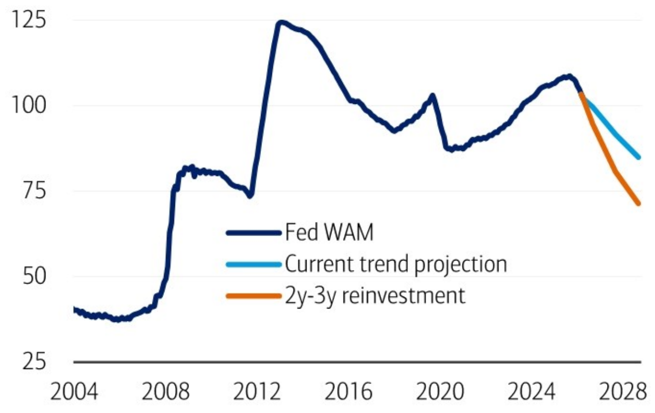
Market impact will be small due to WAM shortening mechanics. Recall, Fed UST coupon maturities are currently reinvested at auction into new-issue USTs. Fed reinvestment is proportional to UST auction amounts, thereby investing in-line with UST market. The Fed matches maturing USTs with USTs that settle on same day (i.e. mid-month maturities invested in 3/10/30Y USTs, end-month maturities invested in 2/5/7Y USTs).

Warsh will likely change this process by reinvesting in the shortest tenor new issue UST coupons. For example, in a mid-month settlement Fed will no longer rollover into 3/10/30Y issues but instead reinvest in all 3Y notes (example in Exhibit 6). Importantly, Fed reinvestments are an "add on" at auction. "Add on" means that the total size & composition of UST debt outstanding is increased by size of the Fed reinvestment.

The Fed's "add on" into 2 or 3Y notes will shorten WAM of total UST market. The key Q then becomes: will the US Treasury offset the mechanical UST WAM shortening from Fed reinvestments? Our A: no. If we are right, Fed WAM shortening has zero impact on UST market or fin conditions. No FCI impact = no reason for Warsh to cut rates.

Composition summary: Fed B/S composition changes are unlikely to matter for markets. The MBS maturity & reinvest practice already in place & priced. Fed shortening of their UST WAM will not have a market impact unless Bessent surprisingly offsets.

Exhibit 5: Fed WAM and WAM projection scenarios (months)
Fed WAM has already started to decline due to RMPs and MBS reinvestments into T-bills but shifting coupon reinvestments into short-dated tenors would speed up this decline



Source: BofA Global Research, FRBNY

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Exhibit 6: Stylized example of Fed reinvestment practice ($bn)
Fed current invests pro rata across curve, we expect this will be shortened

Current Practice			Future Possible Practice		
UST Auction Size			UST Auction Size		
3Y	10Y	30Y	3Y	10Y	30Y
50	25	25	50	25	25
Fed Maturing			Fed Maturing		
10			10		
Fed UST Auction Add On			Fed UST Auction Add On		
3Y	10Y	30Y	3Y	10Y	30Y
5	2.5	2.5	10	0	0
UST Size Outstanding			UST Size Outstanding		
3Y	10Y	30Y	3Y	10Y	30Y
55	27.5	27.5	60	25	25

Source: BofA Global Research

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Warsh big Q: ample or scarce? Our A: ample, all the way

Most important Warsh B/S Q (to us): does Warsh support ample or scarce reserves? Our A: ample. Recall, Fed definitions of ample & scarce, for a given move in reserves: ample = limited money market movement; scarce = large money market movement.

We strongly believe Warsh would support ample; if not, he would likely be forced to support it. Ample benefit = easy to implement, ensures banking system flush with cash, limits money market volatility, & supports modestly easier financial conditions. Ample cost = slightly larger balance sheet. Scarce benefits & costs are opposite of ample.

We expect Warsh will support ample because it underpins easy financial conditions. We believe Trump cares much more about easy financial conditions than size of Fed B/S. Warsh expected to have open ear for Trump policy preferences.

Warsh will likely be forced to accept ample by rest of Fed. The Fed formally adopted an ample reserve regime in 2019 and all members of Fed leadership support. Some are quite vocal & colorful in support. Specifically, Fed Governor Waller reportedly said in a NABE Feb '26 speech: "You don't want banks searching under sofa cushions for money every night… That is incredibly inefficient and stupid." Quote last word stands out to us.

Ample vs scarce summary: Warsh very likely to support ample.

Blue sky: set bank SRP = IOR to reduce reserve buffer

Warsh will likely be looking for other ideas to reduce the balance sheet. We offer a novel approach, which Dallas Fed President Logan has previously referenced: **bank SRP = IOR**.

Our idea: bank SRP = IOR. Banks could borrow cash from the Fed using UST or agency collateral at a level equal to their deposit rate. We see bank SRP open throughout the day, like discount window (no discrete operation times). It would allow banks to monetize UST or agency paper at a market rate & hold less reserve buffer. Banks likely willing to use SRP at IOR b/c more cost efficient v today & less stigma b/c at market. The Bank of England currently operates policy in this way (see: Global plumbing primer).

To be most effective the Fed could further reduce stigma by changing reporting. Specifically, the Fed could remove the weekly reporting practice that shows reginal Fed district reserve distribution. When Fed liquidity tools are tapped the street uses the weekly regional Fed reserve distribution data to narrow in on firms that may be in trouble. Removing this reporting requirement would make bank SRP=IOR more effective.

Bank reserve buffer can be reduced via (1) bank SRP=IOR (2) stigma reduction. Reserve buffer is dropped b/c banks have more attractive terms to monetize USTs or agency paper. Monetizing via always open SRP also improves intraday liquidity options. Reduced reserve demand can then allow Warsh to shrink Fed sheet.

Note: we see an important distinction between bank SRP & dealer SRP. Our comments above are focused on bank SRP, i.e. commercial bank SRP access. We expect dealer SRP to be treated differently. We would expect dealer SRP at 5-10bp above bank SRP & IOR. Dealer SRP > bank SRP b/c (1) banks tend not to lend in repo unless 5-10bp > IOR (2) dealer SRP > IOR would allow more room for free repo market trading.

Blue sky summary: bank reserve demand can be reduced by (1) bank SRP=IOR (2) Fed reporting change to reduce stigma. It's not widely discussed now, we think it will be.

Bottom line: Warsh B/S bark worse than bite. Warsh unlikely to meaningfully reduce Fed B/S size; he will adjust Fed B/S composition but it shouldn't impact markets. Warsh will likely support ample. Blue sky ideas are possible: bank SPR=IOR could be effective.

Acronym list:

TGA: Treasury general account

SRP: standing repo

IOR: interest on reserves

TL;DR: too long, don't read

HQLA: high quality liquid assets

RRP: reverse repo

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- **Global Rates Year Ahead 2026** – When carry met rally, 25 November 2025
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- 2025 reflections **Liquid Cross Border Flows**, 8 December 2025

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