THREE ON THURSDAY

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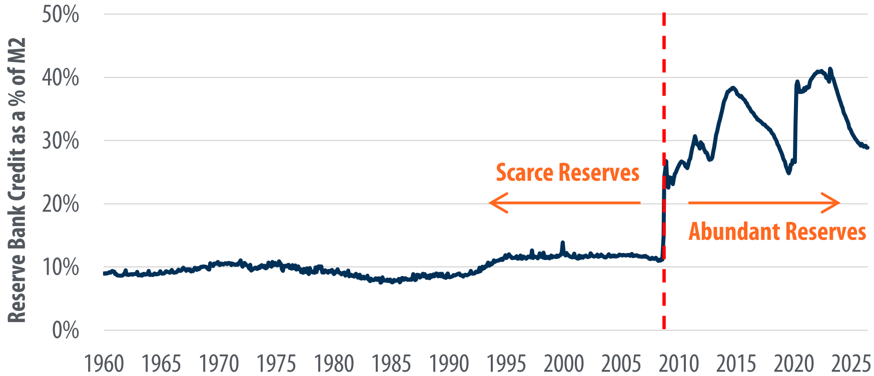
Can Warsh Shrink the Fed's Balance Sheet?

The Federal Reserve's (the "Fed") role in financial markets changed dramatically following the 2008 Financial Crisis. Quantitative Easing (QE) and the shift to an abundant-reserves system transformed the Fed from a relatively modest market participant into one with a multi-trillion-dollar balance sheet and an outsized financial-market footprint. New Fed Chairman Kevin Warsh has long argued that this footprint has grown too large, potentially distorting markets and blurring the line between monetary and fiscal policy. His arrival has renewed the debate over whether the Fed can shrink its balance sheet, reduce the supply of reserves, and still maintain effective control over short-term interest rates. This week's "Three on Thursday" examines the evolution of the Fed's role in the banking sector, its current state, and the challenges that could stand in the way. View the three charts below for a deeper understanding.

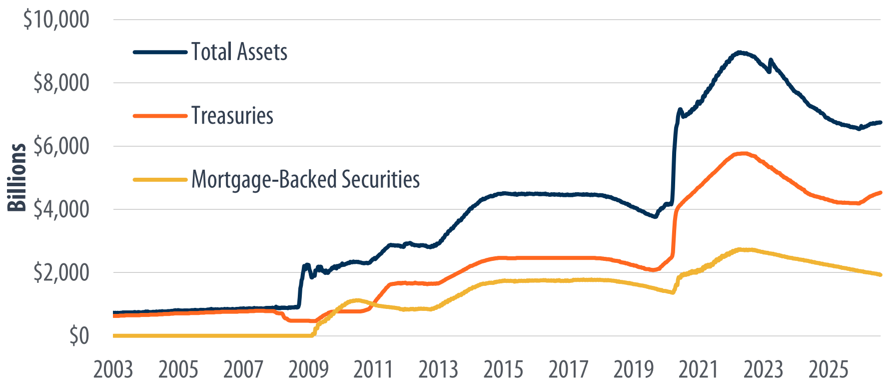
Federal Reserve's Footprint in the U.S. Banking Sector



Source: Federal Reserve Board, First Trust Advisors. Monthly data 1/1960 - 6/2026.

Before the 2008 Financial Crisis, the Fed operated under a "scarce reserve" model to manage monetary policy. For decades, bank reserves held at the Fed were roughly 10% of bank deposits (measured by the M2 measure of the money supply in the chart – a broad measure of money that includes currency, checking and savings deposits, and other highly liquid assets). Because reserves were scarce, relatively small purchases or sales of Treasury securities could influence their supply and, in turn, short-term interest rates. Adding reserves eased monetary policy, while draining them tightened policy. This changed with QE, as the Fed bought bonds with newly created reserves, dramatically increasing the amount of liquidity in the banking system. Under today's abundant reserve model, reserves are roughly 30% of M2, and the Fed relies heavily on the interest rate it pays on reserve balances to keep the federal funds rate near its target. Warsh has been a vocal critic of this expanded Fed footprint and has argued for a smaller balance sheet and a monetary system less dependent on abundant reserves, which he believes would reduce the Fed's influence over financial markets.

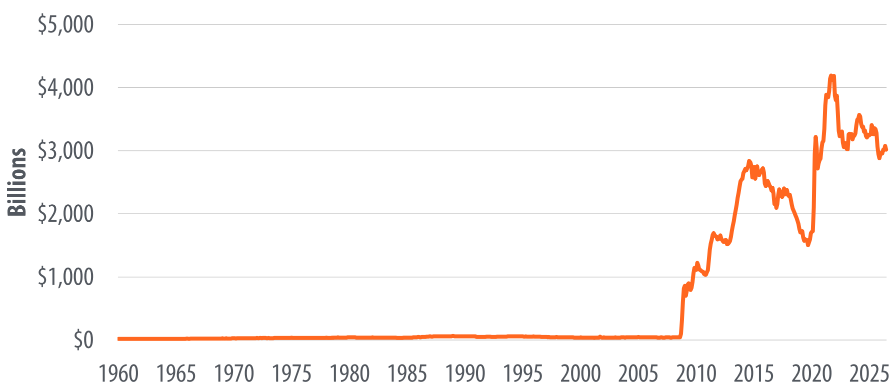
Federal Reserve Balance Sheet



Source: Federal Reserve Board, First Trust Advisors. Weekly data 1/1/2003 - 8/5/2026.

Although Warsh has advocated for a smaller Fed balance sheet, recent developments have moved in the opposite direction. After peaking near $9 trillion in 2022, Quantitative Tightening (QT) reduced total assets by roughly $2.4 trillion to about $6.5 trillion by the end of 2025. Even then, the balance sheet remained more than 50% above pre-COVID levels, and more than 7 times the size pre-Financial Crisis. Since QT ended, that progress has begun to reverse. In late 2025, the Fed launched "reserve management purchases," buying roughly $40 billion of Treasury bills per month, which the Fed says is needed to accommodate the banking system's growing demand for reserves and maintain what it considers an "ample" level of liquidity. This has pushed total assets back to $6.75 trillion as of last week, even as mortgage-backed securities continue to run off, falling to about $1.93 trillion. Warsh may favor a smaller Fed footprint, but unwinding nearly two decades of balance sheet expansion will be far easier said than done.

Reserves Held at the Federal Reserve



Source: Federal Reserve Board, First Trust Advisors. Monthly data 1/1960 - 6/2026.

With the advent of reserve management purchases, the natural question is: how much is "ample"? The irony is that even the Federal Reserve admits they don't know the precise answer. Before the 2008 shift to an abundant reserve framework, bank reserves held at the Fed averaged roughly $30-50 billion for decades. Today, they stand just over *$3 trillion*, roughly double their pre-COVID level, and over sixtyfold more than their pre-Financial Crisis level. Why do banks need so many reserves today? One major reason is regulation. Post Financial Crisis liquidity requirements have encouraged banks to hold significantly more high-quality liquid assets, including reserves. Fed Governor Stephen Miran has called this "regulatory dominance," arguing that regulation itself has increased banks' demand for reserves and, in turn, forced the Fed to maintain a larger balance sheet. If Warsh wants a smaller Fed balance sheet, he may ultimately have to shrink its regulatory footprint first.