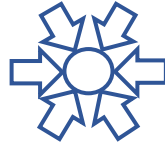


Monetary Policy is More than Interest Rates: The Strategic Impact of Federal Reserve Reform



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- Structural reform of the Federal Reserve sets the terms and conditions on which regulatory and supervisory reform will proceed.
- Indeed, no single decision has as much immediate bottom-line impact as whether or not the Fed continues to pay interest on bank reserve balances and/or retains the ONRRP.
- New policy sharply reduces the odds of emergency-liquidity support outside the discount window, making its operability a still more pressing concern.
- Treasury Secretary Bessent is clear on the Fed model he prefers and he has the direct and indirect authority to achieve it.
- Look for structural change starting in 2026.
- Structural change to Fed supervision is likely in concert with pending changes to examination practice.
- Pending changes to the Federal Reserve Banks could lead to new policy opening master accounts to nonbanks.

Thank you, Ursula, and what a pleasure to join you opening at this important conference. I know you've a full agenda with leading regulators and industry counsel that will consider the raft of major regulatory and supervisory rewrites already well underway in the Trump Administration. But, you all may not be as familiar with the broader context in which Treasury influences these decisions – now subservient to its wishes¹ – and how a new monetary-policy vision is Treasury's prime directive. As a result, I'll lay out how Treasury wants to redesign the Federal Reserve, why it may well get much of what it wants, what that means to your banks, and what you can do about it.

The New Federal Reserve

I will not take time this morning to run through the drama surrounding Stephen Miran's addition to the Federal Reserve Board and White House efforts to expel Lisa Cook from this once-hallowed institution. These are important actions, to be sure, but the drama surrounding them distracts from structural changes with considerably more near-term impact on your banks than any reduction in Federal Reserve independence, much as that is to be deplored when it comes to monetary policy.

Structural reform of the Federal Reserve is a top Treasury priority, and Treasury has the power to get much of what it wants. Unlike many recent Secretaries, Secretary Bessent is focused on the Fed, making his monetary-policy thinking known in a September 5 op-ed in the *Wall Street Journal*² and a longer article in the latest issue of *International Economy*.³ I base my comments on what's to come from the views clearly expressed in these articles and other Administration discussions. Full disclosure: I agree with much of Mr. Bessent's thinking and not just because he cites my book on economic inequality and Fed policy.⁴

Mr. Bessent's target is what he calls "gain of function" central banking. Here, he deploys a term usually used to describe viruses modified to make them more lethal to central banking in order to lay out plans for a Federal Reserve cut back in size, impact, and powers. The imagery is a bit conspiratorial, but the analytics are sound.

Given that you are all lawyers, I'll note that this proposal rests, like CEA Director Miran's confirmation testimony,⁵ on what I believe to be a far better read of the Federal Reserve Act than the one put out by the Fed. In recent years, it has repeated its adherence to what it calls the "dual mandate," but the law in fact mandates three objectives: maximum employment, price stability, and "moderate long-term interest rates."⁶ The 1977 and 1978 revisions to the Fed mandate further define these terms to incorporate in "maximum employment" a goal related to "real income" and, when it comes to price stability, one focused on household purchasing power.⁷ What's more, the 1946 law still governing the Federal Reserve requires it to serve the "general welfare" of the nation in concert with the goals of the rest of the federal government.⁸

One could of course debate this interpretation of the law, but what matters now is what Mr. Bessent thinks it says and what he and the Trump Administration's members of the Board of Governors plan to do about it.

Cutting the Fed Down to Size

Mr. Bessent firmly believes that the Fed's huge portfolio gives it far, far too much influence over financial markets, fiscal policy, credit allocation, and economic equality. As he notes, it has also led to a cumulative \$700 billion loss to the Fed because it pays banks more on reserve assets than it earns on its massive balance sheet.⁹

Several Republican senators have also taken strong exception to these interest payments,¹⁰ but there is almost no recognition on the Hill that the Fed has also sent billions in earnings to MMFs and certain other nonbanks. This is via the Overnight Reverse Repurchase Agreement Program (ONRRP), a quasi-reserve facility the Fed set up in 2014 when IORB was failing to put the intended floor under short-term rates. The ONRRP is a floor under the floor – yet another clear testament to how badly monetary policy works as currently designed even though the Fed essentially ratified its model at the end of August.¹¹ If Banks lose

IORB but the ONRRP remains open, billions could flow to nonbanks, putting banks at a still greater disadvantage, especially under stress.

IORB isn't Mr. Bessent's *bête noire*, and he is well aware of the ONRRP's quixotic presence on the Fed's balance sheet. What really bothers him is the huge Fed portfolio and its dramatic impact, all of it unintended and none of it to the benefit of effective monetary policy. In its most recent framework statement, the Fed failed to do more than stand by the need for "ample" reserves without defining what this means or why it needs them.

The Treasury Secretary doesn't need legislation to force a rollback, noting that the fiscal impact of the Fed's balance sheet invades Treasury's traditional turf and warrants immediate retrenchment.¹² He can and I think will order portfolio reductions as quickly as he thinks this possible without threatening Treasury markets or rapidly driving up interest rates. As a result, banks can't count on IORB at present levels for much longer unless they make a convincing case to Treasury that returning the Fed to its traditional open-market monetary-policy model would be unduly risky.

You may not care all that much about this, but your treasurers fervently want the portfolio to be as big as possible so they can park capital-advantaged funds at the Fed that serve many regulatory purposes and earn banks \$186 billion a year in interest on reserve balances.¹³ No single federal action I know has the bottom-line impact of Fed-portfolio policy.

Closing the Window

Mr. Bessent also firmly believes that central banks should adhere to the famous Bagehot dictate that lender-of-last-resort liquidity should come as infrequently as possible, at a high price, and only to banks with demonstrable viability.¹⁴ What does this mean in practice and thus how best to plan for emergency liquidity?

Ever since 2008, the Fed has practiced "socialism for investors, capitalism for everyone else." Look, for example, at the misery visited on homeowners following the crash in comparison to the billions in backstops that bailed out all financial institutions of size along with debt and equity markets. In an effort to forestall this, Congress in 2010 added Treasury approval as a prerequisite for central-bank emergency liquidity outside the discount window.¹⁵ Panicked by the 2020 pandemic, Treasury in Trump I went along with trillions in emergency liquidity across the financial market when the pandemic struck. The Biden Treasury Department also blessed the far less urgent Bank Term Funding Program in 2023.

This won't happen again in Trump II, absent the equivalent of a nuclear strike in the global financial market. Even if Trump appointees on the FRB want to go back to the good old days of open windows, this Treasury will not approve any 13(3) facility that does not follow the Bagehot dictum and, even then, is indisputably required to prevent catastrophe. This is, I fear, more likely because decades of ready backstops have led to embedded moral hazard, sharply increasing the odds of a "Minsky Moment" – i.e., a sudden run for the exit after it's closed.

What can you do about this? First, ensure your bank is discount window-ready so that it's eligible for emergency liquidity support that does not require Treasury approval.

Second, since the Fed is notoriously bad at keeping the window open, advocate for rapid operational improvement and 24/7 FedWire access. The Fed is thinking all this through in its years-long, cautious

fashion.¹⁶ It needs to do more and do it a lot faster, including with regard to modernizing your liquidity rules to give you a needed buffer of discount-window liquidity under acute stress scenarios.

I used to oppose this on grounds that banks should stand on their own feet, but banks have a special mission and unique access to the central bank for which they pay every day in all the rules you know all too well. Banks have earned the right to backstops; nonbanks haven't, and the more they get them, the more investors discount risks in private credit, PE, and the hedge funds that can roil financial markets in no time at all thanks to comfortable expectations that the Fed stands behind even the highest-risk, super-leveraged financial institutions and assets.

The Fed's Regulatory Footprint

Mr. Bessent is similarly scathing when it comes to the Fed's regulatory and supervisory expertise. He wants the Fed out of these businesses, and not just because he thinks the central bank isn't good at them. As he says:

The core problem is structural: the Fed now regulates, Lenz's to, and sets the profitability calculus for the very banks it oversees. This is an unavoidable conflict that blurs accountability and jeopardizes monetary policy independence...Monetary policy [has] become hostage to supervisory self-interest.

This is a harsh judgment, assuming some intentionality on the Fed's part when it failed so many supervisory tests in recent years. But Mr. Bessent isn't about second chances. Nonetheless, the cure to these ills is, he says, turning bank supervision and regulatory duties over to the OCC and FDIC. This takes new law, but building a higher firewall at the Fed between its supervisory and monetary-policy duties can be done by edict and I think it will be instituted to the greatest extent possible under current law by the Fed's next chair in full consultation and even under direction of the Treasury Department.

This will accelerate solutions many of you seek, but a warning: supervision subject to political will can be also subject to political whim. Sound barriers need to be established to give elected authorities and their administrators a voice in how supervision is done, but not who is supervised how.

Bye-Bye, Reserve Bans?

There is no question that the Reserve Banks' structure is anachronistic. This is true not only due to the indisputable fact that the money centers of 1913 in which Banks reside are nothing close to current financial centers and population distribution. Congress created the geographic system and made it a public-private hybrid to ensure full representation of the voices of American farmers and small businesses as well as to contain the "Wall Street" financial and corporate powerhouses both progressives and populists feared would otherwise dominate monetary policy and the availability of discount-window loans, created not just as liquidity backstops, but also to provide seasonal lending to keep farmers on their feet. Time for a new gig.

The 1913 Act also put five rotating Federal Reserve Bank presidents on the Federal Open Market Committee to add diversity reflecting ground-level economic reality, but no Reserve Bank President has cast a dissenting vote since 2010, when then-Kansas City Fed President raised the same concerns about the Fed's huge portfolio that bedevil us to this date.¹⁷

As the Fed's payment-system role increased, regional centers were also essential to the processing and transport of paper-based payments and for the public-sector infrastructure investment essential to establishing a nationwide electronic system. Tens of thousands of small banks also needed nearby examiners in the days before effective nationwide transport and communications.

That, of course, was then. Now, the Board of Governors dominates the Reserve Banks, which are increasingly only operational centers for the payment system and regional centers of financial and economic research. The Reserve Banks do, of course, also supervise banking organizations in their districts, but the conflicts of interest and flat-out incompetence of the way this was done as late as 2023 has led to still more centralization in Washington without, as far as I can tell, much improvement.

Top-down changes in Fed supervisory policy are underway,¹⁸ but this does not satisfy Mr. Bessent or, for that matter, Members of Congress on both sides of the aisle. As you know, payment-system access is one of the hottest challenges facing your banks as stablecoin issuers take advantage of the "GENIUS Act"¹⁹ and Treasury joins other federal policy-makers in building President Trump's "golden age of crypto."²⁰ Under the President's executive order,²¹ payment-system operations fall outside the protections from Executive Branch interference that insulate monetary policy to at least some extent.

In the near term, the White House may simply demand that the Reserve Banks open master-account access. Over time, it and Congress will also try to bring the Banks under far more direct executive-branch control by requiring Presidential appointment and Senate confirmation for Reserve Bank presidents. However, under the current system, all Reserve Bank presidents are up for review and, perhaps, termination in March of this year. Depending on who then sits on the Board of Governors, that could lead to a new Reserve Bank system a lot sooner and a lot different, far more quickly.

Conclusion

In 2017, the Fed was called the "only game in town."²² Markets to this day still look to it, not themselves, to judge risk and anticipate reward. This makes life easier, but it's also riskier – when the Fed gets it wrong, as it does all too often, inflation surges, risks propagate, financial markets grow still more dangerous, and economic inequality is still more pernicious. These issues aren't the lawyerly ones you know, but they're the most acute policy problems your corner offices face.

It's not just how rates drive unrealized losses and net interest margins that matter. It's also how the Fed makes the decisions that drive key revenue sources, set the competitive balance between banks and nonbanks, stifle innovation, and, as Mr. Bessent rightly says, threaten the "body politic."²³

¹ Exec. Order No. 14215, Federal Register 90 No. 35 (February 24, 2025)

<https://www.govinfo.gov/content/pkg/FR-2025-02-24/pdf/2025-03063.pdf>.

² Scott Bessent, "The Fed's 'Gain of Function' Monetary Policy," *Wall Street Journal* (September 5, 2025)

https://www.wsj.com/opinion/the-feds-gain-of-function-monetary-policy-ac0dc38a?st=zMqPxP&reflink=desktopwebshare_permalink

³ Scott Bessent, "The Fed's New 'Gain-of-Function' Monetary Policy," *The International Economy* (Spring 2025)

https://www.international-economy.com/TIE_Sp25_Bessent.pdf.

⁴ Karen Petrou, *Engine of inequality: The Fed and the Future of Wealth in America*, John Wiley & Sons, Inc. (2021).

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- ⁵ Stephan Miran, “Opening Remarks,” *Testimony before the Senate Committee on Banking, Housing, and Urban Affairs* (September 4, 2025) https://www.banking.senate.gov/imo/media/doc/miran_testimony_9-4-25.pdf.
- ⁶ Federal Reserve Reform Act of 1977, Pub. L. No. 95-188, 91 Stat. 1387, (November 16, 1977), available at https://fraser.stlouisfed.org/scribd/?title_id=1040&filepath=/files/docs/historical/congressional/federal-reserve-reform-1977.pdf.
- ⁷ *Id.*
- ⁸ Employment Act of 1946, Pub. L. No. 79-304, 60 Stat. 23, 23 (February 20, 1946), available at <http://www.legisworks.org/congress/79/publaw-304.pdf>.
- ⁹ Bessent, *supra* note 3.
- ¹⁰ Michael S. Derby, “Effort to strip Fed of interest paying power seen likely to bring upheaval to markets,” *Reuters* (June 12, 2025) <https://www.reuters.com/sustainability/boards-policy-regulation/effort-strip-fed-interest-paying-power-seen-likely-bring-upheaval-markets-2025-06-12/>.
- ¹¹ Federal Reserve Board (FRB), “Statement on Longer-Run Goals and Monetary Policy Strategy,” (August 22, 2025) https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf.
- ¹² Bessent, *supra* note 3.
- ¹³ FRB, “Federal Reserve Banks: Combined Financial Statements 2024” (March 21, 2025) <https://www.federalreserve.gov/aboutthefed/files/combinedfinstmt2024.pdf>.
- ¹⁴ Bessent, *supra* note 3.
- ¹⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA), 12 U.S.C. 12 (5301), (2025) <https://www.govinfo.gov/content/pkg/COMPS-9515/pdf/COMPS-9515.pdf>.
- ¹⁶ FRB, “Request for Information and Comment on Operational Aspects of Federal Reserve Bank Extensions of Discount Window and Intraday Credit,” *Federal Register* 89 No. 175 (September 10, 2024) <https://www.govinfo.gov/content/pkg/FR-2024-09-10/pdf/2024-20418.pdf>; FRB, “Expanded Hours for Fedwire Funds Service & National Settlement Service,” *Federal Register* 89 No. 123 (June 26, 2024) <https://www.govinfo.gov/content/pkg/FR-2024-06-26/pdf/2024-14018.pdf>.
- ¹⁷ Liaquat Ahamed, *Lords of Finance: The Bankers Who Broke the World*, Penguin Random House (2009).
- ¹⁸ FRB, “Revisions to the Large Financial Institution Rating System and Framework for the Supervision of Insurance Organizations,” *Federal Register* 90 No. 133 (July 15, 2025) <https://www.govinfo.gov/content/pkg/FR-2025-07-15/pdf/2025-13223.pdf>.
- ¹⁹ Guiding and Establishing National Innovation for U.S. Stablecoins Act of 2025, Pub. L. No. 119-27, S. 1582, 119th Cong. (2025) <https://www.congress.gov/bill/119th-congress/senate-bill/1582>.
- ²⁰ President's Working Group on Digital Asset Markets, “Strengthening American Leadership in Digital Financial Technology” (July 30, 2025) <https://www.whitehouse.gov/crypto/>.
- ²¹ *Supra* note 1.
- ²² Mohamed A. El-Erian, *The Only Game in Town: Central Banks, Instability, and Recovering from Another Collapse*, Penguin Random House (2017).
- ²³ Bessent, *supra* note 3.