Federal Reserve interventions during financial crisis actually worked, study finds

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(Phys.org) —Contrary to popular belief, the Federal Reserve's effort to encourage banks' lending during the recent financial crisis by providing them short-term loans worked—and, in fact, worked quite well—a new study finds.

Jennifer Dlugosz, PhD, assistant professor of finance at Washington University in St. Louis' Olin Business School, worked with colleagues Allen Berger, of University of South Carolina; Lamont Black, of DePaul University; and Christina Bouwman, of Case Western Reserve University.

Examining novel data released after the crisis, they found that banks' increased use of the Fed's Discount Window and Term Auction Facility (TAF) was associated with increased lending to firms and households.

They explain their findings in a recent working paper, "The Federal Reserve's Discount Window and TAF Programs: 'Pushing on a String?'" available through the Social Science Research Network.

"There were many news reports during that time that banks were hoarding cash from government interventions and keeping it for themselves," Dlugosz said. "Our results show, at least in the context of these programs, that was not the case. Banks that received funds did increase their lending."

Since its inception, the Federal Reserve has served as a "lender of last resort" to the banking system,via the Discount Window, by providing temporary, short-term funding to solvent banks experiencing liquidity problems.

In 2007-08, as concerns about subprime mortgages grew, banks found their usual market sources of funding more difficult to come by. In response, the Federal Reserve extended Discount Window loans, reduced the cost of credit and established the Term Auction Facility, which aimed to provide funds in an auction format, to stabilize the financial system and increase banks' lending.

Dlugosz and her co-authors set out to see if this effort worked.

Their study answers three questions:

- Which banks used funds from the Federal Reserve during the crisis?
- Did these funds substitute for or complement other funding sources?
- Did banks use these funds to increase their lending?

Despite the long history of the Fed's role as a lender of last resort, these questions have not been studied previously because the banks receiving funds from the Federal Reserve historically have been kept secret. Information on crisis-time borrowing only became public due to disclosure requirements in the Dodd-Frank Act and Freedom of Information Act requests by Bloomberg News and Fox Business Network.

Dlugosz and her co-authors found that Discount Window and TAF use was widespread. Twenty percent of small banks and more than 60 percent of large banks took advantage of the programs. Some banks relied on the Fed quite heavily, with top borrowers using these programs to fund as much as 5 to 15 percent of assets daily, on average, over the crisis period.

For small and large banks alike, an increase in Discount Window and TAF funding from the Fed was associated with increased lending. Those results held for both short-term and long-term loans, and for virtually all types of lending aside from residential real estate lending.

A common criticism of government support is that it creates "moral hazard." In other words, theere is concern that banks expecting to receive government support will take more risk than they otherwise would.

However, using detailed data on borrower quality and lending terms that's available for a subset of banks in the sample, the study found loan quality stayed the same or improved while contract terms remained unchanged.

More information: The research paper is available online: papers.ssrn.com/sol3/Papers.cf … ?abstract_id=2429710

Provided by Washington University in St. Louis

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