Research first to show effectiveness of Federal Reserve emergency lending 2007-09

March 16 2017, by Erika Ebsworth-Goold

New research from Olin Business School examines data from the 2007-09 financial crisis to show how the US Federal Reserve can effectively assist banks in times of financial uncertainty. Credit: Washington University in St. Louis

This week, the Federal Reserve hiked interest rates for just the third time in nine years. While many Americans know the Fed for its role in making monetary policy, it serves another lesser-known but hugely important purpose: providing temporary, short-term funds to banks as a "lender of last resort."

During the financial crisis from 2007-09, the Fed took drastic steps to ensure that banks had access to liquidity so they could continue lending. It extended the maturity of loans available through its Discount Window from overnight to 90 days and established the Term Auction Facility, which offered similar funding through a series of special auctions. Banks borrowed from these facilities to the tune of a staggering $221 billion per day during the crisis.

For the first time, new research from Washington University in St. Louis examines data from the crisis to show how the Fed can effectively assist banks in times of financial uncertainty. No matter the program or the bank size, this infusion of liquidity spurred lending that ultimately reached homes and businesses, thereby benefitting the economy, the researchers found in their analysis.

"Perhaps contrary to popular beliefs, our research shows that the Fed's actions were effective in encouraging banks to lend. This suggests that the credit crunch we witnessed could have been a lot worse in the absence of these facilities," said Jennifer Dlugosz, assistant professor of finance at Olin Business School, and a former economist at the Board of Governors of the Federal Reserve System.

Dlugosz—along with co-authors Allen Berger, professor of banking and finance at the University of South Carolina, Lamont Black, assistant professor of finance at DePaul University, and Christa Bouwman, associate professor of finance at Texas A&M University—analyzed data about the banks that took part in the Fed's financial crisis programs. In the past, the information had not been released due to concerns about the stigma associated with accepting the assistance. However, the data became public in 2010 after media outlets Bloomberg News and Fox Business Network filed a Freedom of Information Act request.

"No one has been able to look at this question before because the data weren't available," Dlugosz said. "This is the first time in history that detailed data on the individual loans has been made public."

During the course of their research, Dlugosz and her co-authors found a total of 20 percent of small U.S. banks and 62 percent of bigger U.S. banks—more than 2,000 in all—used the Discount Window or the Term Auction Facility at some point during the crisis. The access to liquidity increased bank lending of almost all types. Meanwhile, they found no evidence that banks were making riskier loans.

"We examined whether or not the Discount Window and the Term Auction Facility helped encourage banks to lend during the crisis," Dlugosz said. "We find that it did. It looks like one extra dollar in liquidity support from the Fed to a bank results in somewhere between 30 to 60 cents in additional lending by the bank, depending on its size.

"It wasn't obvious at the time whether this was going to work. The Fed is a lender of last resort for banks. We already had some idea it was effective in preventing bank failures, but this paper also shows us it can also be useful in encouraging banks to lend."

The research paper recently was accepted at the *Journal of Financial Intermediation*.

More information: Allen N. Berger et al, Bank Loan Supply Responses to, Federal Reserve Emergency Liquidity Facilities, *Journal of Financial Intermediation* (2017). DOI: 10.1016/j.jfi.2017.02.002

Provided by Washington University in St. Louis