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The Fed Rates that Resuscitated Wall Street

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The extraordinary measures the Federal Reserve undertook in its response to the global financial crisis were largely carried out in secret. It took pressure from Congress, through the Dodd-Frank Act of 2010, as well as a Freedom of Information Act lawsuit filed by Bloomberg, to get the Fed to release data on more than 21,000 transactions and 29,000 pages of documents detailing its interventions. This data held information—such as the names of the borrowers, frequency of borrowing, type of collateral, dates, and interest rates—that up until that point had been undisclosed. I would like to focus on one portion of that data: the rates charged by the emergency lending facilities set up by the Federal Reserve.

In *Lombard Street* (1873), Walter Bagehot laid out principles for lending in liquidity crises: central banks should lend freely to *solvent* banks with *good collateral* but at *penalty rates*. These principles have served as a theoretical basis for thinking about the lender-of-last-resort (LOLR) function for close to 100 years and have been cited as justification for the Fed's specific interventions in response to the 2008 crisis.

However, examination of the data shows that most of the Fed's emergency facilities lent at rates that were, on average, at or below (sometimes well below) market rates, with the big banks the primary beneficiaries. The top eight individual borrowers in total loan origination borrowed roughly $11.5 trillion (reserves and/or Treasury securities), with a combined weighted mean interest rate paid of 1.49 percent. Although collectively the facilities totaled approximately $17.7 trillion in loan originations, three banks borrowed close to 40 percent of this total: Citigroup, with $2.469 trillion; Merrill Lynch, with $2.256 trillion; and Morgan Stanley, with $2.069 trillion. For all three banks, the majority of the borrowing came from the Primary Dealer Credit Facility.

Most of the facilities created were engaged in lending for sustained periods of time. The average length of the facilities, excluding the single-tranche open-market operations program (which was not designed as a *standing* facility), was more than three years. If the individual support to Bear Stearns and AIG is also excluded, the average length is still close to two years (22 months). There were many instances of lending that had especially low borrowing rates. The lowest rates were given to Morgan Stanley and Goldman Sachs: both borrowed at 0.01 percent in December 2008, receiving $50 million and $200 million, respectively.

Fed intervention in times of liquidity crises is a necessity. In such an event, a central bank should stand ready to fulfill its role as LOLR, but it should not lend without penalty rates, without good collateral, or for sustained periods of time. Multiple problems arise when the Fed engages in such action—moral hazard being first among them. Moreover, the extraordinary durations of the facilities are themselves consistent with critics' claims that the banks were insolvent, and not with the idea that this was a liquidity crisis.

Lending at low rates to insolvent banks for a sustained period of time can have the effect of increasing bank profitability. No doubt the low rates offered by the Fed in the recent crisis provided a subsidy for the banks' balance sheets, and no wonder that the crisis was tamed after the Fed bought $1.25 trillion in arguably toxic assets (mortgage-backed securities).

However, by departing from its traditional function as LOLR to depository institutions, the Fed effectively went from aiding markets to making markets. Lending at or below market rates, allowing banks to negotiate these rates through auctions, and rescuing insolvent banks has not only validated unstable banking instruments and practices but also possibly set the stage for an even greater crisis.

The data also suggest a deeply flawed institutional relationship between the too-big-to-fail (TBTF) banks and the Fed. There were other ways and means of resolving the crisis. Why were these particular methods employed this time around?

In addition to its excessively close relationship with the big banks, the Fed is driven by its terror of what might happen if it allows one of them to fail. Yet this strategy only encourages TBTF institutions to behave irresponsibly, as they know they have the Fed as a backstop. So not only does the Fed prop up TBTF banks engaging in the riskiest activities, but its interest rate subsidies also give them an unfair advantage over thousands of better-run banks that do not have access to such cheap finance.

The lone solution is real reform. This requires dramatically scaling back the size of TBTF financial institutions, eliminating unfair subsidies, and implementing targeted regulations.

A more detailed discussion of the issues can be found at www.levyinstitute.org/publications/?docid=1711.

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