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Statement by
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Chairman
Board of Governors of the Federal Reserve System
before the
Subcommittee on Telecommunications and Finance
Committee on Commerce
U S House of Representatives
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Thank you for this opportunity to present the views of the Federal Reserve Board on securities margin requirements. The Board commends the Subcommittee for its willingness to reconsider the public policy objectives of margin regulation and to consider amendments to the relevant statutes. Today, I shall present the Board's views on the objectives of Federal Reserve margin regulation and the need for statutory amendments to promote those objectives. As I shall discuss, the Board has concluded that federal oversight of securities credit is appropriate as part of comprehensive systems of oversight of safety and soundness of certain lenders--broker-dealers and banks. However, the Board is not convinced that the existing statutes authorizing Federal Reserve margin regulations--section 7 and subsection 8(a) of the Securities Exchange Act of 1934--effectively serve the purposes that apparently motivated their passage. Consequently, as it has for many years, the Board continues to believe that self-regulatory organizations should be given greater responsibility for margin regulation. Repeal of sections 7 and 8(a) of the Securities and Exchange Act of 1934 would leave federal oversight of securities credit extensions by broker-dealers to securities regulators, including self-regulatory organizations (SROs). It would also allow banking regulators to develop an approach to prudential oversight of securities credit extensions by banks that is more compatible with their overall system for overseeing bank safety and soundness.

We understand that implementation of this approach raises many important issues that would take some time to resolve. The SEC has expressed concerns about the interplay of margin with other financial responsibility rules for broker-dealers, competition between market participants, the solvency of financial institutions, and systemic issues. We look forward to working with the SEC and with

other members of the Working Group on Financial Markets to determine what other regulatory changes would be necessitated by repeal of sections 7 and 8(a). In addition, the SROs would need to work with the SEC to modify their margin rules, a process that likely would take some time. Therefore, if Congress decides to repeal sections 7 and 8(a), it may wish to consider delaying the effective date of such action.

Objectives of Margin Regulation

As I noted, the statutory basis for federal margin regulation is contained in the Securities Exchange Act of 1934, which gives the Federal Reserve Board the authority to regulate margins--that is, the minimum downpayments or, equivalently, the maximum collateral values for loans--on all securities other than government securities and other "exempted" securities. Reflecting views that were widely held when the 1934 Act was passed, Congress apparently intended this margin regulation to achieve three main objectives: (1) to constrain the diversion of credit from productive uses in commerce, industry, and agriculture to "speculation" in the stock market, (2) to protect unsophisticated investors from using margin credit to establish excessively risky positions, and (3) to forestall excessive fluctuations in stock prices.

The Board believes that experience and regulatory changes during the six decades since the passage of the 1934 Act support the conclusion that margin regulation is not the best way to achieve those objectives. Concerns about a diversion of credit, which apparently weighed most heavily in 1934, were exaggerated. It is now widely recognized that the use of credit to finance securities does not materially reduce the amount of credit available for other uses. The

borrowed funds do not disappear, rather, they are transferred to the seller who reinvests the proceeds

Customer protection concerns today are more reliably addressed by other regulations and policies applicable to the issuance and distribution of securities and to the conduct of broker-dealers. These include disclosure requirements, sales practices rules, and investor education efforts such as those recently initiated by the Securities and Exchange Commission (SEC).

Finally, the view that the existing margin statutes are necessary to control stock price volatility is not supported by empirical evidence that has accumulated since 1934. Numerous statistical studies of the relationship between margins and stock price volatility have been conducted, and the preponderance of that evidence suggests that changes in margins have not affected price volatility in any measurable way. To be sure, experience with the effects of changes in securities margin requirements is both limited and dated (initial margin requirements on equities have changed only about twenty times since 1934 and have not changed at all since 1974). But the view that changes in margin requirements do not affect asset price volatility is also supported by numerous studies of exchange-traded futures and options, including contracts on equities and equity indexes.

The Federal Reserve Board also has doubts about the effectiveness of margin regulation for achieving the purposes of sections 7 and 8(a) of the 1934 Act. The underlying assumption is that the ability of investors to leverage can be restricted by regulating margins on loans collateralized by securities. While in 1934 many investors may have had no other means of borrowing funds to invest in securities, today investors have many alternatives. With

these alternatives available, margin requirements cannot effectively limit leverage

In the Federal Reserve Board's view, federal oversight of securities credit makes sense only as part of broader systems to ensure the safety and soundness of financial institutions such as broker-dealers and banks. Safety and soundness oversight necessarily must address all sources of risk to those institutions. When such institutions make loans against collateral in the form of securities the margin required is an important element in the risks they face and, as such, is an appropriate object of prudential supervision and regulation.

As I shall discuss later however, the most effective approach to prudential oversight of securities credit depends on the nature of the overall safety and soundness regime applied to the financial institution. Indeed, there are several regulatory models for achieving safety and soundness--all potentially effective. U S authorities take quite different approaches to ensuring the safety and soundness of broker-dealers and banks for example. Different approaches to oversight of securities credit may well be desirable. In any event, the best approaches to prudential oversight do not appear compatible with the statutory framework of sections 7 and 8(a) of the 1934 Act which, as I have noted earlier was designed for entirely different purposes.

The Margin Provisions of H R 2131

The Board has evaluated the margin provisions of the Capital Markets Deregulation and Liberalization Act of 1995 (H R 2131) against the view that the objective of margin oversight should be the safety and soundness of financial institutions subject to comprehensive prudential oversight. H R 2131 would repeal

section 8(a) of the 1934 Act and amend section 7 substantially. The Board believes that repeal of section 8(a) is consistent with safety and soundness but has difficulty reconciling the amendments to section 7 with that objective.

Section 8(a) restricts broker-dealers from borrowing from lenders other than broker-dealers and banks when using exchange-listed equity securities as collateral. Removal of these financing constraints would promote the safety and soundness of broker-dealers by permitting more financing alternatives and hence more effective liquidity management.

Section 7 is the section that provides the Board with authority to regulate securities credit. Among the amendments to the section contained in H.R. 2131, the Board views the restrictions on the authority of SROs to impose margin requirements on their members as fundamentally inconsistent with prudential objectives. The inclusion of these provisions in the bill evidently reflects dissatisfaction by some firms with their SRO's administration of margin requirements on debt instruments traded in the over-the-counter markets. If there have been problems in this area, those problems should be resolved by the members of the SROs, if necessary with the assistance of the SEC. The Board does not believe that the solution to these problems is to abandon the principle of self-regulation of broker-dealers.

Although we support a lowering of regulatory burdens in general, the Board finds it difficult to support the various exclusions from margin regulation that the bill would provide. These proposed exclusions would appear to reflect a view that the objective of margin regulation should be customer protection, an objective that

I have indicated the Board believes is far more effectively addressed through other regulations and initiatives

Ultimately the Board has concluded that, because section 7 was originally enacted for completely different purposes margin regulation cannot be successfully reoriented toward prudential objectives through amendments to that statute. Although regulatory burdens associated with the statute could be reduced through amendments, the residual framework would continue to impose compliance costs and would not effectively serve any public policy purpose.

An Alternative Approach to Margin Reform

Instead the Board believes that the safety and soundness objective that is appropriate for margin oversight could best be achieved by repealing both section 7 and subsection 8(a) of the 1934 Act. I have already discussed the case for repeal of subsection 8(a). Repeal of section 7 would promote safety and soundness by leaving responsibility for oversight of securities credit to those entities responsible for comprehensive oversight of financial institutions. Specifically, securities credit extended by broker-dealers would be overseen by the SEC and their respective SROs. Securities credit extended by banks would be supervised by their respective primary banking regulators. Extensions of securities credit by other entities would be subject to federal oversight only if their overall safety and soundness is subject to such oversight.

In the case of broker-dealers the Federal Reserve Board sees no public policy purpose in it being involved in overseeing their securities credit extensions. The SROs and the SEC are much more likely to develop an oversight regime that is most consistent with their overall approach. The Board has already incorporated SRO rules into its margin regulations for some debt instruments and securities

options. Where possible, the SROs have set margin requirements that better reflect the credit risks to lenders than the uniform and arbitrary initial requirements that currently apply to equities. The Board would expect that if the SROs were given responsibility for initial margins on equities, they would replace the existing requirements with more risk-sensitive standards. The self-interest of the SROs in the safety and soundness of their members and the integrity of their markets should ensure that such changes are consistent with safety and soundness. If these incentives proved inadequate, the SEC would have the authority to enforce changes in SRO oversight.

Just as oversight of the safety and soundness of SROs is best left to the SROs and the SEC, prudential oversight of banks is best left to the respective banking regulators. If section 7 were repealed, the Board would expect to work with the other federal banking regulators to develop a framework for the oversight of bank securities credit that is consistent with the overall framework of banking supervision and regulation. From its perspective as a banking regulator, the Board sees existing margin regulations under section 7 and 8(a) as an anomaly, reflecting the non-prudential purposes underlying the existing margin statutes and regulations. These margin regulations involve a regulatory assignment of a maximum collateral value (or, equivalently, a minimum loan-to-value ratio) for securities. Banks make far larger volumes of real estate loans and auto loans than securities loans. But, except in limited instances required by statute, banking regulators do not regulate collateral values (or, equivalently, loan-to-value ratios) for such assets. Banking regulators typically leave such judgments to bank management and seek, through general policy guidance and on-site review of loans

to ensure that the banks' judgments are consistent with safety and soundness

Given the opportunity, we would urge banking regulators to take a similar approach to the supervision and regulation of loans against securities collateral. General guidance on prudential considerations with respect to such lending might be provided in the form of a supervisory policy statement. Examiners could then ensure that lending decisions by banks were consistent with those prudential considerations. This approach would allow banks discretion in setting collateral requirements to take account of factors such as the price volatility and market liquidity of the securities, the time period allowed for borrowers to eliminate collateral deficiencies, and the general creditworthiness of the borrower.

The Board sees no compelling public policy reason for federal oversight of securities credit extended by lenders that are not subject to comprehensive federal safety and soundness oversight. In any event, with the exception of loans involving employee stock ownership plans (ESOPs), securities credit extensions by lenders other than broker-dealers and banks currently are negligible (most recent data show credit extensions by such lenders totaled just over \$400 million). Credit extensions that are part of ESOPs already have been exempted from most requirements of margin regulations, including minimum initial margins. Other lenders have been important in the past, but generally only when margin requirements have been set higher than currently and well above levels necessary for prudential reasons. If broker-dealers and banks are not required to set margins at levels higher than necessary for safety and soundness, it seems unlikely that other lenders would again play a prominent role.

Some may argue that the approach to margin regulation that the Board is advocating would not provide a level playing field for all providers of securities credit. It is not clear how relevant an issue that would be, if so. The Board does not believe that competitive equity requires that an identical oversight regime be applied to all players in a marketplace, provided competition from whatever source ensures adequate customer choice. Banks and broker-dealers already compete effectively with one another in a wide range of markets, including markets for credit secured by government securities, despite fundamental differences in approaches to prudential oversight of the two types of entities. In any event, the Board would expect that the repeal of section 7 would over time lead both the SROs and the banking regulators to adopt more flexible and more compatible approaches to prudential oversight of credit extensions collateralized by securities.

With respect to competition from other lenders, as I have argued, such competition is unlikely to be serious if securities and banking regulators do not handicap broker-dealers and banks by requiring margin levels higher than necessary for safety and soundness. More fundamentally, the Board is concerned by the implications of a view that the notion of a level playing field requires federal oversight of all providers of services that compete with services provided by regulated financial institutions. So long as we have a limited safety net for banking institutions, there will inevitably be some disparities in the competitive environment for financial institutions. However, we believe that their impact on overall competition is minor and the endeavor to rectify them is far more costly than any perceived benefits.

In conclusion, the Board believes that the primary objective of federal oversight of securities credit should be the safety and soundness of institutions, such as broker-dealers and banks, which are subject to comprehensive prudential regulation. Subsequent experience, analysis, and regulatory and market developments support the conclusion that section 7 and subsection 8(a) of the 1934 Act may not effectively serve the purposes for which they were originally enacted. Repeal of these sections would leave federal oversight of securities credit extensions by broker-dealers to their SROs and the SEC and would allow banking regulators to develop an approach to oversight of bank securities credit that is more compatible with their overall approach to bank safety and soundness.

The Board looks forward to working with the SEC and other members of the Working Group on Financial Markets to determine what other regulatory changes would be necessitated by repeal of sections 7 and 8(a). If Congress decides to repeal sections 7 and 8(a), it may wish to consider delaying the effective date of such action to allow time for such interagency discussions and time for the SROs to modify their margin rules.