Broderick

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MARGIN REQUIREMENTS AND CREDIT ADMINISTRATION

Your Chairman was kind enough to provide me with a copy of the talk which you heard two weeks ago from Mr. Gayer Dominick, and in reading this over I was impressed by his statement that one of the major problems now confronting the New York Stock Exchange and its member firms is to adjust themselves to the unfamiliar experience of being subject to Government regulation. This seems to me to be a very significant observation. The regulation of margin requirements by Governmental authority has never been undertaken before by any Government in any country. In these circumstances it is evident that not only the personnel of the Exchange and its member firms are confronted with a new situation but also that the regulatory authorities have much to learn about the principles and procedures which will best serve the public interest. It is my own feeling that in addressing themselves to this new situation there is a notable and growing disposition among all parties concerned to cultivate the right spirit, to think carefully about the important problems involved, and to assemble and organize the necessary basic information.

The banks of the United States have been operating under Government supervision for about 100 years and for the last 20 years have had to determine their own credit policies in relation to the credit policy of the Federal Reserve System. Brokers and dealers in securities, however, although they have been engaged for a great many years in extending credit to their customers, had no opportunity prior to the passage of the Securities Exchange Act of 1934 to acquire experience under Government supervision.

The experience of the banking authorities in the particular field of brokerage credit is also a matter of very recent development, so that the period through which we are now passing is one in which the regulatory authorities as well as the persons who are subject to regulation are becoming accustomed to new duties and learning to adjust themselves to new responsibilities. In this situation it has seemed to me appropriate to discuss with you some of the circumstances which affect the new relationship and condition its development.

The Securities Exchange Act of 1934 grew in large part out of the national experience during the boom period of 1924 to 1929 and during the earliest years of the subsequent depression. The conditions that were responsible for that boom and that depression, while by no means thoroughly understood as yet, were nevertheless sufficiently well understood as early as 1932 to persuade thoughtful men that developments in the stock market during the boom period had not only reflected other developments but had themselves contributed in an important way to the upswing and subsequent downswing of the business cycle. In recognition of this view, the platforms of both the Republican Party and the Democratic Party in 1932 promised action by the Federal Government, and such action was no doubt hastened by the new outburst of speculation in securities which took place in 1933. Legislation was proposed in Congress early in 1934, which in due time assumed the form of the Securities Exchange Act of 1934. This legislation was very comprehensive in scope. It provided, among other things, for the registration, under Federal supervision, of securities exchanges and securities traded on exchanges. By this means the Act provided machinery by which the Federal Government could insure that adequate information might become available to investors in listed securities. Certain trading practices on the exchanges were also brought under Government regulation. At the same time the amount of credit that might be extended by brokers to their customers was subjected to the influence of Federal regulation. It was necessary for the Congress to consider in this connection whether or not the administration of the whole of the Securities Exchange Act, including not only the part relating to trading practices but also the part relating to margin requirements, should be placed in the hands of a single agency -- the newly created Securities and Exchange Commission -- or whether the part relating to margin requirements should be entrusted to the Federal Reserve Board. Arguments on both sides were considered by the Congress. One of the principal arguments for giving this power to the Commission was that the Commission must necessarily have to administer a large part of the Act and should in the interest of effective administration administer the entire Act. Another was that the Commission, if given power over margin requirements, might use this power to good purpose in performing certain of its statutory functions with relation to such matters as excessive trading by members of exchanges and the manipulation of security prices. On the other side of the question it was contended that if the extension of credit by brokers and dealers was to be regulated by the

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Federal Government, such regulation should be accomplished through the agency, namely the Federal Reserve Board, which by virtue of its position was charged with responsibility for the general credit situation. It was also contended that the Federal Reserve Board, by virtue of its powers with respect to member banks of the Federal Reserve System, was in position to influence the amount of credit extended by member banks to brokers and thus to influence indirectly the amount of credit extended by brokers to their customers. To divide the field of credit administration, by giving the Board control over the margin requirements of banks and giving the Commission control over the margin requirements of brokers, would involve the risk that the two agencies might work at cross purposes -- to the detriment of the public interest. It was for these reasons that the power to regulate margin requirements, both with respect to brokers and with respect to banks, was vested by the Congress in the Federal Reserve Board. The line of division between the two agencies, roughly stated, is that matters relating to trading practices of all kinds should be within the jurisdiction of the Commission and matters relating to the extension or maintenance of credit, whether by banks or by brokers, should be within the jurisdiction of the Board.

By this solution of the question, division of authority between the Board and the Commission with respect to banks was avoided, the banks remaining subject to the regular banking authorities. It resulted, however, in causing brokers to be subject to the jurisdiction of the Commission in some respects and the jurisdiction of the Board in other respects. It became the function of the Board to prescribe the margin rules, both with respect to brokers and with respect to banks, but the enforcement of these rules, so far as brokers are concerned, became the function of the Commission, chiefly for the reason that in consequence of its other duties the Commission would be obliged in any event to have the necessary administrative organization for dealing with brokers.

Before the days of the Securities Exchange Act, the margin requirements imposed by brokers on their customers were in general in close relation to the margin requirements imposed on brokers by their banks. The banks fixed their margin requirements with a view to the protection of their loans, and the brokers in turn passed on these requirements to their customers with a view to their own protection. It was the safety of the particular loan that concerned the bank, which was interested in always having enough collateral to enable it to liquidate the loan by the sale of the collateral. In the old days, therefore, both bankers and brokers developed a well set habit of mind with respect to margin requirements. If such requirements were high enough to protect the lender against loss, this was deemed to be sufficient, notwithstanding the fact that they might not be high enough to serve the public interest. The purpose of the Securities Exchange Act, so far as margin requirements are concerned, was to change this situation. The Act takes for granted that both banks and brokers, in the pursuit of their own interest, will always try to obtain enough collateral to protect themselves against loss, and there is nothing in the Act to prevent any bank or any broker from requiring as much collateral as the lender may consider necessary. But since the lender's own requirements may not be high enough to prevent the excessive use of credit for the purpose of purchasing or carrying securities, as judged from the point of view of the public interest, the Act provides that the Board shall prescribe margin rules for this purpose.

The theory of the Act with respect to this matter can be illustrated by reference to the so-called statutory formula for margins which was laid down by Congress in the Act and was adopted by the Board when the Board came to issue Regulation T in the autumn of 1934. According to this formula, the amount of credit which a broker might extend to his customers was not fixed in relation to the amount of his capital, nor with relation to the amount which he might be able to borrow at banks on customers' securities. Regardless of the amount of his capital, or the amount which he might himself be able to borrow, he was not permitted to lend in any event more than a fixed percentage of the value of the collateral and was not permitted to loan up to this percentage in case the security was one that had recently risen rapidly in price. The test of whether a security had risen rapidly was based on the amount by which its current market price had come to exceed its lowest market price at some earlier period. In the event that the security had risen by a certain percentage, namely 33 1/3 percent, the broker might not extend any additional credit on that security no matter how much further its price might advance. This was the principle of the formula, but it provided, by way of exception, that in case a security had risen by another and higher percentage, namely 82 percent, the broker might extend more credit on the security but might do so only within a specified limit. The point to be noted is that in principle the formula prevented the amount of credit that might be extended on securities in rising markets from going up with the market, even though the broker might consider himself perfectly safe in extending additional credit to the customer. According to this principle the old connection between a rising market and a growth in credit was dissolved. At least it was dissolved so long as the stock remained in what was then called the anti-pyramiding zone, the stretch of value between 133 1/3 percent and 182 percent of the price of the security at the basing point. The old connection between a falling market and the contraction of credit was likewise dissolved.

The statutory formula, viewed without particular reference to the statutory figures, amounted in effect to an admonition by Congress, not only to the Federal Reserve Board but to all parties concerned, against permitting the stock market to draw too much credit into use on the way up. This admonition was based on experience. The experience was that rising markets tend to feed on themselves, with advances in the market value of securities providing the collateral on which further advances may be predicated, with the result that rising markets often over-reach themselves and give way in turn not only to falling markets but to sharp contraction in the amount of credit in use. Such developments were viewed by Congress as being against the public interest. Their consequences extend far beyond the personal fortunes of the individuals concerned. In this view, it is not a matter of much consequence that some speculators and investors make profits while others suffer losses, or that such persons may make profits at some times and suffer losses at other times. The important considerations, from the point of view of the public interest, are that unduly wide swings in the market have bad effects on the national economy; they promote the excessive use of credit on the upswing, not only for purchasing or carrying securities but also for other purposes;

and then on the downswing they have a bad effect on the general credit and business situation. It was in order to bring a new influence to bear on such developments that the Congress, in passing the Securities Exchange Act and setting forth the statutory formula, imposed upon the Federal Reserve Board the responsibility for fixing the margin requirements and taking action from time to time to raise or lower such requirements.

In October 1934, when Regulation T went into effect, the margin requirements of the New York Stock Exchange appear to have averaged about 25 percent of current market price, whereas the Board's requirements as laid down by the regulation varied from 25 percent for most stocks to 45 percent for some stocks, and averaged about 28 percent. The increase from 25 to 28, therefore, in the autumn of 1934, was an increase incidental to the adoption by the Board at that time of the statutory formula with the statutory figures. The Board's action in adopting at that time this formula with these figures was based in part on the fact that such action, though not made mandatory by the Act, was clearly contemplated by the Act, and in part on the belief that in the existing circumstances the workings of the formula would be in the public interest.

The statutory formula was so contrived as to cause margin requirements to advance automatically in a rising market, but until March 1935 market conditions were not such as to permit the formula to have much effect in this direction. At that time, when the recent two-year advance in stock prices began, the estimated average requirement under Regulation T was about 30 percent. Thereafter, however, as the market advanced, more and more stocks rose to the level at which the margin requirement went up automatically by $1 for every dollar of price advance, which meant that for stocks advancing rapidly the margin requirement, though it may have started at 25 percent, rose automatically to 30, 35, 40, and eventually to 45 percent, which was the highest prescribed by the statutory formula. By the end of 1935 or the early weeks of 1936, in fact, stocks representing more than half of the total trading had risen so far that they were subject to the flat 45 percent requirement, and the estimated average requirement for all stocks was about 40 percent. At that time the average level of stock prices, which had been advancing rapidly for nearly a year, was still advancing, and the volume of credit extended by brokers to their customers, which is reported currently as customers' debit balances, had been increasing for a number of months. In these circumstances, in order to forestall excessive growth in the use of credit for stock market purposes and in order to exert a restraining influence on speculation, the Board raised the upper limit of the statutory formula from 45 to 55 percent. This increase applied not to all stocks but to the stocks which had risen by as much as 82 percent above the basing point — that is, stocks which at that time represented about three quarters of the total trading. The effect of this increase on the estimated average requirement for all stocks was to advance the same from about 40 percent to about 46 percent.

A further increase resulted during February and March 1936 from the automatic workings of the statutory formula, then on the 25-55 percent basis. This automatic increase is estimated to have advanced the average requirement from about 46 percent to about 48 percent.

The latest increase in the margin requirements is the one announced by the Board on March 25, 1936, effective April 1, 1936. This increase was incidental to the action of the Board in changing the basis of the margin requirements from the statutory formula with its sliding scale to a flat percentage of the market price. Such a change of basis had been advocated by brokers from the beginning, largely on the ground that the statutory formula, by reason of its complications, was too difficult to understand, and that the office work which it necessitated was needlessly burdensome and expensive. Early in 1936 the Board had under consideration the adoption of Regulation U, prescribing margin requirements for banks, and it was found to be the general desire of the banks to have a simpler formula. The consideration was also advanced that regardless of the preference of the brokers and the banks it would be in the public interest for the Board to have a formula so simple and easily understood that whenever the Board, in the exercise of its discretion, should announce an increase or decrease in the margin requirements, the general public would have no difficulty in understanding just what had happened. So the Board decided to adopt a margin requirement based on a flat percentage of the market price, and it was such a requirement that was announced at the end of March 1936. It was a flat 55 percent.

This 55 percent requirement was the same as that which had already been in effect for two months on many of the stocks affected by the Board's January action -- namely, stocks which were as much as 122 percent above the basing point specified by the statutory formula. At the end of March these stocks represented about two thirds of all the trading on the New York Stock Exchange. As to the margin requirements on these stocks, therefore, the Board's March action effected neither any increase nor any decrease. Between January and March there had been a further advance in stock prices, and in these circumstances it was the judgment of the Board that it would not be in the public interest for the margin requirement on the stocks which were already subject to the 55 percent requirement to be reduced. Adoption of the flat 55 percent for all stocks was accordingly decided upon, including those on which the previous requirement under the statutory formula (with the January amendment) had ranged from 25 percent to 55 percent. Allowing for this fact, and basing calculations on average figures for all stocks traded, it was estimated that the increase was from an average level of 48 percent to a general level of 55 percent, or an increase of about 7 points. Thus the March increase, as an incident to a change in formula, was of about the same proportions as the January increase.

The effect of all the increases, taken together, between September 1934 and April 1936, was to increase the margin requirements from the flat 25 to the flat 55 percent level, pursuant to the action of Congress in June 1934, the initial adoption of the statutory formula, and subsequent action taken by the Board, in the exercise of its best judgment under the law, for the purpose of restraining speculation in securities and preventing the excessive use of credit for the purchasing or carrying of securities.

Under the Securities Exchange Act of 1934 the Board was required to lay down margin rules for brokers and was authorized to lay down similar rules for banks and other persons. The obvious reason for this authorization was to make the Board's power effective over the whole field of credit administration, in order to prevent circumvention of any of the Board's margin rules. In the late months of 1935 and early months of 1936, it appeared to the Board that the time to adopt margin rules for the banks had arrived, both for the reason that with the increased margin requirements of brokers there was increased incentive for customers to resort for their borrowing to banks and for the further reason that by issuing Regulation U at a time when there was little speculative demand for credit at the banks, the Board would be establishing a mechanism to which the banks would become accustomed in due season and which would be in active operation in the early stages of any growth in the demand for stock market credit that might in due time be felt by the banks.

It is too soon to attempt to draw many lessons from experience under the new system, because such experience has been too brief. The new system did not go into effect until the middle of October 1934 so that it has been in effect for but little more than two years. The period has not only been a short one but the conditions of the time have been perplexing. The business of the country has been in the process of recovery from the later stages of a deep depression. Money rates have declined, production and employment have increased, corporate earnings have increased, and security prices have advanced. There can be no doubt that the advance in security prices has reflected to some extent perfectly natural causes, but it is certainly not for me to say to what extent this has or has not been the case. The prices of common stocks are now at about the level of the late months of 1927 and they have advanced on the average during the past two years by about as much as they advanced during the four years 1924, 1925, 1926, and 1927. It is a noteworthy fact, however, that the amount of credit extended by brokers to their customers is not only far less at the present time than it was in 1927, but that it has increased during the past two years by a much smaller amount than it increased during the four years 1924-1927. The increase in the amount of credit extended by brokers to their customers during the last two years has amounted to less than $500,000,000, or less than 50 percent, while the increase in this item from the beginning of 1924 to the end of 1927 may be fairly estimated at as much as 100 percent. In making this comparison, the amount of credit extended by banks -- to borrowers other than brokers -- for the purpose of purchasing or carrying securities is left out of account, but this omission is without prejudice to the comparison inasmuch as bank loans for this purpose are known to have increased during the 1924-1927 period whereas they appear to have shown little change, or even to have decreased, during the past two years.

The contrast presented is a very impressive one. There are doubtless many reasons for it. One factor, however, has certainly been the fact that margin requirements of brokers during the 1924-1927 period were at the general level of 20 percent of the current market price, whereas such requirements during the past two years, under Regulation T, have at no time been less than 30 percent (on the average) and have risen during that period to 55 percent. On the face of the record, therefore, it would appear that the Securities Exchange Act of 1934 has been an important influence in preventing excessive growth in the use of credit for the purpose of financing transactions in securities.

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