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Statement of Wm. McC. Martin, Jr.,

Chairman, Board of Governors of the Federal Reserve System,

at hearings on the study of the stock market

before the

Senate Committee on Banking and Currency,

Monday, March 14, 1955.

Mr. Chairman and Members of the Committee, as you are aware the Federal Reserve System has responsibility for regulating the general flow of credit and money with the objective of contributing to a healthy growing economy. In the Securities Exchange Act of 1934, the Board of Governors of the Federal Reserve System was given special responsibilibility for preventing the excessive use of credit for the purchase or carrying of securities.

Let me say at the outset that this responsibility of the Board of Governors relates to stock market credit and not to the price of stocks. The Congress rightly, in my judgment, did not place on the Board responsibility for trying to determine the level at which stocks should sell. Even if all credit were eliminated from the stock market, cash purchases could bid up the prices of stocks to high levels. Regulation can restrain the use of credit for stock market purposes, but it cannot serve as a guarantee against all speculative excesses.

When Congress was considering the Securities Exchange Act in 1934, the country was concerned with two major problems. One was to foster economic recovery and get the millions of unemployed reemployed. The other was to prevent recurrence of the situation which brought about the unemployment. An important factor in that situation was that stock purchases were pyramided on the basis of credit extended on very thin margins. As a result, a break in stock market prices, that in any event would have been severe, was magnified into a disastrous financial crash for the whole country.

The Securities Exchange Act was notformulated to restrict the natural operation of the stock market, but to rid the market of such evils as manipulative practices and inadequate disclosure of information vital to investors. Thus the market could better perform its basic investment functions. The margin requirement provision of the Act was not designed to deny the use of credit to the stock market; its explicit objective was to prevent the excessive use of credit. This legislation was designed to help create a healthier securities market as part of a strong, vigorous free enterprise economy.

Organized stock exchanges are designed to function so as to encourage growth in equity ownership rather than debt, with resulting benefit to the economy. For business to raise equity capital through the issuance of common stock, it is important to have active and orderly markets for stocks.

The exchanges serve the economy by providing continuous, ready markets for securities that constitute an important proportion of the assets of many individuals and businesses. Individuals, to make purchases of goods or services, frequently have to sell or borrow on their securities to obtain the necessary cash. Furthermore, businessmen often sell their securities or pledge them as a basis for loans to meet payrolls or to obtain other capital. Sales or borrowing transactions of these kinds would be far more difficult without market centers where investors, traders, brokers, and dealers are brought together. Sales of new security issues by business corporations would also be more difficult if buyers did not know they could later dispose of such assets readily.

In my judgment, a properly functioning stock market is important to the attainment of a high standard of living and steady growth of employment opportunities for all the people. We could not today have our system of mass production and distribution if it were not possible for corporate enterprises to assemble through the securities markets varying amounts of individual savings into large aggregates of capital. A major distinction between highly developed and industrialized economies and underdeveloped economies is the lack in the latter of effective markets for mobilizing the individual savings of their people.

The task of the Board, as I see it, is to formulate regulations with two principal objectives. One is to permit adequate access to credit facilities for security markets to perform their basic economic functions. The other is to prevent the use of stock market credit from becoming excessive. The latter helps to minimize the danger of pyramiding credit in a rising market and also reduces the danger of forced sales of securities from undermargined accounts in a falling market.

Regulation T applies to loans made by brokers and dealers in securities to their customers. It prescribes loan values--that is, sets margin requirements--on securities that are registered on a stock exchange. Except for specific exemptions, it altogether forbids brokers to make loans to customers to purchase or carry securities where no collateral is offered, or where the collateral offered consists of securities unregistered on a stock exchange. The securities exempted from this prohibition are obligations of the Federal, State, or local governments and some instrumentalities thereof. Only on these exempted securities are brokers permitted to establish their own loan values.

The loan values for the purchase or carrying of registered securities which have been imposed by this regulation have been consistently small by historical standards, i.e., margin requirements have been high. Most of the time under the regulation, margin requirements have ranged between 40 per cent and 75 per cent, with one brief period of 100 per cent. During the twenties, margin requirements imposed by individual brokers were customarily 25 per cent or less, with 10 per cent margins not uncommon.

Over the life of Regulation T, loans on securities by brokers to their customers, as measured by customers' debit balances, have been as low as 500 million dollars and as high as the present figure of 2.6 billion. From the autumn of 1953 through February of this year, they rose from 1.6 billion dollars to 2.6 billion, which is the highest figure since 1931 when the statistical series on customer borrowings from brokers began. Comparable figures for the twenties are not available, but borrowings by brokers and dealers, which are generally smaller than brokers' loans to customers, ranged from 1.5 billion dollars to 8.5 billion between 1923 and 1930. It is estimated that borrowings by brokers and dealers currently do not exceed 2-1/2 billion dollars, excluding those against U. S. Government securities.

In Regulation U, relating to security loans made by banks, the Board is faced with a different problem. First, the law reaches only to bank loans for the purpose of purchasing or carrying registered stocks. It exempts loans which are secured by bonds and those which are not for the purpose of purchasing or carrying registered securities. Second, the nature of the banking business itself makes the problem different.

Whereas brokers confine themselves largely to making loans for the purpose of purchasing or carrying securities, banks make loans against security collateral for a wide variety of purposes, personal as well as business. Banks also make loans on a wide variety of other collateral and on the general credit worthiness or financial standing and established character of borrowers, and the funds made available from these loans may, without knowledge of the banks, be used by customers for various purposes.

In view of this wide diversity of bank lending operations, the Board, in formulating Regulation U, has sought to avoid the effect of unduly burdening the extension of credit through the banks for all of these purposes. It is chiefly for these reasons of law and practice that the Board's margin regulations applicable to banks relate only to loans which are secured by registered or unregistered stocks and are used for the purpose of purchasing or carrying registered stocks.

From the beginning, the Board has realized that regulations applicable to this intricate lending process ran the risk of leaving loopholes through which bank credit might leak into stock market speculation. This was a calculated risk which was believed to be preferable to detailed rules that would impose a greater impediment to constructive financing than could be justified by avoidance of any leakage that could result from the existing regulation.

The amount of credit extended by banks to customers other than brokers and dealers for the stated purpose of purchasing or carrying securities (excluding U. S. Governments) is estimated to be about 1-1/2 billion dollars today, around three-fourths larger than in the late thirties and no doubt much smaller than in the late twenties. The amount of bank loans to brokers and dealers on such securities is estimated currently not to exceed 2-1/2 billion dollars. This amount is roughly three times as large as that in the late thirties and about the same as that in the late twenties, when brokers were obtaining a large part of their borrowing from nonbank sources. The volume of bank credit extended to brokers and dealers over much of the period of the regulation has fluctuated within a relatively narrow range, although it has generally followed an upward path since the end of 1948. From the autumn of 1953 to early this year, bank credit to brokers and dealers, which includes underwriting credit, rose about 1 billion dollars. At no time since the regulations were adopted in the mid-thirties has the total amount of bank credit for the purpose of purchasing or carrying securities been a large proportion of commercial bank loans and investments.[1]

On the basis of a recent survey requested by this Committee and covering 271 banks in selected large cities which make most of the loans collateraled by securities, we estimate that early in February all member banks had outstanding 7.2 billion dollars of loans on securities, including loans against U. S. Government securities. About 4.2 billions of this total were estimated to be loans made for the purpose of purchasing or carrying securities. Of purpose loans, almost 2.9 billion were to brokers and dealers and about 1.3 billion were to others. The remaining 3 billion dollars represented all security loans made by banks to individuals and businesses for other purposes than the purchase or carrying of securities. Even though some leakage of bank credit into stock market uses may occur through the avenue of loans not designated for the purpose of purchasing or carrying securities, the relative amount of such leakage cannot be large in the aggregate.

1/ Currently total loans and investments of all commercial banks amount to 156 billion dollars, of which 70 billion represents loans and 86 billion investments.

A more likely and less easily discovered avenue of leakage of bank credit into stock market uses is through loans secured by collateral other than stocks or unsecured. This is a type of credit that could be used speculatively by "empire builders" in their attempts to acquire financial control of corporations. This kind of credit may not be large in relation to total bank credit, but it certainly could be important in individual cases. However, the problem of preventing an excessive flow of credit into the stock market through this avenue is an extremely difficult one with which to deal from a regulatory standpoint without interfering unduly with normal banking activities.

Although the volume of stock market credit since Regulations T and U were imposed has not been large by historical standards, a considerable percentage of total trading by the public has been based in part on credit. This does not mean that borrowed funds have financed a corresponding portion of stock trading. Margin customers have had to observe the margin requirements and to use their own funds for a large part of the financing. There is little doubt that the use of credit in stock transactions adds to total demand for securities but this is true of all use of credit. For example, use of instalment credit, which today totals in excess of 22 billions, has added to the demand for consumer durable goods. Similarly, residential mortgage credit, currently aggregating more than 75 billions, has added to the demand for housing.

It is important to look at the whole picture of credit outstanding in the economy in order to see in correct perspective the over 4 billion dollars of direct stock market credit and the 3 billion of other security loans by banks. Total credit in the economy since the end of 1946 has increased from about 400 billion dollars to around 600 billions. Of the increase of nearly 200 billion dollars, about 80 billion was in business long-term and short-term credit, over 60 billion was in urban mortgage credit, 20 billion was in consumer credit, 20 billion in State and local government debt, and the balance was distributed among other sectors. The increase in loans for purchasing or carrying securities probably did not exceed 2 billion dollars over this period.

As I have emphasized, the statute enjoins "excessive use of credit" in stock markets. It is difficult to define what constitutes "excessive use of credit" in stock markets, or for that matter in any field. It is largely a question of judgment and not merely a statistical computation. So far as stock markets are concerned, however, it seems to me that there are certain signs or symptoms of unhealthy tendencies when businessmen or the public generally become unduly preoccupied with stock markets and stock prices. An unsound speculative psychology may then develop that can have adverse effects throughout the economy.

Margin requirements are a comparatively new device in the arsenal of central banking. As I indicated at the outset, they are not and cannot be cure-alls for stock market excesses or abuses.

An inquiry such as this Committee is conducting is useful and constructive. It sheds light on important aspects of the economy and its functioning. It enables the Congress to ascertain how regulatory measures are operating and whether they are adequate or need modification. Finally, it seems to me, it serves to remind us all that the underlying strength of the nation depends not only on wise laws and regulations but upon enlightened leadership and good morals in the market place.

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