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## CREDIT CONTROL

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Under various provisions of federal law there are five principal means of credit control which the Federal Reserve Banks or the Board of Governors may use. These are:

- Discounts
- Open Market Operations
- Direct Action
- Reserve Requirements
- Margin Requirements

### Discounts

The Federal Reserve Act provides that each Federal Reserve Bank establish from time to time rates of discount, subject to review and determination by the Board of Governors of the Federal Reserve System. To this the Banking Act of 1935 added the new requirement that such rates shall be established "every fourteen days, or oftener if deemed necessary by the Board". This does not mean that the rates must be changed every time, but that they must be regularly and frequently reviewed.

When the Federal Reserve Act was adopted the prevailing idea seems to have been that discount rates were the most important means of credit control. This idea was apparently based upon a belief that member banks would borrow funds at a low rate of interest in order to relend at a higher rate. As a matter of fact, banks rarely borrow from the Reserve Banks for the purpose of relending. They do not like to borrow and as a general thing they will not borrow, no matter how low the rediscount rate is, except when they have to augment depleted reserves.

The Federal Reserve Act formerly limited the classes of paper which Federal Reserve Banks could discount for member banks, on the principle that a definite preference should be maintained for short-term credit based on self-liquidating commercial transactions. The Reserve Banks were, therefore, given the power to discount only paper arising out of commercial, industrial, and agricultural transactions, or paper backed by United States Government obligations.

As a result of various financial and economic developments, the classes of paper which could be used as a basis for borrowing from the Reserve Banks for many years constituted a decreasing proportion of the assets of member banks. In 1929 it was only about twelve percent of their total loans and investments, and in 1934 it was only eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks whose assets as a whole were good nevertheless had very little that was technically eligible. They therefore had to dump their assets on a falling market in order to raise the funds they needed.

The new banking act increases the powers of the Federal Reserve Banks so that advances may be made to member banks for periods not exceeding four months on any security satisfactory to the Reserve Bank. This amendment modifies and makes permanent the emergency legislation which was adopted in 1932.

#### Open Market Operations

If the Reserve Bank had no other means of credit control than the power to discount the paper of member banks at given rates, it might

have to wait passively and idly until individual member banks decided that they would like to borrow. As a consequence of the need of meeting responsibilities more positively, other means of credit control have been developed.

Open market operations consist of the purchase and sale by the Reserve Banks of securities, mainly government obligations, for the purpose of increasing or decreasing the supply of credit available in the money market as a whole. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available; because in the process of paying for the securities that are sold the reserves of member banks become diminished. And as a member bank's reserves decline toward the legal minimum it is less able to make extensions of credit.

On the other hand, by purchasing securities the Reserve Banks put funds into the market and more credit becomes available; because the funds which are released in payment flow directly or indirectly into the reserve accounts of the member banks and enlarge them. And as their reserves expand, they are in a position to extend more and more credit.

In principle, therefore, open market operations enable the Reserve banks to increase or decrease the funds available for lending, by buying or selling securities. They enable the Federal Reserve banks to take corrective action with respect to abnormal credit conditions on their own initiative.

The powers of the Reserve Banks to buy and sell securities in the open market were granted in general terms in the original Federal Reserve Act. The first operations were carried on by the Federal Reserve Banks independently of one another, but it was soon found that action would have to be coordinated; and a committee representing several banks was formed for the purpose of directing the operations. For some time purchases had been made with the idea of providing income to meet expenses, but it was eventually realized that such an objective was in conflict with that of moderating a given condition of the money market, and must, therefore, be subordinated or even abandoned.

The Banking Act of 1933 gave specific recognition to open market operations and established a Federal Open Market Committee of twelve members, one representing each Federal Reserve Bank, to take the place of the former non-statutory committee. At the same time the law adopted substantially the statement of purpose which had already governed open market operations. This was to the effect that they be conducted "with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Banking Act of 1935 made a further change by providing that the Federal Open Market Committee should consist of the members of the Board of Governors of the Federal Reserve System and five representatives chosen by the twelve Federal Reserve Banks.

#### Direct Action

Direct action means efforts to discourage credit policies of

given member banks in given circumstances. Opportunity for it occurs on various occasions, but particularly when a member bank is being examined, or when it is seeking to rediscount some of its paper. In this sense, direct action is aimed at the correction of specific conditions in particular banks. It may also be resorted to with reference to general conditions and for the purpose of enforcing general credit policy.

The effectiveness of direct action was increased by the Banking Act of 1933 in several particulars. If a member bank makes undue use of bank credit for any purposes inconsistent with sound credit conditions, it may be suspended from recourse to credit facilities of the Federal Reserve System. Furthermore, authority has been given to remove any officer or director of a member bank who continues to violate the law governing the bank's operation or who has persisted in unsafe and unsound practices in conducting the bank's business.

#### Power to Change Reserve Requirements

Recent legislation has also given the Board power to change reserve requirements. For most banks (chiefly those outside the larger cities) the requirement is and has been for years that they have reserves equal to at least 7 percent of their demand deposits, and 3 percent of their time deposits. The power to alter these requirements was first given the Board in 1933, but under limitations which were later removed by the Banking Act of 1935. The Board is now authorized to change the reserve requirements "in order to prevent injurious

credit expansion or contraction", but it is not permitted to lower them below the present requirements nor increase them to more than twice the present requirements. The result of raising them would be to decrease the lending power of member banks and consequently the amount of available credit. The effect of lowering them later on would be, of course, to enlarge the lending power and the amount of available credit.

#### Margin Requirements

Another new form of general credit control recently authorized pertains to margin accounts and loans made for the purpose of purchasing or carrying registered securities. Authority for the Board to issue regulations in this field was granted by the Securities Exchange Act of 1934.

Pursuant to these provisions the Board has issued twin Regulations, T and U. Regulation T, following Sections 7 and 8(a) of the Securities Exchange Act of 1934, governs the extension and maintenance of credit by brokers and dealers in securities for the purpose of purchasing or carrying securities. Regulation U, following Section 7(d) of the Act, governs loans made by banks for the purpose of purchasing or carrying stocks registered on exchanges. In general, these regulations fix the maximum loan value of securities subject to their provisions at 45 percent of their current market value. This means a margin requirement of 55 percent. This loan value applies equally to margin accounts with brokers and to similar loans made by banks.

In the case of brokers who are financing other brokers in order to enable them to carry accounts of their customers - as may happen, for example, when a large city broker is financing a correspondent broker in a smaller community - loan values of 60 percent are permitted. Special provision is also made to facilitate the financing of securities' distribution.

The Board has authority to change the loan value percentages as necessary in order to prevent, in the language of the Act, "the excessive use of credit for the purchase or carrying of securities."

For example, under the regulation last issued, it is possible to borrow \$45 on each \$100 of stocks, valued at the market. If market prices nevertheless rise so that the \$100 worth of securities becomes worth \$125, \$150, or \$200, at the market, the amount that can be borrowed, namely 45 percent, becomes of course progressively greater, until such time as the Board finds it advisable to reduce the ratio of loan value. As the Board reduces the ratio, the effective demand is checked. In principle, therefore, the Board has the power to prevent the use of too much credit for speculation and to prevent an expansion dependent too largely upon the ease with which money can be borrowed. Moreover it is enabled to do this without making credit any the less available for commercial, agricultural or industrial purposes, and without raising its cost for such purposes.

The power which has been given the Board to impose and relax restraints upon the demand for credit for speculative purposes is

definitely selective. It is aimed at a particular use of credit and at the specific channels through which demand becomes effective. For this purpose, it extends the powers of the Board outside the Federal Reserve System to reach directly brokers and nonmember banks. It differs from powers of discount, because while these powers may be exercised to discriminate against paper directly involved in speculative uses, they cannot prevent the speculative use of funds procured by the discount of paper not directly involved in speculation. It also differs from the power to conduct open market operations which influence the total amount of funds but not the uses to which they can be put. The same thing is true of the power to alter reserve requirements. Direct action can be used to discriminate against the speculative use of credit, but only in individual cases.

In the case of margin accounts, however, the regulation is directed at an unmistakable objective and cannot miss affecting the speculative use of credit. In the case of loans by banks for purposes of speculation it may be felt that the objective is less distinct, since the purpose of such loans may be disguised. This may appear especially possible since Regulation U permits a bank to rely upon a signed statement, accepted in good faith, as to the purpose of a given loan. Of course if means of evasion develop, they will have to be dealt with, but the Board has chosen to avoid imposing inquisitorial investigations in the absence of reason for believing that evasions will be deliberate or of serious consequence.

It is not the function of the Board to attempt control of security prices nor to do anything in conflict with the responsibilities of the Securities and Exchange Commission in its supervision of securities exchanges.

Conclusion - Limitation on Means of Credit Control

Although the five means I have discussed by which credit control may be exercised - discounts, open market operations, direct action, reserve requirements, and margin requirements - appear to be very comprehensive and powerful, it would be a mistake to convey the impression that a perfect control of credit will be effected through them. In the first place, their application cannot be mechanical nor governed by simple unvarying rules. Credit and economic relationships are extremely intricate, and the circumstances under which the need for action arises are always to some extent different and special.

For one thing, there has never been a time when the membership of the Federal Reserve System included as many as half the banks in the country. Although it is true that the System includes most of the large banks and that it, therefore, includes the bulk of the banking business of the country, still from the point of view of the communities they serve and of relations with other banks, the importance of the thousands of small banks which are outside the System is not negligible.

For another thing, United States Treasury activities must be taken into account. These have to do in part with the operations of

the Exchange Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve large sums and intimately affect the banking and credit situation.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold to the United States from abroad - a movement that in the last two years has added over three billion dollars to the reserves of member banks and created a quite unprecedented credit situation.

These factors, among others, necessarily limit and modify the exercise of credit control.

In concluding I want to assure you how much I appreciate the opportunity you have given me to discuss these matters. I feel, as I have probably said before, that an administrative agency cannot function properly without having behind it a well informed and sympathetic public interest. Credit control unfortunately is a matter which bristles with technical difficulties and abstract ideas; but it is nevertheless essential, if the important objectives of credit control are to be achieved, that at least their general purpose and philosophy be understood.