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REGULATION T'S MARGIN RULES ARE STUCK IN A TIME WARP

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Talking Points

1. By treating all customers and all stocks the same, Regulation T helped inflate the bubble and accelerated the bust.
2. A two-factor rating system that weighs both customers and stocks for creditworthiness would limit volatility in future boom/bust cycles.
3. Such a rating system would also force broker dealers to remember the "know your customer" rule, and the technology is available.

As the dawn of a new bull market may be approaching, we need a better policy for extending credit on securities to combat the volatility implicit in boom and bust cycles in the marketplace. The existing **Federal Reserve** Regulation T, which governs the extension of credit by brokers and dealers to customers is antiquated and can't cope with the structure of today's marketplace. I think Regulation T was a contributing factor to the recent stock market bubble and its subsequent bear market bubble burst. We need a bona fide credit policy that creates an investment incentive without introducing more credit risk into the system.

Regulation T allows an investor to purchase a marginable security with an initial deposit of 50% of the purchase price. Thus, an investor purchases $10,000 worth of XYZ company common stock by depositing $5,000 into a margin account at a broker dealer. In return for the investor borrowing $5,000, the XYZ stock is pledged as collateral to the broker dealer. Furthermore, there is a maintenance margin requirement of 25%. Thus, if the value of the customer's securities falls below 25% of the loan, the customer would receive a margin call to replenish the equity in the account by depositing cash or other marginable securities. Though the broker dealers may establish house margin rules that are more restrictive than Regulation T, they rarely do so.

Why Regulation T Is a Problem

Let us look at the case of two different stocks presented to a broker dealer for margin extension by a customer. Stock 1 is Strong Co., a highly capitalized company with a healthy balance sheet and solid earnings that has been public for 10 years and has traded in a manner of low historical volatility. Stock 2 is Bubble Co., a fairly new company, highly levered, with a nonexistent earning record and a highly volatile trading history. According to Regulation T and in common practice, the client would have to deposit 50% of the value of the purchase of either stock and would be subject to the 25% minimum maintenance. Now think of Strong Co. as **Johnson & Johnson** (JNJ:NYSE) and Bubble Co. as **Amazon** (AMZN:Nasdaq). I doubt that a rational person would lend an equal amount against the poorer-quality asset as against the higher-quality asset. The marketplace should act in a similarly prudent manner. When broker dealers lend money to an investor to purchase a security, they should evaluate the loan as if they were making it to the company.

Listen to the Market

What happened in the recent past was that by agreeing to lend an equal amount to a client for each company, as the price and concurrent volatility increased in AMZN relative to JNJ, more speculative margin trading took place in AMZN relative to JNJ. That inflated the bubble even more. As prices came down, AMZN had to be sold down faster than JNJ to meet the margin calls. And the bubble deflated even faster. The market signals to us a stock's risk through its volatility. Let's listen to it.

Now let's look at the example of two different investors seeking to purchase the same stock on margin. Investor No. 1, Joe Goode, has an excellent credit history and is an experienced investor. Investor No. 2, Johnny Stiff, has a lackluster credit record and is new to speculative investing. Once again, Regulation T is applied in a dogmatic way: 50% upfront and 25% maintenance are all the investor needs. A prudent credit officer would lend more to Joe than to Johnny on the same piece of collateral. The boom market had investors new to investing chasing up the price of stocks, piling on margin debt without the benefit of being protected by a credit extension policy consummate with their investor profiles.

So what should the Federal Reserve do? I propose a two-factor approach to margin lending for customers to replace the existing fixed-lending arrangement. The fix would be an important safeguard in preventing such a magnitude of stock price volatility in a future boom and bust cycle.

How to Fix It

Under my proposal, all investors would be assigned a customer credit rating from 1 to 10, with 10 being the rating for the most creditworthy customers. This rating would be based on important credit criteria as determined by the credit policy of the broker dealer within guidelines established by the Federal Reserve. To prevent the broker dealer from weighting all of its customers as 10s, lenders would have to compile and file their credit rating statistics to the Federal Reserve. Any statistical irregularities would be subject to regulatory audit and review.

Second, a rating of risk for marginable securities according to the historic trading volatilities would be maintained and published by the stock exchanges. Stocks across all exchanges would then be ranked from lowest to highest volatility according to these calculations. The top 10% (lowest volatility) would receive a 9 rating; the next 10% would receive an 8 rating, continuing down to the bottom 10%, which would receive a zero rating. Stocks would not be eligible for margin lending (receiving a default zero rating) unless they had traded for at least a year, and would have eligibility yanked upon delisting or if they trade below $5 a share.

To determine the initial margin requirement for a stock, simply multiply a customer's credit rating by the stock's risk rating and divide by 100. Then subtract this amount from 100%. For example an 8-rated customer with a 7-rated stock would have a 44% initial margin requirement on a loan of 56%. The maintenance level would be set at 50% of the initial level, or in this case 22%.

A similar approach could be devised for the debt markets.

Of course, I would expect the usual uproar and pushback from the broker dealer community, complaining about the difficulty in developing and maintaining this enhanced margin policy. My response to that is threefold. First, there is plenty of money being made on margin, so a few bucks spent to get it straightened out is money well spent. Second, this would force broker dealers to remember the "know your customer" rule. Finally, the technology is available.

While this is just a framework, I fully believe that it should be looked at as a building block to develop a long-overdue successor to Regulation T.

Note to the Federal Reserve -- I am available for further consultation.

Disclosure

Rothbort has no positions in stocks mentioned in this article.