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AN ECONOMIC ANALYSIS AND BRIEF LEGISLATIVE OVERVIEW OF USURY CEILINGS

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ABSTRACT

This report gives an economic analysis of usury ceilings, laws which set the maximum legal rate of interest to be charged on particular types of loans. It provides a brief overview of recent Federal legislation dealing with usury, with special emphasis on the Federal authorities mandated by P.L. 96-221, and the effectiveness of Federal preemption of State usury laws.

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AN ECONOMIC ANALYSIS AND BRIEF LEGISLATIVE OVERVIEW OF USURY CEILINGS

INTRODUCTION

A usury ceiling is the maximum interest rate that may be charged on a particular type of loan. Most often, these ceilings are applied to credit instruments in such "basic" markets as the mortgage and consumer loan markets.

The charging of interest was not a common practice until the Renaissance and the economic expansion that occurred during this period. Nevertheless, there were legal restrictions on the payment of interest in the Western world, some of which were relaxed by the 19th century. Public opinion continued to favor some form of restriction on excessive rates of interest, and these laws, although heavily modified, remain in effect today.

Usury ceilings have been a controversial issue for many centuries. In this country, one of the earliest important pieces of Federal legislation dealing with usury was the National Bank Act of 1863 (12 Stat. 665). Section 46 of this Act limited federally-chartered banks to the interest rates allowed by the laws of the States or Territories in which they were located. Section 30 of the National Bank Act of 1864 (13 Stat. 99) provided that if there was no such law, interest rates could not exceed 7 percent.

Of more importance was the 1933 amendment to the Act (12 U.S.C. sec. 85), which, as amended, permits National banks to exceed State usury ceilings. It allows National banks to charge a rate of 1 percent in excess of the discount rate on 90-day commercial paper in effect at the Federal Reserve Bank in the

Federal Reserve district where the bank is located, or a rate allowed by the State, Territory, or District where the bank is located, whichever is greater. 1/

Another example of Federal override of State usury ceilings was contained in Public Law 93-501 (October 29, 1974), under which National banks, State-chartered, federally-insured banks and thrift institutions (savings and loans and mutual savings banks), and small business investment companies were permitted to charge interest of up to 5 percent over the discount rate at the Federal Reserve Bank in the Federal Reserve district where the institution was located on business and agricultural loans of $25,000 or more. This Act expired on July 1, 1977, but, as a result of Public Laws 96-221 and 96-399, its substance is presently in effect as to business and agricultural loans of $1,000 or more.

Recently, the issue of usury ceilings has again surfaced, mainly because interest rates, as determined in the market, have generally surpassed the maximum legal rates as specified under usury laws. In 1980, legislation was passed providing for temporary and permanent overrides on many types of State usury ceilings in an effort to remedy the situation. This legislation, P.L. 96-221, will be discussed later in this report.

Along with this discussion of P.L. 96-221, this report will give a pro and con analysis of usury ceilings, and a brief overview of other recent legislation dealing with this issue.

1/ This latter option allows National banks to charge the rate allowed for State banks, or the highest rate permitted for any lender for the particular type of loan involved. As will be noted, Public Law 96-221 in effect gives State-chartered, federally-insured banks and other depository institutions the same options permitted National banks under 12 U.S.C. sec. 85.

II. ARGUMENTS SUPPORTING USURY CEILINGS

The major argument in support of usury ceilings is that borrowers are able to obtain needed funds at fair rates of interest. Without usury ceilings, proponents contend that many people, (mostly low income), would be priced out of the credit market because of the high rate of interest. That is, left unregulated, lenders will charge extremely high rates of interest.

Another argument used in support of usury ceilings concerns the ability of borrowers to conduct themselves efficiently in the credit market. Supporters claim that most borrowers are naive, and have very little knowledge of how the financial and credit markets actually operate. For example, according to proponents, knowledge of interest rates and their trends is generally minimal among non-institutional borrowers, and, as a result, lending institutions might be prone to charge high rates of interest.

A related argument deals with the relationship between lender and borrower. Specifically, proponents, and much of the general public, view borrowers as being at a severe disadvantage in the face of large, well-financed lending institutions. In part, this belief is a result of the public's conception of lenders as having a high degree of market power. Since this view is widely held, legislators have often moved very slowly in raising or eliminating usury ceilings.

A fourth contention of proponents of usury ceilings concerns the negative relationship between interest rates and investment. Many people argue that lower interest rates tend to promote a higher rate of investment. Hence, supporters claim that low usury ceilings, by requiring low interest rates, promote investment, leading to a higher rate of economic growth.

Finally, a fifth contention of supporters of usury ceilings is that the issue of usury ceilings should be left up to the individual States. Many supporters feel that it is unwise to allow Federal overrides of State usury laws and ceilings, such as those mandated in P.L. 96-221.

III. ARGUMENTS OPPOSING USURY CEILINGS

The main theme underlying arguments of opponents of usury ceilings is that usury laws distort the credit market and its operation.

First, opponents contend that usury ceilings do not enable some who could not otherwise borrow to do so (as proponents claim). As a result of the lender's tendency to balance off risk and return, opponents argue that usury ceilings cause high risk, low income customers to be pushed out of the credit market without obtaining the needed funds. Eventually, some point in the credit granting process will be reached where the lower rates of interest, as called for under usury laws, will not compensate lenders for the risk that they would undertake in extending loans to certain parties, most of whom would be low income, high risk borrowers. Taking the place of this group of people, and pushing them out of the credit market, will be low risk, high income borrowers, whose low risk would compensate lenders at lower rates of interest.

For example, in the State of Washington, consumer loans from credit card companies were at an annual rate of 18 percent. However, the maximum rate allowed under usury ceilings was lowered to 12 percent in 1968. This action resulted in an excess demand for credit at an interest rate of 12 percent. Supporting the argument of usury ceiling opponents is the fact that low risk, high income borrowers pushed the high risk, low income potential borrowers out of the market. 2/

Hence, in response to the argument that usury ceilings allow people, especially those with high credit risk and low income, to obtain credit at

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2/ Bowsher, Usury Laws, pp. 123-124.

lower rates, usury ceiling opponents contend that they are not even given a chance at obtaining credit, but are replaced in the market by lower risk borrowers. Furthermore, opponents contend that the supply of loanable funds available in markets regulated by usury ceilings declines. As was previously mentioned, usury ceilings are generally imposed on such "basic" markets as mortgage and consumer loan markets. Loanable funds may be taken from these regulated markets and put into unregulated markets which offer a higher rate of return. Often, these unregulated markets cater to the low risk, high income group of borrowers. Therefore, potential funds available to borrowers in the regulated markets, which many have a high number of high risk, low income borrowers, tend to contract.

Another argument used by opponents of usury ceilings is that because the market is distorted, optimum distribution of goods and services, in this case, financial and credit instruments and services, does not come about. The contention of the opponents under this argument is that if allowed to operate freely, the operations of the credit market will result in optimum allocation of resources and maximum social satisfaction. Opponents contend that usury ceilings result in inefficiencies in the market, and a less than optimal allocation of resources will result as a consequence of these market inefficiencies.

A third argument supporting the opponents' contention concerning market distortion deals with the tendency of funds to leave States where low usury ceilings are in effect. Simply put, if lenders in a State are bound by usury ceilings while those in other States are not, the supply of loanable funds in the sectors covered by these ceilings will leave that State, while the supply will expand in States without usury ceilings. Obviously, this process would result in severe State-to-State differences in such "basic" financial and credit sectors as housing and consumer loans. Without usury ceilings, opponents claim that this distortion would not come about.

There are several examples often cited by these opponents to support their case. One such example deals with the State of New York, and its former 8 1/2 percent ceiling on home mortgages. This ceiling resulted in New York mutual savings banks holding about 48 percent of their total mortgage portfolio in out-of-State mortgages for the period between 1966 and 1976. 3/

Missouri had a similar experience in 1973 and 1974 with its former 8 percent ceiling. During these two years, mortgage loans at savings and loans declined by 37 percent in the State. The corresponding statistic in neighboring States was only 6 percent. 4/

A third example often cited is Texarkana, Arkansas, a city both in Texas, with lenient usury laws, and Arkansas, with a comprehensive 10 percent usury ceiling. Usury ceiling opponents note that nearly all institutions dealing in the financial and credit sector are on the Texas side of the city, although the population is distributed evenly between the two States.

A related argument often put forth by the opponents of usury ceilings concerns the depressing effect on State economies of usury laws. They claim

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3/ Nathan, Economic Analysis of Usury Laws: An Empirical Survey, p. 164.

4/ Ibid., p. 165.

that economic growth is slowed because of usury ceilings and the resulting lack of loanable funds.

The classic example of such an argument deals with the State of Tennessee, where a 10 percent ceiling on interest rates existed. When market rates were below the maximum legal rates, Tennessee's economy was growing at a rate that was faster than the rate of growth of the national economy. However, when market rates rose above the 10 percent maximum rate, growth slowed considerably. For the period 1974-1976, losses to the Tennessee economy have been estimated as being $150 million per year in output, 7,000 jobs per year, $80 million in retail sales, and financial assets loss to financial intermediaries was $1.25 billion per year. 5/ Opponents claim that without the 10 percent usury ceiling in effect, this slowdown in economic growth would not have occurred, and the Tennessee economy would have continued to grow at a rapid rate in comparison with the national economy.

There is a counter-argument to the claim that low interest rates, as a result of usury ceilings, will lead to a higher rate of investment. This counter-argument is that lower interest rates, resulting from usury ceilings, will push the savings rate down. Because of the low rates of return, holders of money may not want to put their surplus funds in financial institutions. Instead, they may wish to hold those funds as idle cash balances, or in some other non-productive form.

A final contention of usury ceiling opponents is that inefficiencies in the market, as a result of usury ceilings, surface in the form of lenders

5/ Ibid., p. 166.

finding loopholes and other ways to avoid usury laws. Then, legislation is drafted to "patch-up" these imperfections, after which, lenders look for further opportunities of avoidance, with the process going on and on. Scarce resources are put to the inefficient use of carrying on this process.

IV. RECENT MAJOR LEGISLATION

Several pieces of major legislation dealing with usury ceilings were adopted in the 96th Congress. These were P.L. 96-104, P.L. 96-161, and P.L. 96-221.

The first, P.L. 96-104 (November 5, 1979), provided for a temporary exemption from State usury laws on certain business and agriculture loans until July 1, 1981. Title I of the Act permitted any national banking association, federally-insured bank, or federally-insured savings and loan association to charge interest on business and agricultural loans of $25,000 or more at a rate of up to 5 percent in excess of the discount rate in effect at the Federal Reserve Bank in the Federal Reserve district where the institution was located.

Furthermore, Title I of the Act relaxed ceilings concerning business loans of small business investment companies. Title III specified that the Act applied in States having a constitutional provision which provides that all contracts with an annual rate of interest greater than 10 percent shall be void as to principal and interest.

The second Act, P.L. 96-161 (December 28, 1979), was very similar to P.L. 96-104. One major difference is that this law applied in all States with any constitutional provisions limiting interest rates.

A third piece of major legislation dealing with usury ceilings was P.L. 96-221 (March 31, 1980), the Depository Institutions Deregulation and Monetary Control Act of 1980. This Act is one of the most important pieces of financial legislation since the Federal Reserve Act of 1913. The Act was designed to improve the Federal Reserve's monetary control capabilities, to enable depository institutions to adapt to the increasingly competitive economic environment in which they now operate, and for other purposes.

A major part of the Act, Title V, deals with usury lending limits. It permanently preempts State usury ceilings on conventional mortgage loans, although this provision can be overridden by the affected States if they act within three years.

Another provision in Title V allows for interest rates of up to 5 percent above the Federal Reserve discount rate on business and agricultural loans of over $25,000. This figure has since been lowered to $1,000 (P.L. 96-399). The provision is in effect for three years, from April 1, 1980 until April 1, 1983, unless overridden by the affected States. As of July 1981, eight States (Colorado, Hawaii, Iowa, Kansas, Massachusetts, Minnesota, South Carolina, and South Dakota) have adopted legislation to override some of the provisions set forth in P.L. 96-221.

A third provision of Title V dealing with interest rates allows federally-insured depository institutions to change the same interest rates permitted National banks by 12 U.S.C. sec. 85 on other loans (see introduction). Again, the affected States have the right to override, but, under this provision, they may override at any time.

Another provision gives special rights to small business investment companies, while a provision of Title III raises the permanent lending limit on loans by Federal credit unions to 15 percent, up from the previous 12 percent, and supplies guidelines as to how the rate may be increased to levels above 15 percent for periods of up to 18 months.

P.L. 96-221 supersedes previous legislation covering the same time period, P.L. 96-104 and P.L. 96-161, providing for more limited overrides of State usury ceilings.

Just as P.L. 96-221 provided for Federal override of State usury ceilings covering the conventional mortgage market, different types of mortgage loans are exempted from State usury ceilings by other legislation.

For example, P.L. 96-128 (November 28, 1979) exempts Veterans' Administration insured mortgage loans from State usury ceilings. Another law, P.L. 96-399 (October 8, 1980) deals with a different type of government-insured loan. Under this Act, the mortgage insuring authority of the Department of Housing and Urban Development (through the Federal Housing Administration or "FHA") is extended through September 30, 1981, along with the authority to set ceiling interest rates for the mortgages.

Finally, several pieces of legislation have been introduced in the 97th Congress regarding usury ceilings. Several, such as S. 963, S. 1406, and H.R. 2501, deal with the issue of preempting State usury ceilings.

V. CONCLUSION

The contentions of those favoring the use of usury ceilings deal primarily with equity, borrower protection, and States' rights. They may be summarized as follows:

1. Borrowers can obtain the needed funds at fair rates of interest under usury ceilings.

2. In general, borrowers know very little about the credit market and its operations, and need the protection provided by usury ceilings.

3. In dealing with large, well-financed lending institutions, borrowers are at a severe disadvantage unless protected by usury ceilings.

4. Lower interest rates under usury ceilings promote a higher rate of investment.

5. Usury ceilings are a matter of States' rights, and it is unwise to have Federal overrides of State usury ceilings.

Similarly, opponents of usury ceilings offer many arguments supporting their main contention that usury laws and ceilings distort the credit market. They may be summarized as follows:

1. Usury ceilings cause high risk, low income borrowers to be forced from the credit market.

2. Optimum distribution of financial and credit goods and services does not come about under usury ceilings.

3. State-to-State differences in the supply of loanable funds results.

4. Usury ceilings have a depressing effect on State economies.

5. The lower rates of interest under usury ceilings result in a lower rate of savings.

6. Inefficiencies result in the credit market as a result of actions taken to avoid usury ceilings.

VI. ADDITIONAL REFERENCES

Further information on the various Acts discussed may be obtained from the Committee and Conference Reports regarding the legislation. The articles listed below may also be helpful.

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