Mortgage Usury Ceilings— Statutory Denial of Home Ownership

by James H. Boykin

There has been considerable debate on the issue of state-imposed usury ceilings in recent years. This issue, affecting so many people, abounds with contradictions, paradoxes and inconsistent logic — all of which hinder rather than help the consumer. Usury laws are not new but due to an unrelenting high level of inflation we are more keenly aware of them. The intent of such laws is quite justified. Nevertheless, their adverse influence has been startling in recent inflationary periods.

It may be helpful to review the meaning of usury and its historical evolution prior to grappling with the nature and effects of state-imposed usury statutes.

USURY IN ANCIENT TIMES

Usury is defined as interest charged in excess of that rate permitted by law. Although regulated by law, usury is influenced by ancient philosophical and religious attitudes. As early as 1800 B.C., Hammurabi, a king of the first dynasty of ancient Babylonia, gave his people the earliest known formal code of laws. All loans had to be accompanied by written contracts witnessed before officials. If a higher than legal interest rate was collected by subterfuge, the principal of the debt was cancelled. From around 450 B.C., the famous Roman Twelve Tables, a codification of law, also dealt with usury. Interest on loans was limited to no more than 8 ⅓% per annum. Higher than legal interest was penalized by fourfold damages.

James H. Boykin, MAI, SRPA, is the Alfred L. Blake Professor of Real Estate in the Real Estate and Urban Land Development Program at Virginia Commonwealth University. Dr. Boykin has served with the Federal Housing Administration, Urban Land Institute and engaged in private real estate counseling. In addition to the publication of numerous articles, he has authored *Financing Real Estate, Mortgage Loan Underwriting and Industrial Potential of the Central City.*

Along with the early development of money and credit, there also grew abuses and prejudices. Most of the earliest legal codes sought either to prevent the abuse of credit or to prohibit its use. The Israelites did not permit lending at interest. As late as 450 B.C., the Iranians considered it dishonorable to take interest on a loan. The Babylonians and Romans permitted credit, but limited the rate of interest. The Greeks encouraged credit without a limit on the rate of interest but forbade personal bondage for debt.

It was not until the eleventh century, when European buying and trade revived, that the Roman Catholic Church's doctrine on usury was examined in detail by scholars and the prohibitions were spelled out by church authorities. Usury was then declared to be a form of robbery, a sin against the Seventh Commandment. Pope Eugene III decreed that "mortgages, in which the lender enjoyed the fruits of a pledge without carrying them towards the principal, were usurous." Restitution was required as in theft.[1]

EARLIER EFFORTS OF GOVERNMENT AID TO HOME OWNERS

The Homeowners' Loan Corporation (HOLC) in 1933 signaled the creation of a national secondary mortgage market. A year later, the Federal Housing Administration (FHA), which helped to establish a national mortgage market, came into being. Both of these governmentally-created agencies became a powerful force in encouraging home ownership for Americans. Due in large part to the efforts of these agencies, home ownership climbed from 45.6% in 1920 to 64.6% by 1975.[2]

CURRENT USURY LAWS

Usury laws today are about as diverse and uncoordinated as seemingly possible.

Perhaps more so than in the past, state legislators are especially concerned with protecting individual consumers from exorbitant interest rates. In striving to accomplish this objective, both individual and corporate consumers frequently are hurt by unrealistically low interest rate ceilings. Implementation of such state usury ceilings creates far more problems than it solves.

Governmental efforts that encouraged home ownership a half century ago have been substantially undermined by legislated state usury ceilings. In earlier periods of moderate inflation and interest rates, there was a relatively unfettered flow of mortgage funds from slow growth, capital surplus regions to rapidly expanding, capital deficit areas. Imposition of state controlled interest rates has set up artificial barriers, inhibiting the free flow of mortgage funds that was intended by the creation of HOLC, FHA, and later mainstays of the secondary mortgage market, FNMA and the Federal Home Loan Mortgage Corporation (FHLMC).

Consider, for example, the following jumble of state usury ceilings in the first five states alphabetically from a digest prepared by the Mortgage Bankers Association of America as of November 30, 1979.

MAXIMUM STATE STATUTORY INTEREST RATES
FOR FIRST MORTGAGE LOANS

State	Maximum Basic Rate	Comments
Alabama	8% add-on for home mortgage loans	Interest equalization bill passed by the legislature was struck down in the courts. Exemption for FHA/VA loans.
Alaska	Variable	5 percentage points over the discount rate charged by the 12th F.R. district. No limit loans over $100,000. Exemption for FHA/VA loans.
Arizona	12%	Exemptions for FHA/VA loans.
Arkansas	10%	Business and agricultural loans over $25,000: 5% over Fed 90 day commercial paper rate.
California	No limit	Loans by regulated lenders including licensed real estate brokers. Exemption for FHA/VA loans.

Even this partial listing of state usury standards clearly depicts the incongruity of state usury laws. An even more acute situation is caused by stringent usury laws that exist in fast-growing states. Most of these are "Sun Belt" states which have high levels of inmigration from other parts of the country. With so much of this population growth prompted by inmigration, the demand for housing is more acute than from increases in existing (and already housed) resident households.[3]

OTHER PRICE FIXING SITUATIONS

There is an inherent weakness in governmental efforts to intervene in the normal distribution of goods and services via private enterprise. Well-intended but short-sighted efforts to substitute the will of government in place of the collective judgment of producers and consumers often have had harsh consequences for the intended "protected" groups as well as for other individuals. One cause for this suffering is the tendency for such legislative action to treat only one dimension of a complex economic issue. These profoundly extravagant governmental efforts have been properly labeled by Senator Thomas F. Eagleton as "panacea politics, the quick fix or instant solution."[4] Such efforts may

seek to limit increases in costs to consumers or raise workers' wages while ignoring the impact of such changes on operating costs of producers or the eventual passage of these increased costs onto consumers. Examples of some of the failures of such price-fixing efforts follow.

FEDERAL MINIMUM WAGE CONTROLS

Consider federal minimum wage controls which exert an upward push on the cost of doing business. The intent of setting a minimum wage over the past 41 years has been to improve the lot of the workingman. Has it succeeded? What has been the result of the minimum wage bill passed by President Carter in 1977 which increased minimum hourly wages from $2.30 in 1977, to $2.90 in 1978, to $3.35 by January 1, 1981? The National Restaurant Association in an interview of its 2,000 members found that after the minimum wage was increased on January 1, 1978, 95% of the members raised their prices, 78% reduced man-hours, and 63% laid off people. More than one-half indicated that they had invested in equipment that would reduce their labor force.[5]

The Marriott Corporation found that the upward pressure of minimum wages just in Washington, D.C., has become so acute that in the past three or four years they were forced to close fourteen restaurants, putting 1,300 people out of work, about one-third of whom were minority youths.[6]

Rather than repeal this economically damaging legislation, the federal government creates make-work programs like CETA — the Comprehensive Employment and Training Act. This program alone was expected to grow by $135 million in 1979 to help offset the job dislocation caused by the minimum wage increase. J. Willard Marriott, Jr., has pointedly criticized this legislation. "In the end, the minimum wage practically wrecks the people it is supposed to help."[7]

RENT CONTROL LAWS

Have rent control laws been any more successful in assisting a "protected" group than minimum wage laws? No! In fact, the dismal failure of governmental intervention in rent control may prove to be even more damaging than wage controls. Rent control provides a shortrun political solution to redistributing wealth from property owners to tenants at apparently no cost to a municipality. In the long run, however, it exacts a heavy price from society. Property owners, trying to bring operating costs in line with income, allow their properties to deteriorate. Building and health code violations follow. Neighborhood blight occurs. The exasperated owners either abandon their properties or convert them to condominiums, usually too expensive for tenants to purchase. The tax base is diminished while the level of public services increases. Also, the deficit in tax revenue must be passed onto home owners and businesses, putting more pressure on these groups to leave the city. Investors refuse to build new apartments in such a hostile environment, leading to housing shortages.

Consider the following track records. By 1948, after 30 years of rent control in Paris, dilapidation was rampant. There was virtually no new construction, and properties could not be sold because of negative returns.[8]

The British experience with rent controls has resulted in no significant housing being built since World War II, except luxury units. In 1947, the private rental sector accounted for 61% of dwellings; thirty years later this share had fallen to 14%.[9]

Similar disappointing results have occurred in Sweden, Holland, and in New York City and Washington, D.C. Abandonments in New York City are occurring at the rate of 20,000 units per year.[10] For Washington, the construction rate dropped 92.4% after rent controls became effective.[11]

A survey of 2,351 controlled apartment units in New York City reveals a fundamental reason for realty investors to avoid rent control cities. From 1970 to 1975 operating costs increased 56.3% while rents increased only 35.6%.[12]

The chronology of events associated with rent control has been: 1) the quality of housing suffers and the quantity is reduced, 2) the private ownership sector withdraws, and 3) the government (using tax dollars) attempts to provide housing.

INTEREST RATE CEILINGS FOR FHA/VA MORTGAGES

A national parallel to state usury laws is the congressionally imposed interest rate ceilings for FHA and VA insured and guaranteed mortgages. By placing ceilings on these federally-sponsored loans, buyers are deprived of using programs which were intended to encourage home ownership through low downpayments. Whenever FHA/VA interest rates lag conventional loan interest rates, the seller is forced to pay discount points to the lender in order to increase the yield on these government-sponsored mortgages to match conventional loan yields. At times these discount points can place a discouragingly severe burden on a seller, so much in fact that many sellers refuse to sell their homes via FHA or VA secured mortgages. These seller-paid discount points can easily reach 3 to 6% of the face amount of a loan. For a $70,000 loan an owner, in addition to having to pay up to 8% of the sales price in sales commission and closing costs, would be required to pay $2,100 to $3,500 in discount points to sell his home.

A similar aversion to be bound by price controls occurs in states where usury laws cause unprofitable mortgage loans. Funds are diverted from a state's mortgage market to other usury-free states or into alternative investments that produce acceptable yields.

EFFECTS OF STATE USURY LAWS

A summary of some recent studies made on the effect of usury ceilings on mortgage lending when market rates exceed usury ceilings follows.

1. A significant increase in out-of-state morgage lending activity occurs at the expense of states constrained by usury ceilings.[13] This funds shift

would be expected of financial intermediaries that are required to invest a specified amount of their assets in mortgages. Lenders not so encumbered simply shift to non-mortgage investments or to mortgages not subject to such price controls. By redirecting a share of these assets into non-mortgage investments, the share of lenders' assets held in mortgages is reduced.[14]

A paradox of this effort to benefit the housing consumer is that it assists an unanticipated group. The targeted consumers in the usury state are denied mortgage funds except on unfavorable terms. The infusion of additional capital into "free market" states raises the supply of mortgage funds in relation to demand. Hence, prospective home owners in unregulated states may obtain favorable mortgage interest rates at the expense of frustrated buyers in usury controlled states.[15]

2. Residential real estate market activity declines. One study in Philadelphia showed a 23.1% decline in single family, residential mortgage lending volume by insured savings associations when a one percentage point change occurred between the Philadelphia and national effective mortgage interest rates.[16] A deterrent to originating below-market interest rate loans is the subsequent difficulty in selling them in the secondary market.

3. More stringent credit rationing occurs in such forms as larger down payments and shorter repayment periods,[17] often with lower income persons being squeezed out of the market. A recent survey clearly reveals this problem. Over half of first-time buyers under age 30 paid less than 20% down on their home. These home buyers represent almost 63% of all first-time home buyers. Nearly a third of these young home buyers entered the home market by means of a 90% or 95% mortgage. It further was revealed that about 45% of first-time home buyers had family incomes less than $15,000 while 54% of home buyers with family incomes between $15,000 and $25,000 paid less than 20% down on their homes. These combined groups represent 71% of all first-time home buyers.[18]

4. Discount points may be charged to the buyer or seller when permitted by state law — reducing the sale profits to the seller or sharply increasing the buyer's down payment. Other means used to increase yields to competitive levels are reducing the loan term and requiring larger down payments. Any of these devices impairs the ability of lower income home buyers to purchase homes.

5. Housing construction is lower in usury-affected states than in those states where mortgage lending is uninhibited by these controls. Various studies have shown this decrease to range from 11 to 23%.[19] Most of the declines varied from 14 to 19%[20] with Ostas observing a 14.4% reduction in permit activity for every one percentage point difference in free market rates and usury rates.[21] Similarly, Robins found that an increase in the statutory ceiling of one percentage point leads to about a 16% increase in single family starts.[22]

Builders and ultimately home buyers suffer in other ways from relatively low usury ceilings. Home builders, if required to pay discount points, can pass the added cost onto buyers or reduce the size, amenities,

or quality of construction. Either of the alternatives may discourage prospective buyers and in turn reduce the volume of housing starts.

6. Lower income families are especially affected by stringent loan terms. For example, in Canada during 1963-67, when interest rates on government-insured loans fell under that of conventional loans, only 13% of the Canadian government loans were made to persons in the bottom third of the income distribution compared to 30% during 1971-75 after the usury ceiling had been lifted.[23] Thus, these prospective home owners feel the pain of this "helpful" legislation. Another group also suffers from these interest rate ceilings. Persons who could afford to pay the prevailing interest rates are denied mortgage funds because of the debilitating influence of such laws.

7. Corporations exempt from usury laws can contribute to a shortage of mortgage funds for individuals. The rationale for this exemption seems to be that corporations, or in some cases loans in excess of some dollar amount, have ample expertise available to protect their interests in any mortgage agreement. Thus, another perplexing situation arises. By the larger borrowers being exempt, funds are diverted away from small borrowers. Alternatively, as in some states, corporations or large borrowers are treated essentially the same as individual mortgagors. The question raised in this situation is why does a large, well-staffed borrower quite capable of protecting itself in negotiating for a mortgage loan need the "protection" of usury ceilings?

USURY CEILINGS UNDER ATTACK

Many of the state usury ceilings either had never been changed or were altered only in recent years as they caused hardships to prospective home owners in this era of sharply rising interest rates.

Today, with unrelenting inflationary pressures pushing the cost of housing up, virtually any housing price controls would seem desirable. Yet usury rate laws are so diverse that they frustrate the free flow of mortgage funds between states. The following digest of present usury laws as of November 30, 1979 according to information developed by the Mortgage Bankers Association of America shows that most states still have fixed usury limits while very few states have eliminated their ceilings altogether.

STATE MORTGAGE INTEREST RATE CEILINGS[24]

Fixed Rates	Variable Rates	No Limit
24 (48%)	16 (32%)	10 (20%)

Ceilings for fixed rate states tend to be set at 12%, followed by several states which have an 18% ceiling; overall, the ceilings range from 10 to 21%. FHA and VA loans commonly are excluded from the ceilings except in Utah where only FHA-insured loans are exempted. Connecticut, with a 12% ceiling, places no limit on realty loans over $5,000. At the other extreme, Hawaii has no limits on loans over $750,000.

In the past few years, a strong trend has developed toward use of floating rate ceilings. The first state to introduce this type of ceiling was Delaware

in 1974. Two more states were added in 1975; just three more were added from 1976 through 1978, but in 1979 twelve states switched to floating rate ceilings.

Exemptions from usury ceilings are effective until certain future dates in some states (Illinois and South Carolina) and over specified dollar amounts in other states (Kentucky and North Carolina). Massachusetts has no limit up to 20% which is classified as "criminal usury" whereas Michigan imposes an 11% ceiling for non-regulated lenders.[25]

FLOATING RATES

The inability of lenders to make mortgage loans has prompted some state legislatures to opt for floating, or indexed, interest rate ceilings. Floating rates are not new. Variable interest rates have been available at California savings and loan associations since 1961 and from the Federal Land Banks since 1972. Even earlier, variable interest rates on construction loans were available via periodically adjusted interest rates that were 3 to 5 points above prime interest rates.

The two most common bases for setting floating interest rate ceilings have been U.S. Government bond rates and the Federal Reserve discount rates. Despite generally favorable reaction to efforts to replace fixed interest rate limits with floating rates, a lingering question remains. Are these indexed ceilings sufficiently high to alleviate curtailment of high risk mortgages during high interest rate periods? An ideal index would continually provide an ample margin so that mortgage lending activity is sustained and the interest rate can be adjusted frequently enough to prevent interruption of mortgage lending activity.

Of the eighteen states using indexed usury ceilings on November 30, 1979, the following breakdown was revealed.

CHARACTERISTICS OF INDEXED USURY CEILINGS

Index (no.)	Point Spread	Frequency of Adjustment
Federal Reserve Discount Rate (5)	3-5%, generally 5%	monthly, quarterly, or rate in effect at date of executed contract
Long Term U.S. Bonds (generally 10 year) (9)	1.5-3%, mostly 3%	generally monthly on 20th day of preceding month
Average Yield for FNMA Conventional Auction in month (2)	.25 & 2%	monthly
Lowest Daily Prime Rate of 3 Largest U.S. Banks (1)	2-3.5%	monthly
Premium Interest Over Maximum Time Deposits (1)	5.5%	

Source: Mortgage Bankers Association of America.

In Minnesota it was discovered that its rate ceiling was too restrictive when set just 200 basis points above the yield on long-term government bonds. Similar experiences occurred in Vermont and West Virginia.[26] Other states, such as Iowa, found that by allowing only quarterly ceiling adjustments, periodic mortgage capital shortages occurred. State floating ceilings are more responsive to borrowers' needs when they are pegged to prime rates or commercial paper rates because these rates are dictated directly by market forces instead of fiscal policy. The ceiling also must be set sufficiently high, perhaps 25 to 50 basis points over the prevailing average conventional mortgage interest rates, on newly-built homes so that higher risk (e.g., 95% loan-to-value ratio) mortgage loan activity is unimpeded.

Congress has been involved in changing state usury provisions. For example, H. R. 2515, signed into law by President Carter, overrides the usury law in Arkansas which affected business and agricultural loans over $25,000. A Senate bill (S. 1988) would grant S & Ls, state banks, and credit unions the lending privileges of national banks which are allowed to make real estate loans up to 1% above the Fed's discount rate. H. R. 2282 provides an exemption from state usury provisions for VA loans if FHA insured loans are exempt by state law.

A strong case can be made for eliminating mortgage ceilings altogether as already done in ten states (with certain exceptions). A step in this direction is made by Congressional bill H. R. 4986 which would override state usury restrictions for home mortgage loans secured by stock.

CONCLUSION

However salutary the intent of state usury ceilings may be, their result inevitably is counterproductive. Imposition of fixed interest rate ceilings distorts mortgage markets, harming lenders and builders as well as prospective home sellers and buyers. Interregional flow of mortgage capital is disrupted, proving particularly harmful in the fast growing "Sun Belt" states where growth is strongly buoyed by inmigration. The ability to provide affordable housing for this unhoused sector of a state's population largely depends on importation of capital which is thwarted by relatively low usury ceilings.

Minimum wage laws failed to improve living standards of low income workers; rent control laws expected to assist lower income apartment residents worsened the quantity and quality of the housing stock; fixed ceilings on FHA and VA sponsored mortgages deprives home owners of access to mortgage funds. The undeniable fact is that each of these expensive governmental efforts at controlling prices and wages have backfired, doing more harm than good for intended "protected" groups. Moreover, there is no more cause for optimism in expecting state usury ceilings to improve the cost and availability of mortgage funds to consumers than there was in expecting price fixing mechanisms to achieve their objectives.

In the past half dozen years there have been attempts to relieve would-be home owners of the constraining noose of usury ceilings by raising the

ceilings, adopting indexed ceilings, or in some states abandoning ceilings altogether. Still, a complex and bewildering array of state usury ceilings confronts prospective home owners. These laws persist even when consumers are protected now as never before by such federal consumer laws as Truth-in-Lending and the Real Estate Settlement Procedures Act.[27] The time has come to replace the outmoded price controls with "ceilings and floors" established by parties transacting business in an open mortgage market. Such a refreshing change would be in the consumers' interest.

REFERENCES

1. This section was largely taken from James H. Boykin, *Financing Real Estate* (Lexington, Mass.: Lexington Books, 1979), pp. 16-17. This topic is covered throughly in Sidney Homer's *A History of Interest Rates* (New Brunswick, N.J.: Rutgers Univ. Press, 1963).
2. *Ibid.*, Table 1-5 "Mortgage and Home Ownership Status of Nonfarm Dwellings, 1900-1975," p. 9.
3. "Usury Ceilings Will Impose Huge Economic Loss In 1979," *Savings & Loan News*, February 1979, pp. 32-33.
4. Thomas F. Eagleton, "Rent Control: Curing the Symptoms, Not the Disease," *Journal of Property Management*, September/October 1979, p. 237.
5. J. Willard Marriott, Jr., "How the Minimum Wage Destroys Jobs," *Fortune*, January 29, 1979, p. 101.
6. *Ibid.*, p. 102.
7. *Ibid.*, pp. 102-3.
8. Ron Utt, "Rent Control: History's Unlearned Lesson," *Real Estate Review*, Spring 1978, p. 88.
9. *Ibid.*
10. *Ibid.*, p. 90.
11. John P. Matthews and James L. Pappas, "Rent Control and Community Impacts," *Journal of Property Management*, September/October 1979, p. 270, citing Urban Land Institute, *Prospects for Housing Production Under Rent Control: A Case Study of Washington, D. C.*, Report No. 24, Washington, D. C.
12. Utt, *op. cit.*, p. 89.
13. Oswald Brownlee, "Minnesota's New Usury Law: Its Effects On Residential Real Estate Trading and Financing" (Minneapolis, Minn.: Savings League of Minnesota, January, 1979), p. 2.
14. *Ibid.*, p. 6.
15. Philip K. Robins, "The Effects Of State Usury Ceilings On Single Family Homebuilding," *The Journal of Finance*, March 1974, p. 235. Robins makes this point by stating, "When usury ceilings are low relative to market interest rates, they have the . . . effect of . . . widening the regional variation in mortgage rates (up to one half) . . .."
16. Charles L. France, *Pennsylvania's Floating Usury Ceiling: An Economic Evaluation* (Working Paper No. 1, Pittsburgh: Federal Home Loan Bank of Pittsburgh, August 1975), p. 3.
17. Brownlee, *op. cit.*, p. 6.
18. "Usury Laws Force Young, Lower Income Buyers Out Of The Housing Market," *Savings & Loan News*, January 1979, p. 29.
19. Bruce Yandle, "Mortgage Usury Laws: Placebo or Paralysis?" *MSU Business Topics*, Winter 1979, pp. 37-38.
20. James E. McNulty, "The Impact of Usury Ceilings on Home Financing," *Real Estate Review*, Summer 1978, p. 72.
21. James R. Ostas, "Effects Of Usury Ceilings In The Mortgage Market," *The Journal Of Finance*, June 1976, pp. 829-30.
22. Robins, *op. cit.*, p. 229.
23. Jean M. Lovati and R. Alton Gilbert, "Do Floating Ceilings Solve the Usury Rate Problem?" *Review* (St. Louis: Federal Reserve Bank of St. Louis, April, 1979), p. 13, citing Lawrence B. Smith, "An Analysis of the Effects of the Removal of the Yield Ceiling on Federally Insured Mortgages in Canada," *Journal of Finance*, March 1977, pp. 195-201.
24. *Maximum State Statutory Interest Rates For First Mortgage Loans* (Washington, D.C.: Mortgage Bankers Association of America, November 30, 1979).
25. *Ibid.*
26. Lovati and Gilbert, *op. cit.*, p. 18.
27. For additional detail on this subject, see Boykin, Chapter 15, "Borrower Protection."