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Minnesota's Usury Law: A Reevaluation

Our April 1975 issue reported that Minnesota's 8 percent usury ceiling wasn't hurting homebuilding, but it wasn't protecting consumers from high interest rates either. It was, however, limiting home financing options. We concluded that if a usury ceiling was necessary, it should be much higher than market rates.

To see if we were right, this article reviews our 1975 arguments and reevaluates them considering what has happened since last May when the usury ceiling was allowed to float close to market rates.

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Minnesota's Usury Law: A Reevaluation*

David S. Dahl, Stanley L. Graham, and
Arthur J. Rolnick

In April 1975 we reported that Minnesota's 8 percent usury ceiling was not hurting homebuilding, but neither was it protecting consumers from high mortgage interest rates.[1] What it was doing, according to our analysis, was limiting home financing options. When market rates rose above 8 percent, residential construction did not change significantly because mortgages were still being made. But a larger share were government-insured loans not covered by the low usury ceiling, so consumers paid the high interest rates. And on the conventional loans still available at 8 percent, consumers accepted less attractive nonprice terms—larger down payments and shorter maturities. We concluded from this study that if a usury ceiling was considered necessary as a consumer protection law, the ceiling should be significantly above market rates.

Last year the Minnesota Legislature adopted a law allowing the usury ceiling to approximate market rates, not quite what we recommended. If our analysis was correct, however, the change to such a floating ceiling when market rates were fairly high would not affect new housing construction but would increase the availability of conventional home mortgages and might ease their nonprice terms.

Did that happen? Let's first review our 1975 arguments and then reevaluate them under the floating ceiling.

The 1975 Analysis[2]

Since we expected the usury law to have its greatest impact when market rates were above the 8 percent ceiling, we began by identifying when that was true. To represent market rates we selected the secondary market yield on mortgages insured by the Federal Housing Administration (FHA), an asset lenders consider a reasonable alternative to conventional mortgages.

Minnesota has had an 8 percent usury ceiling on conventional home mortgages since the early 1920s, but only lately has this market rate risen above it: from June 1969 to January 1971 and from October 1973 to April 1976 (Chart 1).[3] In the first period, which spanned 20 months, the secondary rate briefly reached 9 percent. In the second period, the rate was closer to 9.5 percent for much of the 31 months, reaching 10.4 percent in September 1974.

With the potential impact periods identified, we examined new housing activity and mortgage financing. To isolate the effect on the usury law from other factors, we compared Minnesota to eleven states with either no usury law or a rate ceiling well above market rates during the periods under review.[4]

*Based on a presentation to the Minnesota Senate Committee on Energy and Housing, March 1, 1977.

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[1] Arthur J. Rolnick, Stanley L. Graham, and David S. Dahl, "Minnesota's Usury Law: An Evaluation," NINTH DISTRICT QUARTERLY, Federal Reserve Bank of Minneapolis, Vol. II, No. 2 (April 1975), pp. 16-25.

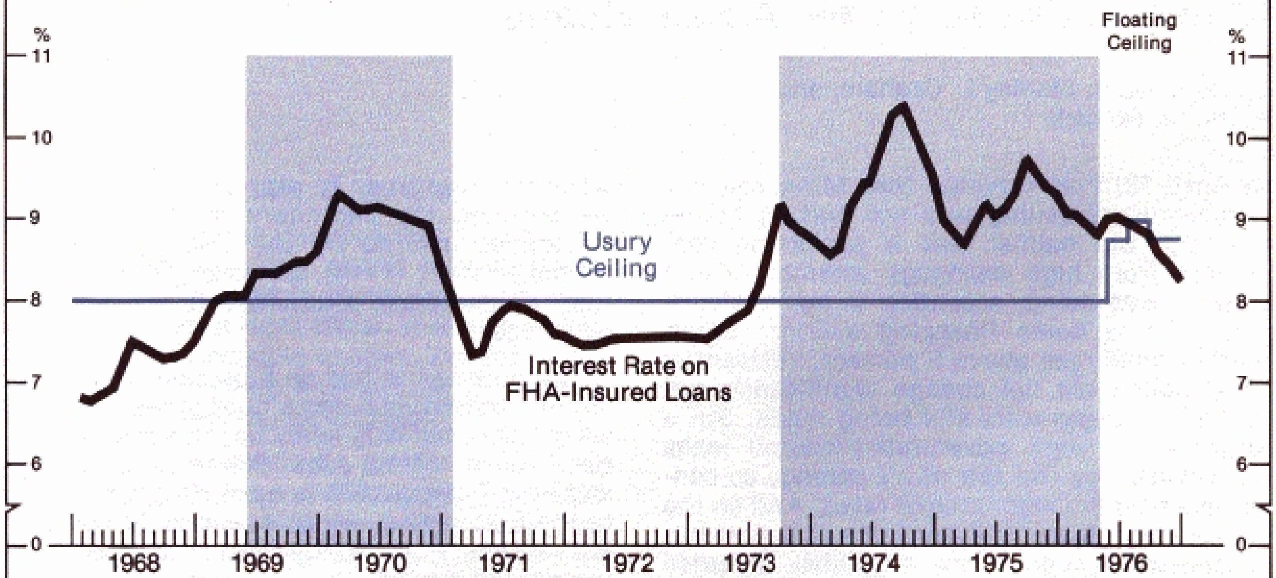
[2] This discussion will span an additional 19 months. The earlier analysis included data only through September 1974; the update reviews data to May 1976 when the floating usury ceiling became effective. The additional data do not change the results of the analysis.

[3] These periods begin 3 months after the FHA rate reached 8 percent, partly because lenders had prior commitments to make mortgages at rates below 8 percent and partly because of a lag before participants reacted.

[4] Nonusury states include California, Colorado, Connecticut, Hawaii, Maine, Massachusetts, Nevada, New Hampshire, Rhode Island, Washington, and Wisconsin. Nonusury SMSAs compared to the Minneapolis-St. Paul SMSA when state data were not available include Denver, Los Angeles-Long Beach, San Francisco-Oakland, and Seattle.

Chart 1

Interest Rate on FHA-Insured Loans* and Minnesota's Usury Ceiling



*Based on opinion reports submited by HUD (FHA) field offices of prevailing local conditions as of the first of the succeeding month. Yields are derived from weighted averages of private secondary market prices for Section 203, 30-year mortgages with minimum down payment and assumed prepayment after 15 years.

Source: FR Board of Governors

Homebuilding

We found that the usury law had no real effect on new home construction. When the number of single-family residential units authorized in Minnesota is compared with the number authorized in nonusury states, the two series appear roughly parallel throughout both impact periods (Chart 2). The difference between them varies somewhat, but not for reasons related to the ceiling.[5] That is, when the ceiling would have had its greatest impact, the difference between new housing activity in Minnesota and in nonusury states did not change significantly.[6]

Mortgage Financing

Since the usury law did not affect homebuilding, mortgages obviously were still being made. We suspected that either loans not subject to the usury law were replacing less profitable conventional mortgages or nonprice terms on conventional loans still available at 8 percent were becoming more restrictive for borrowers (and safer for lenders).

We found that both had happened.

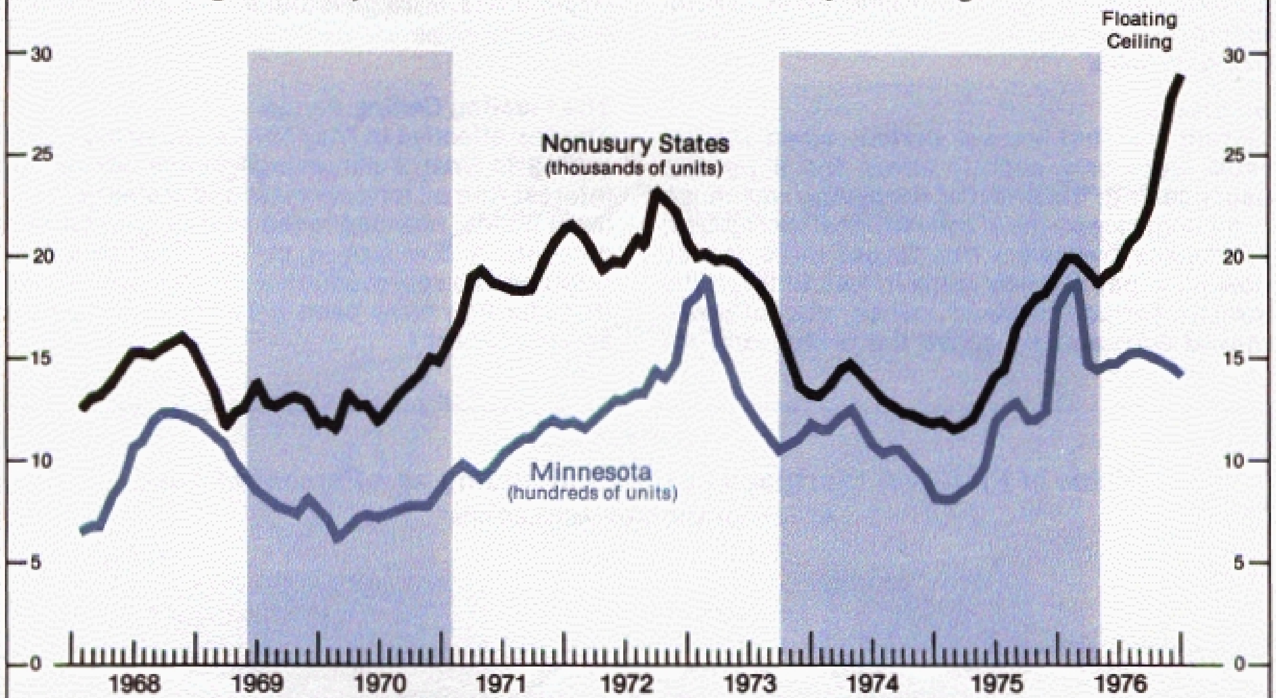
Home financing did shift from conventional mortgages to FHA or Veterans Administration (VA) loans when market rates were especially high (Chart 3). In the first impact period, when market rates were about 9 percent, the value of FHA/VA mortgages outstanding as a percent of total mortgages at savings and loans increased about the same amount in both Minne-

[5] In fact, since both series begin to fall before they reach the shaded areas, rising interest rates rather than the 8 percent ceiling would seem to have caused the general housing slowdown.

[6] These observations were confirmed by a statistical analysis testing for correlation between impact periods and the difference between the series. Although there was a positive correlation—specifically, during the periods the difference tended to be larger—the results were statistically insignificant.

Chart 2

Single-Family Residential Units Authorized by Building Permits*



*Seasonally adjusted 3-month moving averages of new, privately owned, single-family housing units authorized. Nonusury states include California, Colorado, Connecticut, Hawaii, Maine, Massachusetts, Nevada, New Hampshire, Rhode Island, Washington, and Wisconsin.

Source: U.S. Department of Commerce, Bureau of the Census

sota and nonusury states. In the second period, though, when rates were closer to 9.5 percent and FHA/VA loans' share in nonusury states steadily declined, their share in Minnesota rose from 22 to 25 percent. This means that almost double the usual share of all new loans added to S&L portfolios here were FHA/VA. So despite the usury ceiling, many Minnesotans did pay considerably more than 8 percent for home mortgages.

Nonprice terms on new conventional mortgages made at 8 percent changed during these impact periods too (Charts 4 and 5). The length of loan maturities shortened more in the Minneapolis-St. Paul standard metropolitan statistical area (SMSA) than in nonusury SMSAs. Before the first period, loan maturities here averaged only about three to four years less than in nonusury SMSAs, but during the first period the difference increased to seven years. In the second impact period, maturity levels declined more modestly in the Minneapolis-St. Paul SMSA while remaining fairly level in nonusury SMSAs.

Besides maturity changes when interest rates were high, the down payments required on conventional mortgages increased relatively more in the Minneapolis-St. Paul SMSA than in nonusury SMSAs. Before the first period, about 28 percent of the new home purchase price was required in Minneapolis-St. Paul. During the first period that rose to 35 percent. The down payment ratio increased in nonusury SMSAs too, but not nearly as much. In the second period, the ratio again rose sharply in Minneapolis-St. Paul while changing very little in nonusury SMSAs.

Summary

During the first impact period, when market rates were only slightly above the 8 percent usury ceiling, the effect of the ceiling was mostly on nonprice terms of conventional mortgages; Minnesota borrowers had to put more money down and pay off their loans in less time. In the second period, however, when market rates moved substantially above the ceiling and remained high for most of the period, the ceiling also affected the mix of mortgage loans; a larger share were government-insured at higher interest rates.

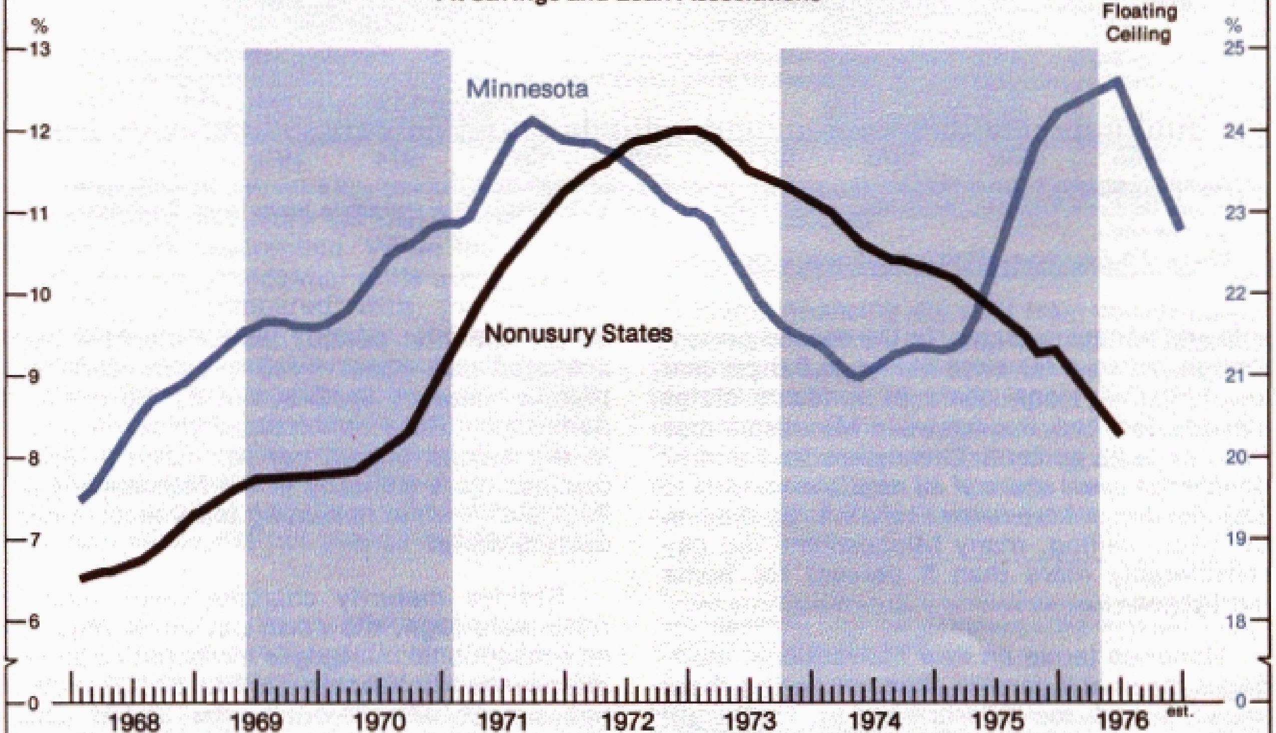
The Floating Ceiling Period

The law effective in May 1976 allowed the usury ceiling to float 2 percentage points above the interest rate on long-term United States government bonds, rounded to the nearest quarter of a percent. A comparison of the floating usury rate and the representative market rate shows that the two have been very close, around 9 percent (Chart 1).

Chart 3

Value of FHA/VA Mortgage Loans Outstanding as a Percent of Total

At Savings and Loan Associations*

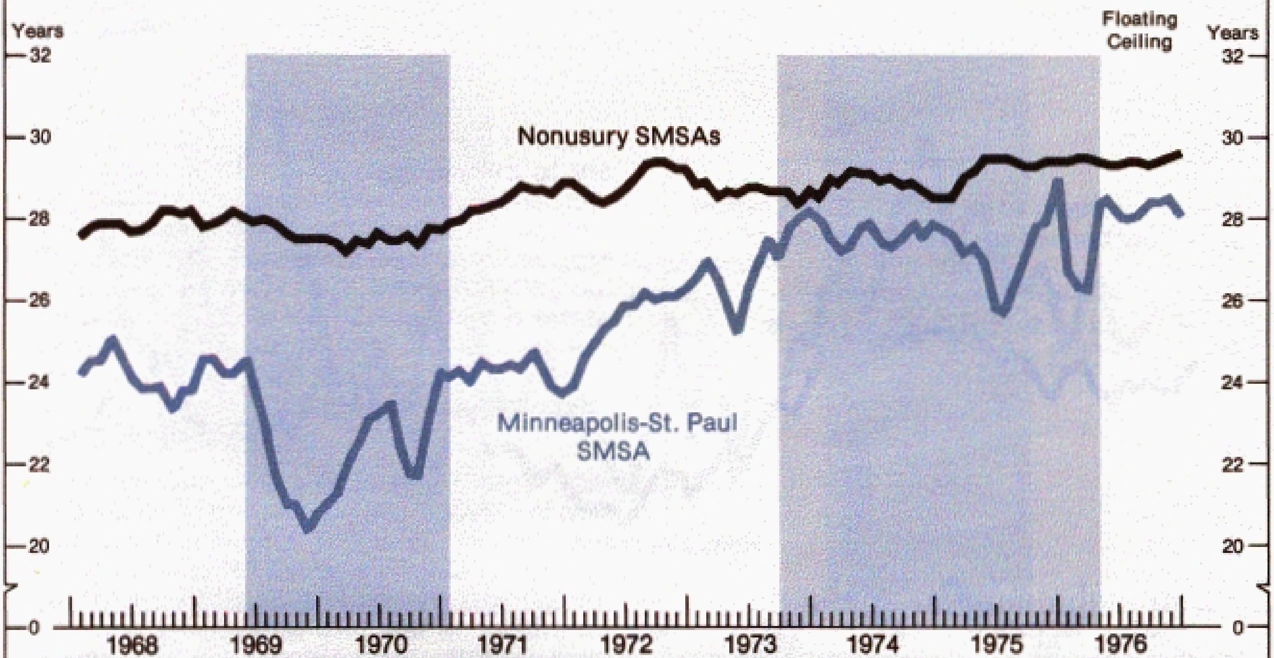


*Nonusury states include California, Colorado, Connecticut, Hawaii, Maine, Massachusetts, Nevada, New Hampshire, Rhode Island, Washington, and Wisconsin.

Source: Federal Home Loan Bank Board

Chart 4

Years to Maturity on New Home Mortgage Loans*



*Weighted three-month moving averages compiled from individual loan data reported by a sample of savings and loan associations, commercial banks, mutual savings banks, and mortgage bankers. Data cover fully amortized conventional first mortgage loans secured by newly built, single-family residential property and exclude federally underwritten loans. Nonusury standard metropolitan statistical areas include Denver, Los Angeles-Long Beach, San Francisco-Oakland, and Seattle.

Source: Federal Home Loan Bank Board

Our 1975 analysis suggests that this switch to a floating usury ceiling would have little effect on homebuilding but would change mortgage financing: with conventional mortgages now available at market interest rates, their percentage of total loans would increase and their nonprice terms might ease. Did that happen?

Homebuilding

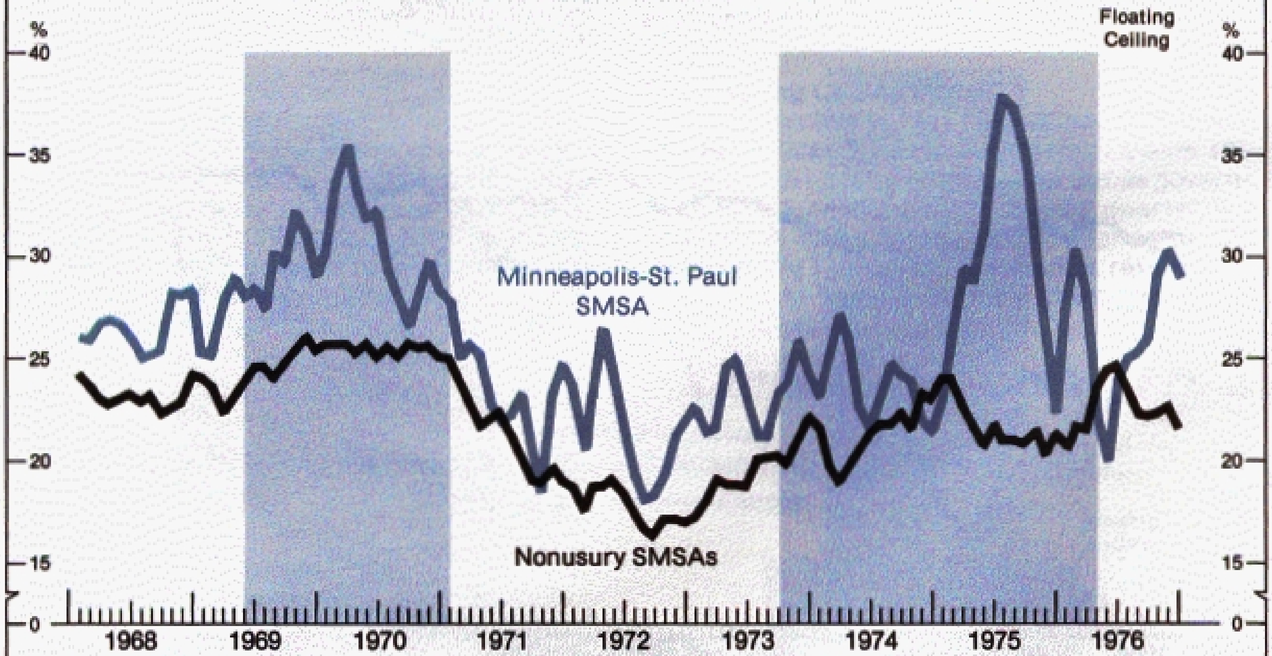
Minnesota residential construction did change some under the floating ceiling, but not because of it. When the ceiling rose to market rates, housing construction increased for a while, both here and in nonusury states (Chart 2). In late 1976, however, it declined slightly in Minnesota. If this decline were related to the higher rates allowable under the new law, construction in nonusury states would have dropped off too; the ceiling was approximating market rates. But housing in nonusury states continued to rise. The decline here, therefore, was probably due to the unusually severe winter. Since several of the larger nonusury states have warm climates, their housing total was not adversely affected.

Mortgage Financing

The floating ceiling did affect the types of loans made, however. Conventional mortgage financing increased dramatically in the last half of 1976 (Chart 3). Looking at it in reverse, the ratio of FHA/VA to total loans outstanding at Minnesota S&Ls declined roughly 2 percentage

Chart 5

Ratio of Down Payment to New Home Purchase Price*



*Weighted three-month moving averages compiled from individual loan data reported by a sample of savings and loan associations, commercial banks, mutual savings banks, and mortgage bankers. Data cover fully amortized conventional first mortgage loans secured by newly built, single-family residential property and exclude federally underwritten loans. Nonusury standard metropolitan statistical areas include Denver, Los Angeles-Long Beach, San Francisco-Oakland, and Seattle.

Source: Federal Home Loan Bank Board

points, indicating that well over 90 percent of the new loans added to their portfolios during this period were conventional mortgages.

As for financing terms, by the end of 1976 maturities on these conventional loans had not changed much since May (Chart 4), but down payment ratios had increased in Minneapolis-St. Paul while remaining essentially unchanged in nonusury SMSAs (Chart 5). Either eight months is not long enough for the floating ceiling to lower down payments and lengthen maturities or, more likely, the ceiling is not high enough.

Summary

Since May 1976, when Minnesota adopted a floating usury ceiling, homebuilding has not been affected by the ceiling (though it has by the weather), but mortgage financing has changed quite a bit. In particular, although maturities and down payments have not been affected, financing has shifted dramatically back from FHA/VA to conventional mortgages. Based on our 1975 analysis, this is what we expected.

But a floating ceiling is not quite what we recommended. Minnesota's floating ceiling has been less restrictive than the old 8 percent ceiling in that conventional loans are more available. Nonprice terms have not eased, however. This suggests that to give consumers a full range of home financing options, the ceiling should be significantly above market rates, not floating with it.

The recovery is strong in most sectors of the Ninth District economy. Considerable improvements in labor market conditions and manufacturing activity are evidence that business has strengthened in early 1977. Homebuilding activity is continuing at the healthy pace it established in 1976. Loan activity at financial institutions in the area is vigorous, and although savings inflows have slowed in recent months, liquidity is ample.

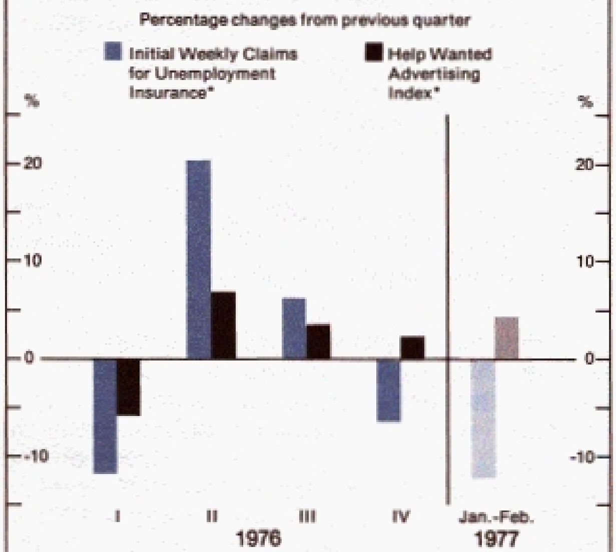
The agricultural sector is still a major concern because of the drought and because of continued low commodity prices. Some optimism has been generated by recent rainfalls in many areas of the district. But low livestock and grain prices are expected to continue at least until midyear, and the resulting reduction in farm cash receipts will reduce personal income—as it did in 1976.

Signs of Strong Recovery

The most encouraging development in the district economy is in the employment situation. The district's unemployment rate[1] averaged 5.5 percent in early 1977; this shows improvement over the 6.1 percent rate in the fourth quarter of 1976 and the 5.9 percent rate in first-quarter 1976. The fall in the unemployment rate is especially significant because it is due more to an increase in the number of people currently employed than to a reduction in the number of people looking for work.

The national unemployment rate showed a similar reduction but remains well above the district rate, averaging 7.5 percent for early 1977. Relatively stronger employment gains were seen in the district than in the nation, partly because this region did not experience as

In early 1977, district unemployment claims fell further and more jobs opened up.



*Based on seasonally adjusted data; four district states' claims, six district SMSAs' ad index.

Sources: U.S. Department of Labor, FRB Minneapolis

severe energy shortages during the unusually harsh winter.

Other indicators of labor market activity offer additional encouragement. From fourth-quarter 1976 to early 1977, the number of initial unemployment insurance claims went down 12 percent and the help wanted advertising index rose 4 percent.

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[1]This and all Ninth Federal Reserve District indicators, except those for manufacturing sales, are seasonally adjusted.

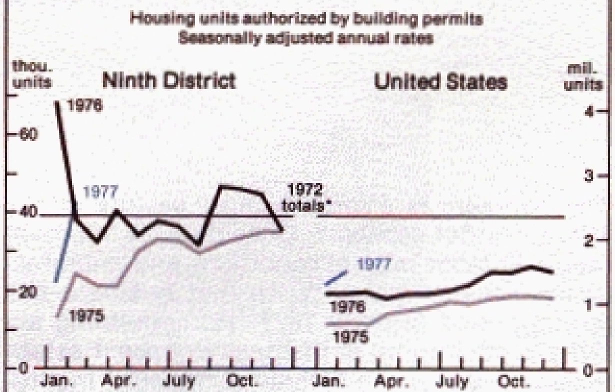
District manufacturing also shows signs of continuing strength. According to our first-quarter 1977 Quarterly Industrial Expectations Survey, manufacturing sales increases in the fourth quarter of 1976 were 18 percent above a year earlier. This is the fifth consecutive quarter in which manufacturers have reported such advances. Most of the fourth-quarter growth was contributed by the durable goods industries, which reported year-over-year sales advances of 23 percent in the fourth quarter; but sales of nondurables showed a respectable gain of 11 percent as well. Further, moderate sales advances will continue for the first half of 1977, if the manufacturers' expectations are correct.

Manufacturing employment was up 2.2 percent in early 1977 compared to the fourth quarter; average weekly hours worked in manufacturing increased slightly then too. If this trend continues, the manufacturing sector should be a source of strength to the district economy in the first half of 1977, since increases in hours worked usually precede increases in employment.

Homebuilding is also experiencing vigorous growth. Although it slowed in December and January because of severe weather, home construction activity recovered substantially in February. Housing units authorized during 1976 were 33 percent above the 1975 level in the Ninth District and 38 percent above 1975 in the nation. But by 1976 permit activity in the district had reached its 1972 peak (adjusted[2]), while United States permits were still 40 percent below the 1972 high point. The increased permit activity in both the district and the nation reflects growth in the number of multifamily and single-family units being built. This is a turnaround from the preceding two years when there was an excess supply in the number of multifamily housing units.

The near-term homebuilding outlook seems favorable. Even with the strong housing expansion of 1976, vacancy rates in the Minneapolis-St. Paul area are below those of a year ago; home mortgage loan commitments at district S&Ls, which increased 25 percent from year-end 1975 to year-end 1976, are at record levels; and liquidity is still ample.

Homebuilding continued to strengthen faster here than nationally.



*District total is adjusted to eliminate the extra permits filed in December 1972 to avoid a Minnesota sewer tax effective in January 1973.

Source: U.S. Department of Commerce

Other district construction activity has been mixed. In 1976 nonresidential contract awards were up 16 percent, after showing no growth in either 1974 or 1975. On the other hand, nonbuilding contract awards declined 49 percent in 1976, following advances of 35 percent in 1974 and 52 percent in 1975.

Loan activity at district commercial banks and savings and loan associations has been quite strong in early 1977. Loans at district member banks increased at an annual rate of 19 percent in the first three months of 1977. This was primarily due to a dramatic increase in business lending, which reflected a more intensive search for loans by large city banks. Rural banks also reported increased lending, reflecting both refinancing of existing loans and increased new loan demand.

Mortgage activity at district S&Ls continues

[2]District total is adjusted to eliminate the extra permits that were filed in December 1972 to avoid a Minnesota sewer connection tax effective in January 1973.

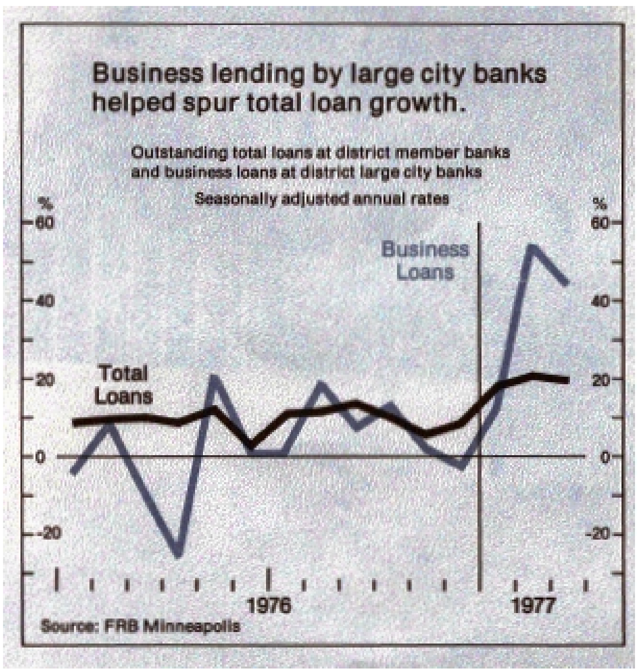
at a high level. Deposit inflows have slowed here as well as in the nation, but liquidity positions at district depository institutions are still strong.

Some Areas Still Slow to Recover

The agricultural sector is still experiencing effects of drought and low prices. Increased marketings boosted 1976 cash livestock receipts 11 percent over 1975, but low prices depressed crop receipts 23 percent. Decreased farm income has reduced deposit growth and led to increased borrowing or refinancing, pushing up loan-to-deposit ratios at rural banks.

Since recent rains have alleviated drought conditions somewhat, farmers will probably proceed with customary planting intentions, although less wheat and more soybeans may be planted because of current inventory and price situations. But abundant red meat supplies and grain stocks, particularly wheat, will continue to have a depressing effect on commodity prices at least until midyear.

Primarily because of a 7 percent decline in cash farm receipts, real personal income in the district showed very little growth over the last 12 months, although real retail sales grew at an average annual rate of about 7 percent. According to a number of district retailers, the pickup in sales that began in mid-March was concentrated in home furnishings, appliances, and home improvement items. In the United States, by comparison, personal income grew at a rate of about 4 percent and retail sales grew at about a 7 percent rate.



Finally, the winter resort season was good in northern Michigan and Wisconsin; but elsewhere it was spotty, and some small ski areas never opened at all. Further, many resort owners surveyed by this Bank are not optimistic about the summer season, since the number of inquiries and advance reservations they have received is running below last year.

A Favorable Outlook for 1977

In summary, most district economic indicators suggest continued strength into the first half of 1977. The lingering problems in agriculture, caused by both prior and current drought stress and anticipated low prices in the next few months, will temper other indicators such as personal income and, to some degree, consumer spending.