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The Impact of the Minnesota Usury Law

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Every legal statute can be judged by how well its intention is realized. The Minnesota usury law,[1] by setting maximum allowable interest charges, is intended to protect consumers from paying "unreasonably high" interest rates. Thus, the usury limits can be interpreted as the maximum reasonable loan charge. By considering the role that interest rates play in the economy, this article will investigate whether the Minnesota usury law has had the protective effect that was intended.

RESTRICTING INTEREST RATE MOVEMENTS

Prices are a means of rationing goods in a market economy. When the price mechanism is operating effectively, supplies of goods are equal to the demands for them at the prevailing price. Interest rates also are prices: prices for borrowing money. Although many people are against restricting price movements and interfering with the price rationing mechanism, the usury law can be interpreted as a belief by the legislature that the restriction of interest rate movements corrects some distortion in the money markets that is not present in most other markets. Implicitly, it is an argument that bankers are somehow different from other groups of businessmen; that they, unlike other businessmen, would charge exorbitantly high prices unrelated to their costs if their behavior were not restricted. And it further assumes that the restriction of interest rate movements will not restrict the flow of credit or that is is desirable to restrict the flow of credit sometimes.

Since the law dictates a maximum allowable rate, it is only when that rate is exceeded that the law is binding and affects the credit market. As seen in the accompanying figure, which shows the Twin Cities conventional and FHA mortgage rates, the Minnesota mortgage rate never reached or surpassed the 8 percent limit before 1969. Why didn't bankers charge the maximum allowable rate throughout the entire period? One answer is that banks can only partially control the rates they charge on loans and deposits. Since banks are only one of many financial institutions, they must charge a rate that is competitive with rates available in other credit markets. Otherwise they risk losing their customers to other competitive institutions.

EFFECTS OF NATIONAL MONETARY POLICY

Table 1 compares an average U.S. corporate bond yield — a competitive long term rate — with the Twin Cities FHA mortgage rate. In the 1960's, the yields on corporate bonds and mortgage loans moved in the same direction. The average annual rate differential between the mortgage yield and the corporate bond yield was .49 between 1961-69. However, the differential narrowed from an average of .55 in the first 6 years to .37 in the last 3 years. This narrowing reflects institutional rigidities in the mortgage yield compared to the bond rate. However, the point to notice is that during the 1960's, the range of the differential between the national bond rate and the Twin Cities mortgage rate was only one-quarter of a percent. This strongly suggests that the competitive Minnesota mortgage rate is determined by factors not controlled by Minnesota mortgage lenders, but rather by factors of national monetary policy that act through the national money and bond markets and are then reflected in local money market conditions.

Considering the FHA rate presented in the figure, it is apparent that starting in June 1969 and continuing up to October 1970, the competitive mortgage yield was above the usury limit of 8 percent. Since this limit is binding only on conventional and farm mortgages, its impact should be observed in changes in the composition of the housing market.

YEARLY HOUSING STARTS IN MINNESOTA

The total number of yearly housing starts in Minnesota more than doubled between 1961 and 1969, from 13,077 to

Table 1. Interest rates on new Twin Cities mortgage loans and corporate bonds, yearly averages, 1961-69

Year	Twin Cities FHA mortgage yield* (1)	Corporate bond yield† (2)	(1)–(2)
1961	5.58	5.08	.50
1962	5.58	5.02	.56
1963	5.47	4.86	.61
1964	5.42	4.83	.59
1965	5.36	4.87	.49
1966	6.23	5.67	.57
1967	6.58	6.23	.35
1968	7.35	6.94	.39
1969	8.19	7.81	.38

* Quoted in "House and Home"; adjusted by the average points charged. The FHA rate, which is not restricted by the usury law, was used here.

†From: *The Economic Report of the President*, February 1970, pp. 242-43.

* The author acknowledges the comments and suggestions of professors Vernon Ruttan, Terry Roe, and John Helmberger of the Department of Agricultural and Applied Economics. The errors are the author's alone.

[1] The earliest enactment of a usury law in Minnesota was in 1877. At that time, the general statement of the law allowed a maximum charge of \$12 per \$100 per year. In 1923, that limit was reduced to \$8 per \$100 per year. However, as the law now stands, the \$8 limit is binding only on consumer and farm mortgage loans. All other classes of loans have either been exempted or have a higher limit. For instance, bank installment and credit union loans have a maximum limit of approximately 12 percent, while small loan companies are limited to charging 33-15 percent, depending on the amount of the loan.

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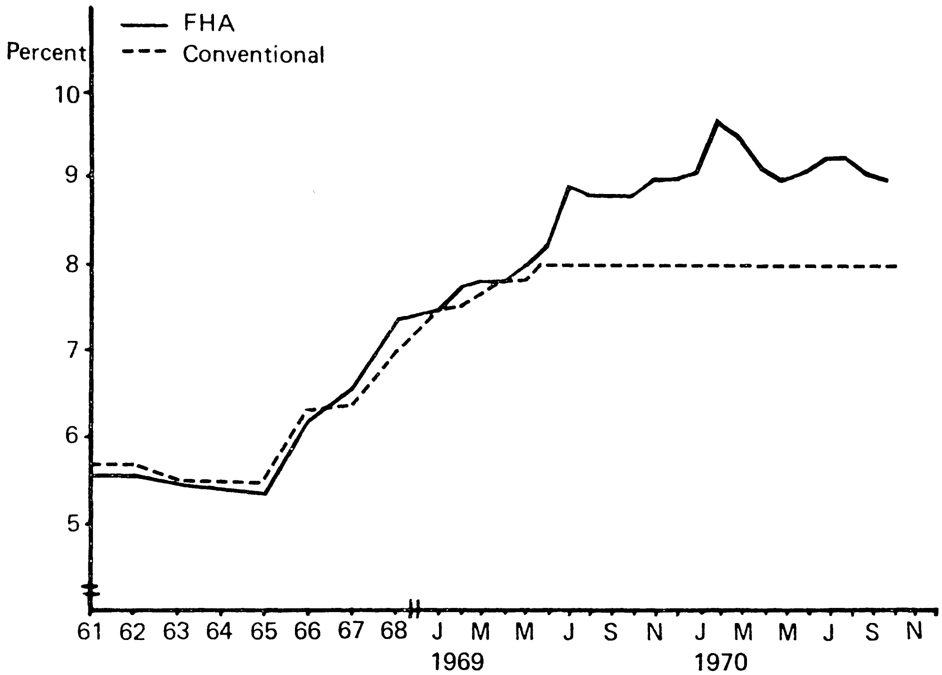

Conventional and FHA effective interest yields, Twin Cities lenders, 1961-70.

26,273 (see table 2). Although starts of private one- and two-family homes increased from 7,323 in 1961 to 11,480 in 1968 (an increase of 57 percent), they had decreased to only 8,790 by 1969. Further, by 1970, private housing starts had decreased to 7,432—hardly more than the initial level. Private one- and two-family housekeeping units have thus declined as a percentage of all new housing starts over the period, from 56 percent to 33 percent.

Comparing 1969, when the usury law initially became binding on mortgage credit, to 1968, the number of new housing units declined by 4.48 percent. This decline can be explained entirely by the 27.4 percent decline in one- and two-family homes. The number of new apartment building starts, whose financing is not subject to the usury law, increased 9.11 percent. Throughout the latter part of 1969 and into 1970, when the return from commercial loans was consistently above the usury limit, the available long term funds went mainly to commercial enterprises. Only a small residual was left to finance new private residential homes. In table 3, the quarterly number of new one- and two-family housing starts of 1969 and 1970 are compared to 1968. Although the decline in the first 6 months of 1969 was only 7.40 percent when the usury law was not binding, the decline in the second half of 1969 and the whole of 1970 was over 33 percent.

This decline indicates that, far from protecting the consumer, the impact of the Minnesota usury law has been to reduce severely the funds available for private home buyers, while expanding those available for other users of credit. Since the usury limit has had a binding effect only on home mortgage borrowers, and since home buyers, unlike corporate and business borrowers, cannot move to other forms of finance, the impact of the usury limits has been to prevent home mortgage borrowers from competing effectively for funds. It is this factor that has led to the drastic reduction in one- and two-family housing starts.

RELATION TO SAVINGS DEPOSITS AND SAVINGS FUNDS

Although the discriminatory impact of the usury law is the single most important factor in explaining the relative shift to apartment units rather than to private one- and two-family homes, the total level of mortgage lending is more a function of the supply of savings deposits and other savings funds available to mortgage lenders.[2] Since the usury limit does not directly affect the ability of mortgage lenders to obtain savings funds, it would have little impact on the total level of mortgage loans made. However, there are other restrictions, usually referred to as regulation Q, that restrict the interest payment banks can pay on their time and savings deposit accounts. Different types of accounts have different restrictions, with most ordinary accounts being lim-

[2] Mortgage lenders include savings and loan associations, savings banks, insurance companies, Federal Land Banks, and contract mortgages.

Table 2. Total number of housing starts and number of one- and two-family housing starts in Minnesota, 1961, 1965, 1968, 1969, and 1970

Year	Number of housing starts* (1)	Number of one- and two-family housing starts* (2)	(2) as percentage of (1)
1961 . . .	13,077	7,323	55.98
1965 . . .	18,485	9,001	48.69
1968 . . .	27,503	11,480	41.74
1969 . . .	26,273	8,790	33.45
1970 . . .	21,049†	7,432†	35.61†

* From: The Federal Reserve Bank of Minneapolis, *Building Permits, Annual Summary.*

† Estimated by projecting the January-November 1970 figure for the entire year.

Table 3. Number of and percentage change in one- and two-family housing starts in Minnesota, quarterly, 1968-70

Quarter	1968*	1969*	1970*	Percentage change 1968 to 1969	Percentage change 1968 to 1970
I	1,897	1,689	1,008	−10.07	−46.87
II	3,216	3,045	2,232	− 5.29	−30.68
III	2,873	2,248	2,588	−21.73	− 9.89
IV	3,196	1,808	1,604†	−43.43	−49.81
Total . .	11,187	8,790	7,432	−21.38	−33.52

* From: *Ninth Federal Reserve District Building Permits,* monthly release.

† Based on October and November figures only, projected for the full quarter.

Table 4. New mortgage loans of savings and loan associations, Minnesota, 1968-70, quarterly*

Quarter	1968	1969	1970	Percentage change 1968 to 1969	Percentage change 1968 to 1970
	- - - millions of dollars - - -				
I	58.1	64.9	44.3	+11.70	−23.75
II	102.9	117.3	96.2	+13.99	− 6.52
I + II	161.0	182.2	140.5	+13.17	−12.73
III	98.2	98.4	119.9	+ 0.20	+22.09
IV	110.7	83.5	110.3	−24.57	− .55
III + IV	208.9	181.9	230.2	−12.93	+10.20

* Source: The Federal Home Loan Bank of Des Moines, Iowa.

ited to 5-5½ percent per year.[3] Since competitive rates for savings funds on the national bond markets rose continually from 1966 to 1970, the large differential in interest return provided a great incentive for individuals to withdraw their accounts with savings and loan associations and buy bonds instead. This type of movement of funds has been particularly evident since the middle of 1969, by which time one could earn an additional 80 percent or more by holding bonds compared to bank accounts.

To indicate how these trends have affected Minnesota mortgage lending, table 4 presents the new mortgage loans of savings and investment associations in Minnesota for 1968 through 1970. Although the dollar volume of new loans increased 13.17 percent in the first half of 1969, it fell 12.93 percent in the second half of 1969 and 12.73 percent in the first half of 1970. This is consistent with what we observed in trends in new housing starts. The fact that there was an increase in new mortgage loans in the second half of 1970 implies that some increase in housing starts should be expected in the first half of 1971. The recent reductions of the prime interest rates also seem to indicate this.

[3] For savings accounts over $100,000, for instance, savings and loan associations can pay up to 7.5 percent per year.

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SUMMARY AND CONCLUSIONS

By comparing the Minnesota mortgage interest rate to an average national bond rate, we have shown that the competitive Minnesota mortgage rate is closely associated with national monetary market conditions, and is not under the control of Minnesota bankers. Considering the composition of housing starts, we then showed that the discriminatory effect of the usury law on one- and two-family housing starts was pronounced in the second half of 1969 and throughout 1970. Thus we concluded that the major impact of the Minnesota usury law was to reduce the relative number of private homes compared to new apartment houses built. And we further asserted that the overall reduction in mortgage loans also was affected by other restrictions on mortgage lenders, such as regulation Q.

What can we then conclude about the implication of the Minnesota usury law compared to the intention of protecting the consumer from paying "unreasonable" interest rates? For most of the period under consideration, the usury limit was not binding and so had no effect at all. During the period when the competitive mortgage rate was greater than the 8 percent limit, there was a noticeable relative reduction in funds available to home buyers, implying the reduction in consumer home purchases. Since this law appears neither to protect the interests of the consumer nor to permit a rational allocation of the resources of Minnesota, it should be modified or repealed.

Postscript: Other Interest Rate Restrictions

The Minnesota usury law is only one of many interest rate restrictions imposed on the financial markets by state and federal legislation and agencies. Although the impact on Minnesota is only marginal from many of these restrictions, it is interesting to note that the kinds of effects disclosed by other analysts are similar to the effects of the Minnesota usury law. Two of these restrictions are worth discussing: (1) regulation Q, the interest rate ceiling on time and savings deposits, and (2) the ceilings on federal, state, and local bond interest rates.

The impact of the ceiling on time and savings deposits has been briefly discussed in the previous article. Our major concern is why these savings institutions should be prevented from paying competitive returns to small savers. Such prevention leads to a flow of funds away from the mortgage market and therefore seems like a highly discriminatory policy at best.

The regulations on the interest payable on federal, state, and local bonds also has undesirable effects. The restriction on federal long term bonds is 4¼ percent. The impact of this is that "by 1970 only 27 per cent of the publicly held marketable bonds had an original maturity of more than seven years, and 33 per cent had a maturity of one year or less."[1] Thus the treasury will have to refinance over $120 billion in short term debt in 1971 alone. The situation is even more drastic with respect to the financing of local school bond issues. With an interest rate ceiling of 7 percent in Minnesota on local bond issues, the ability of local communities to raise money for school expansion since the middle of 1969 has been extremely limited. The result has been various local school crises.

The crucial factor to keep in mind in considering all these restrictions is that although the desirable intent is to protect various types of borrowers from paying "unreasonably" high interest rates, the actual outcome of too restrictive a policy is in each case quite the reverse: the inhibition of these borrowing groups in raising funds.

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[1] Warren J. Gustus, "The Ceiling That Should Be Razed," *The Federal Reserve Bank of Philadelphia Business Review*, December 1970, p. 13.

IN REVIEW

Recent Publications

Each year the Department of Agricultural and Applied Economics issues a list of papers and publications prepared by its faculty. Copies of the most recent list, which covers the period from July 1969 through June 1970, may be obtained by requesting Economic Information Report R70-7, *List of Faculty Publications in Agricultural and Applied Economics.*

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P70-15 *Rural Development and the Welfare of Rural People.* Arley D. Waldo.

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P70-23 *The Impact of the Minnesota Usury Law.* Mathew Shane.

P70-24 *Capital Markets, Stability, and Economic Growth.* Mathew Shane.

P70-25 *The Derivation of Bounds to the Global Optimum of an Integer Fixed Charge Problem.* Terry Roe.

ECONOMIC INFORMATION REPORTS

R70-5 *1969 Farm Business Summary by Type of Farming for Northern Minnesota.* Truman Nodland and Edgar Persons.

R70-6 *1969 Farm Business Summary by Type of Farming for Southern Minnesota.* Truman Nodland and Edgar Persons.

R70-7 *List of Faculty Publications in Agricultural and Applied Economics, July 1969-June 1970.*

R70-8 *Agricultural Outlook for 1970-71.*

ECONOMIC STUDY REPORTS

S70-4 *Labor Needs in Lake State Dairy Farming: 1967, 1975 and 1980.* Boyd M. Buxton.

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EXPERIMENT STATION PUBLICATIONS

Government Regulation of the Farm Supply Industries. Brian G. Gnauck and Dale C. Dahl. Station Bulletin 492.

Quarterly Econometric Model of the Turkey Industry in the United States. M.A. Soliman. Technical Bulletin 275.

A Method of Estimating Normative Prices and Supplies in Federal Order Milk Markets. D. G. Stitts and J. W. Hammond. Technical Bulletin 278.

The Minnesota Fertilizer Industry: Trends and Prospects. Dale C. Dahl, William G. Bursch, and Robert A. Rathijen. Miscellaneous Report 76.

EXTENSION SERVICE PUBLICATIONS

Minnesota Seed Cleaning Plants. Willis E. Anthony and Clayton W. Ogg. Special Report 36.

Consequences of Changing Production Standards for Manufacturing Grade Milk. Jerome W. Hammond and Boyd Buxton. Special Report 37.

Zoning: Principles and Definitions. Robert W. Snyder. Extension Folder 251.

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