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STATUTORY INTEREST RATE CEILINGS AND THE AVAILABILITY OF MORTGAGE FUNDS

Remarks

By

Andrew F. Brimmer
Member
Board of Governors of the
Federal Reserve System

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As frequently happens when market processes are subjected to statutory regulation, the attempts by the Federal and State governments to fix the maximum rates of interest which lenders can charge on residential mortgages have produced effects the reverse of those intended: usury laws, originally designed to protect individual borrowers, have increasingly prevented these potential borrowers from obtaining mortgage funds. While most public attention has been focused on the adverse effects of statutory ceilings on Federally underwritten mortgages, many State-imposed ceilings also severely limit the access of homebuyers to mortgage funds in a number of areas.

In the last few years, and especially in the wake of the severe difficulties experienced by the homebuilding and financing industries during the period of monetary restraint in 1966, a major effort has been launched, on both the Federal and State level, to moderate the rigidities of statutory ceilings on mortgage interest rates. This effort has achieved varying degrees of success. Statutory limits on FHA and VA mortgages have been suspended temporarily, and in a number of States maximum rates have been raised. Nevertheless,

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Note: Most arguments and data presented in this paper refer to home mortgages, and multifamily mortgages involving borrowers other than corporations, which are usually excepted from State usury ceilings, but not Federal ceilings.

as market interest rates (including rates on residential mortgages) have continued to rise under the impact of growing credit demands during the current period of monetary restraint, usury ceilings remain a serious obstacle to the flow of mortgage funds in some States. Moreover, in several important geographical segments of the mortgage market, maximum rates are still generally frozen at the extremely unrealistic ceiling of 6 per cent. Thus, the task of coming to grips with the problems posed for housing finance by out-dated statutory interest rate ceilings are still before us.

The principal points of these remarks can be summarized briefly:

- The inherent deficiencies of the residential mortgage as a capital market instrument are compounded by rigid statutory ceiling on interest rates which lenders can charge.

- Statutory interest rate ceilings, whose roots are deeply imbedded in historical experience, are so low in a number of States that they pose a serious obstacle to the functioning of their mortgage markets.

- The adverse effects of usury ceilings -- while most evident in the behavior of lenders -- are particularly harsh on builders of new houses and on owners of existing homes. These effects can be seen most clearly in the case of FHA and VA underwritten mortgages, where discounts provide a sharp and readily measurable indicator of the impact of inflexible rate ceilings.

- The recent moves to suspend statutory ceilings on FHA and VA mortgages and to raise ceilings in several States have been only partially successful. Discounts are again sizable on FHA and VA mortgages, and newly-raised ceilings in a number of States are again interfering with the flow of mortgage funds.

- Thus, there is still a major job ahead if we are to develop a mortgage market capable of meeting the expanding demands for residential finance.

Structural Defect in Mortgage Financing

The deficiencies in mortgages generally -- and in residential mortgages particularly -- which make them a special type of financial asset are widely known. However, it may be well to remind ourselves again that a substantial part of the obstacle to the development of a truly viable mortgage market arises from the characteristic of the instrument itself. Furthermore, some policies and regulations affecting Federally-underwritten mortgages have also helped to give mortgages a special standing (not always beneficial) in the capital market.

Most varieties of debt instruments other than mortgages are relatively homogeneous within broad categories. For example, investors normally accept corporate bonds of the same maturity and quality rating as reasonably close substitutes -- with relatively small change in yield differentials required to encourage substitution. In contrast, mortgages are differentiated in so many ways -- by maturity, credit worthiness of the borrower, legal requirements of the State in which the property is located, etc. -- that they clearly are not interchangeable. Federal guarantees and insurance tend to add homogeneity. However, while less than one-fifth of all residential mortgages on new homes in the period 1963-66 had such protection, the proportion has declined further in 1967-68. Moreover, additional fees and rate limitations have also tended to reduce the effectiveness of efforts to create a genuinely competitive, nationwide financial asset out of the residential mortgage.

The institutional structure of mortgage markets has also limited the ability of the mortgage to compete with other financial assets. Undoubtedly, one of the most serious obstacles is posed by Federal and State statutory ceilings. Interest rate limitations on mortgages established by such statutes inevitably make mortgages non-competitive in periods when generally rising interest rates force yields on market securities up to or beyond the statutory ceilings. While discounts can increase the yield on mortgages, many lenders find the use of discounts a difficult procedure for technical and other reasons. Moreover, both laws and administrative regulations inhibit their use, and the impact on the cash position of the seller or builder is often so large that it further reduces the use of discounts.

Origins and Scope of Statutory Interest Rate Ceilings

Interest charges have been made since ancient times, and the efforts to regulate such charges are equally ancient. Apparently the practice of charging interest on loans fell into disrepute quite early after it began; undoubtedly this was partly because interest rates were high and penalties for default were heavy.

The historical record (from ancient Greece, through the Jews, to the Christian Church, to the secular authorities in Europe and to the American States today) is replete with efforts to prohibit or regulate interest charges -- which almost from the very beginning became known as "usury". Over time, however, the authorities began to distinguish between low interest rates and high interest rates --

with the concept of usury being reserved for the description and condemnation of high interest rates. On the basis of this distinction, England in 1545 eliminated the prohibition on usury and established a legal maximum interest rate. Other countries followed this example. Over the years, however, Great Britain ceased fixing legal interest rates, and left it to the courts to determine whether a rate is usurious.

In this country, it was the States -- not the Federal Government -- that followed the legacy stemming from the English action of the sixteenth century. In general, States fix a legal rate at which debts may be assessed after they have become due and remain unpaid, and they also fix the maximum rate permitted in a contract. With the advent of the Federally-underwritten FHA and VA mortgages, the Federal Government did become involved in the making and administering statutory ceilings on mortgage rates.

Today, 46 of the 50 States have established statutory ceilings on mortgage interest rates. As shown in the table on the following page, if we put aside the four States which permit any rate to be charged, the vast majority of the States have set ceilings in the range of 7-8 per cent and 10-12 per cent. However, four States (New Jersey, Tennessee, Vermont and West Virginia) have established ceilings as low as 6 per cent. Moreover, at the beginning of this year, four other States (Delaware, Maryland, Pennsylvania and Virginia) still limited the maximum rate to 6 per cent.

State Statutory Ceilings on Contract Interest Rates on Home Mortgages
May, 1968

Rate Ceiling (Per cent)	Number of States	Names of States
Any rate	4	Connecticut[1/], Maine, Massachusetts, New Hampshire.
21	1	Rhode Island.
12	4	Colorado, Hawaii, Nevada, Washington.
10	12	Arkansas, California, Florida, Kansas, Montana, New Mexico, Oklahoma, Oregon, Texas, Utah, Wisconsin[1/], Wyoming.
9	1	Nebraska.
8	15 and D. C.	Alabama, Alaska, Arizona, Delaware[2/], District of Columbia, Georgia, Idaho, Indiana, Louisiana, Maryland[3/], Minnesota, Mississippi, Missouri, Ohio, South Dakota, Virginia.
7-1/2 - 5	1	New York[4/]
7	8	Illinois, Iowa, Kentucky, Michigan, North Carolina, North Dakota, Pennsylvania, South Carolina.
		New Jersey, Tennessee[5/], Vermont, West Virginia. (In Tenn. and W. Va., S & L's may charge a premium above the limit.)

1/ On loans of $5,000 or less, the maximum rate is 12 per cent.

2/ The State legislature on May 23 passed a bill for the rate to go from 6 per cent to 8 per cent.

3/ As of July 1, 1968.

4/ The State legislature on May 21 passed a bill to give the State Banking Board the discretion to set the rate between 5 per cent and 7-1/2 per cent.

5/ On loans exceeding $50,000, the maximum rate is 7-1/2 per cent.

Note: In many States with ceilings, FHA-insured and VA-guaranteed mortgages are excepted.

As one examines the geographical pattern of mortgage rate ceilings, it is easy to discern the broad outlines of a mechanism designed to attract funds from surplus savings areas to capital deficit regions. Leaving aside New England (where apparently steps to free the mortgage market were undertaken years ago), it is evident that State statutory ceilings were set in the East at a fairly low 6 per cent, reflecting the sizable volume of savings generated in this area over the years. The advanced degree of industrial development, the high ratio of savings to personal income, and the growing stock of wealth of households -- all supported the evolution of strong financial institutions. The latter in turn were able to mobilize savings in substantial volume to be invested in their immediate areas or channelled into distant regions where the demand for funds greatly exceeded the supply. The regions facing the greatest capital shortage were the South and West, with the Mid-West falling between the two extremes. Thus, again leaving aside New England, as one generally fans out from the Middle Atlantic region, the contours of mortgage rate ceilings rise in a fairly regular pattern. While valleys appear in several instances, the average of the maximum rates is definitely higher the farther out one travels.

Unfortunately, the older eastern regions are no longer blessed with as large a volume of excess savings as they were in the past. With the strong demands for funds -- demands arising from the large and persistent deficit in the Federal budget, from State and local governments, from corporate borrowers, from foreign borrowers, as well as from households competing for mortgage funds -- savings intermediaries in these older regions of the country are behaving in exactly the way one would expect them to behave: they are investing their funds where they can obtain the highest returns. In the process, mortgage borrowers in a number of States are attracting a declining share of the total savings flows.

Adverse Impact of Statutory Rate Ceilings

Low statutory interest rate ceilings affect the home mortgage market adversely by reducing the demand for credit as well as the supply of funds. This in turn means reduced activity in homebuilding and in the transfer of existing dwellings. These adverse effects can be traced in the behavior of lenders, of builders and of households.

Lenders: The principal reaction of lenders to low rate ceilings is to reduce the supply of new commitments. As one would expect, as market interest rates (including those on mortgages) converge on statutory ceilings, domestic lenders tend to reduce in-State lending and to expand the investment of funds out of State. At the same time, low rate ceilings discourage in-State lending by out-of-State institutions. In general, such ceilings divert funds to investments whose yields are more free to move in response to market forces.

This pattern of reaction was amply illustrated by the behavior of New York City savings banks. In view of the 6 per cent ceiling (which has been in effect until now) in New York State, savings banks have been investing an increasing proportion of their funds in properties in other States and in high-grade corporate bonds. This is clearly understandable when the maximum of 6 per cent generally obtainable on mortgages secured by properties located in New York is set against market yields in the first four months of this year in the neighborhood of 6-3/4 per cent on out-of-State conventional mortgages and against slightly higher secondary market yields on mortgages underwritten by the Federal Government. Also during the first four months of this year, newly-issued high-grade corporate bonds have offered yields well over 6-1/2 per cent. The magnitude of out-of-State mortgage investing that the New York savings banks are doing was indicated in early March by the Superintendent of Banks while testifying in support of a bill that would empower the State Banking Board to fix mortgage rate ceilings in line with current market yields. He reported that in 1967 savings banks in New York State had invested $916 million in mortgages within the State and $1.1 billion in out-of-State mortgages. He also reported that there was a rising trend toward out-of-State mortgages throughout 1967, and that no reversal had occurred so far this year.

Where legal, lenders charge discounts or adopt other means of raising the effective yield. Expressed in the form of "points" (i.e., a given percentage of the principal amount involved), such discounts on FHA-insured loans provide an indication of the market's changing evaluation of the effective rate on mortgages in excess of the statutory ceiling. For example, on 6 per cent, FHA-insured loans, the market yield in April, 1967, was 6.29 per cent, and the discount was 2.5 points. Over the following twelve months, as interest rates rose generally, the same category of 6 per cent, FHA-insured loans in April of this year were yielding 6.94 per cent in the secondary market, and the discount had risen to 7.9 points. However, for public relations reasons, lenders are often reluctant to make loans subject to substantial discounts. Instead, many lenders prefer to withdraw from the market.

Home Builders: Other adverse effects of low statutory ceilings during periods of rising market yields can be seen in the behavior of builders. The first place to look is the interaction between lenders and builders. During such periods, banks and other short-term lenders reduce construction loan commitments to builders as the volume of permanent takeout commitments from long-term lenders is cut back and as the stiffening terms of such permanent commitments shift more of the risk to construction lenders.

As market rates press against statutory ceilings, homebuilders may have to absorb an increasing share of mortgage discounts in their profits, thus weakening incentives to build. Whenever possible, however, builders try to pass discounts along to buyers in higher prices or lower quality construction. Lower-priced construction, where profit margins are probably smaller than in higher-priced dwellings, may be hit the hardest. When mortgage discounts become "excessive," builders may withdraw from home construction and temporarily go out of business or into other lines of construction activity where discounts are less of a problem.

Households: The impact of statutory mortgage interest rate ceilings on individual households can be seen in the behavior of both buyers and sellers of homes. Homebuyers, presumably the party for whose benefit maximum mortgage rates are set, are discriminated against in a number of ways: the availability of funds is reduced, and housing prices are inflated by discounts. Many borrowers would be better off financially by paying market interest rates rather than higher housing prices, involving large down payments and about the same monthly housing outlays. The range of choice of available housing is restricted by reductions in new construction and the withdrawal of some existing homes from the market. And whatever volume of credit is provided by mortgage lenders is extended on more restrictive non-rate terms than would otherwise prevail.

In circumstances where statutory ceilings generate discounts, home sellers, whenever possible, try to pass such discounts in higher prices, rather than absorb the amount in reduced capital gains. Otherwise they may temporarily withdraw their homes from the market, or seek to finance the sale through possibly higher-cost (to buyers) financing involving the use of take-back second mortgages. The propensity of sellers to withdraw their homes from the market can be seen dramatically in the behavior of applications for FHA insurance on used dwellings. For example, in late 1961, FHA-insured mortgages were carrying discounts of about 4 points, and insurance applications were at a seasonally adjusted annual rate of approximately 560,000. For almost two years, discounts fell steadily and leveled out close to 2 points in mid-1963. Over the same period, insurance applications climbed steadily to around 650,000 at an annual rate. With the maintenance of a fairly easy monetary policy through the fall of 1965, discounts remained in the neighborhood of 2 points, and loan applications on existing homes rose further to a peak of almost 900,000 units. However, with the adoption of a policy of monetary restraint in late 1965 -- which was pursued until the fall of 1966 -- discounts rose sharply and reached nearly 7-1/2 points in the third quarter of 1966. Under the market pressures implied by such deep discounts, loan applications were cut by more than half, dropping below some 400,000 units at an annual rate. The relatively easy monetary policy of 1967, brought a noticeable decline in discounts to about 2.5 points by April, and loan applications recovered to an annual rate of about 700,000. But this respite was short-lived. The strong competition for long-term funds (particularly from corporations) put new pressure on market yields as the year progressed, and discounts on FHA insured mortgages again rose steeply. By April 1968, such discounts had reached about 7.9 points, and loan applications on existing houses had fallen below 600,000 at an annual rate as sellers progressively withdrew their homes from the market.

In many cases, rather than withdrawing their homes, sellers try to bury the discount in a higher price. Actually, he gains little by such an effort, because any real estate brokerage fee is calculated on the total price. In fact, the seller's net proceeds would be somewhat lower under these circumstances than would be the case if no discount were involved and capitalized.

Recent Developments in Ceilings on Mortgage Rates

The types of behavior examined above were responsible for much of the frustration -- on the part of lenders, builders, and households -- which stimulated the recent efforts to modify mortgage statutory ceiling laws at both the Federal and State levels. Federal action involved Congressional passage of PL 90-301 -- and Presidential approval on May 7 -- which suspends temporarily (until October 1, 1969) statutory limits applicable to interest rates on all FHA and VA market rate mortgage programs. The limits had been 6 per cent on home loans and from 5-1/4 to 6 per cent on multifamily loans. In addition, the legislation raised the permanent ceiling on all market rate multifamily programs to 6 per cent.

The same law authorized a regulatory rate ceiling on Federally-underwritten loans adequate "to meet the mortgage market." Acting under this authority, FHA and VA specified an across-the-board limit of 6-3/4 per cent for all market-rate programs within States permitting this level of rates on Government underwritten loans. The effect was to bring about some reduction in discounts. However, since market yields on FHA and VA mortgages currently exceed 7 per cent, discounts remain fairly substantial. At present such discounts probably range between 4 and 6 points nationwide, compared with more than 8 points at the time the law became effective.

At the State level, several liberalizing moves have been made recently. North Carolina raised its ceiling on mortgage loans to

7 per cent from 6 per cent, effective in June, 1967. Effective March 1 this year, Virginia adopted a ceiling of 8 per cent, compared with the previous 6 per cent maximum.

On May 7, the Governor of Maryland signed a bill raising the usury ceiling to 8 per cent from 6 per cent, effective July 1. In the interim, apparently some FHA and VA mortgages are being closed under terms calling for 6 per cent interest payable through June 30 and 6-3/4 per cent thereafter. A special (and unusual) feature of the legislation would apparently prohibit the charging of any discounts, points, or similar fees on all mortgages, presumably including FHA and VA loans. It is reported that the Maryland Attorney General is preparing an opinion on the precise application of this unusual feature. If all FHA and VA mortgages were included, of course, no lender could make a Government underwritten loan at a discount in Maryland, and funds for this type of investment could become scarce indeed. In fact, much of the benefit of the move to a higher ceiling on mortgages would be erased.

In Pennsylvania, the Governor on May 17 signed a bill permitting a lender to charge a premium of 1 percentage point above the existing 6 per cent usury ceiling. Formerly, only savings and loan associations could charge up to 7 per cent. Permission to charge the premium, which expires five years from the effective date, applies only to newly-made mortgages. No existing mortgage, according to the law, may be renegotiated at the premium.

It is reported that many long-term mortgages in Pennsylvania have been made under a provision calling for renegotiation of the rate after each successive 3-year period. Apparently, the new law would prohibit renegotiation of such loans at the premium rate, although the courts may have to resolve the uncertainty. In the meantime, while the new law in Pennsylvania is definitely a step forward, on closer examination, the stride seems not to have been as long as one originally thought.

Strong efforts are being continued in New York and a few other States to liberalize 6 per cent usury ceilings. The outcome of these efforts assumes even more critical importance in light of the trend of mortgage rates. Since mid-April, home mortgage yields have risen above 7 per cent for the first time in the postwar period. If further increases should occur, investment in home mortgages will come under increasing restraint within an additional 8 States with 7 per cent usury ceilings. Last year, these 8 States (Illinois, Iowa, Kentucky, Michigan, North Carolina, North Dakota, South Carolina -- and Pennsylvania which just moved to 7 per cent) accounted for 18 per cent of all housing units for which building permits were issued within the nation's 3,014 permit-issuing places.

Concluding Remarks

Thus, a significant task remains ahead of us, if we are to develop a truly viable mortgage market. A critical ingredient in the process is the early abolition of statutory rate ceilings.

The public policy objective of usury ceilings is to protect mortgage borrowers in unfavorable bargaining positions from "excessive" charges on loans extended by private lenders. But when going yields exceed usury ceilings substantially, this objective becomes increasingly difficult to achieve. Meanwhile, other unintended and unfavorable consequences (as mentioned above) are produced. The anomalous outcome may be that borrowers in States with quite high usury ceilings, or with no usury ceilings, are more successful in their quest for adequate credit from private sources on more reasonable overall terms than are borrowers in low-rate States. Retention of below-market usury ceilings thus inevitably inhibits lending in the private sector, giving rise to demands for greater lending from public sources.

To the extent that more Government agency credit is forthcoming, public credit tends to be substituted for private credit, and when subsidies are involved they are granted at the expense of all taxpayers. The substitution of public for private credit runs exactly counter to the settled position of public policy as set forth in an interagency committee report on "Federal Credit Programs" presented to the President in 1963. This committee recommended that "Government credit programs should, in principle, supplement or stimulate private lending, rather than substitute for it."

Personally, I am not aware of any reports showing that mortgage borrowers in such States as Massachusetts, Maine, and Connecticut -- where any mortgage rate may be charged -- have been forced to borrow at exorbitant rates of interest, even on junior financing. On the other hand, we have learned from informal sources that since going market yields (rates) tend to prevail in these States, lenders have been more willing to make new commitments on local properties there than they have been in adjacent or nearby States such as New York, Vermont, or Pennsylvania, where usury ceilings are (or were) 6 per cent and discounts may or may not be charged.

Finally, the need for any usury "protection" will also be substantially lessened, if not eliminated, once the truth-in-lending legislation that has been passed by Congress is in force. The Consumer Credit Cost Disclosure section, Title I of the Consumer Credit Protection Act, which is cited as the Truth In Lending Act, requires that the borrower be given a complete statement of all charges involved. Those charges that are defined to be part of the finance charge are to be computed in terms of an annual interest rate. In the case of real estate, the computation of the annual interest rate includes any points which may be involved on the mortgage. Because of this required statement, the borrower should have a more accurate idea of the actual costs involved with any particular mortgage and also a more useful basis for comparison in his choice of mortgage contracts.

In the meantime, the efforts to remove State usury ceilings on mortgage interest rates are still worth pursuing.