Research Department
Federal Reserve
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FRB SF Weekly Letter

Over The Limit

Usury laws, an ancient device for setting legal limits on loan interest charges, have recently reduced consumer-credit availability in states with low statutory ceilings. Their effect thus has resembled the impact of interest-rate ceilings on the supply of passbook-savings deposits. Below-market interest-rate ceilings on deposits—deposits being loans made by consumers to depository institutions—have induced consumers to shift their funds from low-yield passbook-savings accounts into financial assets paying a market rate of return. (The recent boom in money-market mutual funds exemplifies this trend.) Similarly, in periods of high interest rates, low fixed-rate usury ceilings have induced financial institutions to restrict their consumer lending in favor of other types of assets yielding a market return. Consumer credit thus has contracted as financial institutions in usury-law states have shifted their loanable funds to other markets.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (MCA) represented an attempt to end low fixed-rate ceilings both on loans made by lenders to consumers (usury statutes) and on loans made by consumers to banks and thrifts (deposit ceilings). The provisions of the Act should reduce the likelihood, and severity, of the periodic consumer-credit crunches and deposit shortages caused by ceilings in the past. Following the trend started by the regulatory agencies' authorization of market-yielding money-market certificates in 1978, the Act provided for a phase-out of deposit rate ceilings over a six-year period. (Last week, the Depository Institutions Deregulation Committee set a definite timetable for the phase-out.) The Act also preempted usury ceilings on mortgage and consumer loans, as well as on some small business and agricultural loans.

Why ceilings?
Usury, in its archaic form, referred to the act of charging interest for the use of money. Today, the payment of interest is taken for granted throughout most of the commercial world—except for countries like Saudi Arabia, where religious strictures prevail against the practice. But even in the present-day United States, debates continue about the charging of "usurious" or "exorbitant" interest.

Almost all American states have usury ceilings of some type. These laws set maximum interest rates that lenders may charge on specific types of loans. The statutes typically attempt to limit interest rates, fees, discount points, or other charges on loans to individuals or small businesses. The ceilings may vary according to the type of lender—commercial bank, thrift institution, finance company, mortgage company, or individual—or they may apply to all lenders. Other factors—purpose of the loan, type of borrower, and size of loan—may also determine ceilings. In modern times, however, most states have limited the use of usury statutes to mortgages and consumer loans.

Some states have set consumer-loan ceilings at a fixed rate. The state of Washington, for example, until quite recent months imposed a 12-percent ceiling rate. Some ceilings may be tied to a market-determined interest rate such as the Treasury bill rate—Washington's new ceiling is four percentage points above the equivalent coupon yield on 26-week Treasury bills. Or ceilings may be based on an administered rate, as in Alaska, where the ceiling is set at five percentage points above the discount rate charged by the Federal Reserve Bank of San Francisco.

Legislatures typically have enacted usury ceilings to protect small borrowers, in an attempt to guarantee that available credit would be priced at a "reasonable rate." Supporters have argued that a legal maximum rate is necessary to protect borrowers from a possible lack of

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competition in lending markets—and from the stronger bargaining position held by lenders because of their large size and easier access to information. Information on loan rates, maturities, fees, and repayment terms is costly for borrowers to obtain, so that they cannot easily shop around to obtain the most favorable terms. Legislatures thus utilize ceilings to limit lenders' ability to turn possible bargaining advantages into high interest rates and fees. In recent years, however, other legislation (such as the Truth in Lending Act) has aided consumers by standardizing the statement of contractual terms and by simplifying comparisons among lending agreements, thereby eliminating some of the supposed need for usury statutes. Moreover, financial markets have become more integrated and competitive over time, so that consumers normally have many borrowing options available to them.

Unintended effects

When market-determined interest rates soar above statutory ceilings, usury laws admittedly limit the price of credit. However, ceilings also effectively limit the return to lenders, making certain loans unprofitable without affecting yields on other types of lending. Limited yields on consumer loans thus induce financial institutions to restrict their consumer lending and also to tighten credit standards on such loans.

Banks in particular have available a wide array of lending opportunities, so that they can adjust their asset and liability portfolios in response to ceilings placed on consumer-loan rates. For example, they may increase their lending to the business community (through direct loans or purchases of open-market paper), to the government sector (via purchases of new securities), or to other commercial banks (through loans of funds in the inter-bank Federal funds market). In many cases, they lend such funds to out-of-state corporations, governments, or financial institutions. Or they may simply reduce their total lending and their managed liabilities accordingly. Because financial institutions are able to alter their portfolio composition, state usury laws thus tend to limit the total amount of credit available to consumers within affected states.

Ceilings also induce institutions to tighten their non-price terms of lending in order to reduce loan volume and to lower costs. To ration the dwindling supply of credit, institutions will tighten credit standards, allocate loans to existing customers, and limit maximum loan sizes. Also, as a means of reducing costs—especially loan losses and administrative expenses—institutions will allocate available credit to their most credit-worthy, low-risk borrowers. Thus, rather than insuring wide-scale availability of credit at artificially low rates, binding usury ceilings may simply guarantee availability of credit to the "best" customers. Borrowers who otherwise might qualify if institutions could charge above-ceiling rates will be left without credit.

Some depository institutions with heavy retail or consumer orientation may find it difficult to switch from consumer lending into other types of lending. Large investment in staff training, marketing programs, and lending facilities—not to mention legal barriers—make it very costly for institutions to switch policy in this way, at least in the short-run. Institutions may be willing occasionally to take short-term losses on some loans in order to preserve profitable long-term relationships with "valued" customers. But now, with the high cost of new consumer deposits (especially money-market certificates), usury ceilings may make consumer lending even more unprofitable than in the past.

Credit availability

Recent large-bank data from the San Francisco (Twelfth) Federal Reserve District provide support for this analysis. From the third quarter of 1979 to the first quarter of 1981—a period of generally very high market rates—outstanding consumer credit actually declined in states with usury-law limitations on consumer-lending rates. In

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other states, consumer lending continued to grow, even in the face of sluggish economic conditions, high interest rates, and the spring-1980 credit-control program. Usury ceilings may not account for all of this difference in states' growth patterns, but they undoubtedly explain a large part of it.

In this 1979-81 period, total consumer loans at large banks in Washington, Oregon, and Idaho, where ceilings were well below market rates, declined at a 5.1-percent annual rate. In dollar terms, their outstanding consumer loans fell from $3.7 billion to $3.4 billion over this time-span, in quarterly average terms. Meanwhile, average consumer loans at large banks in five other Western states without usury ceilings rose at a 3.2-percent annual rate, despite all the negative factors affecting consumer markets at that time.

Usury-law changes

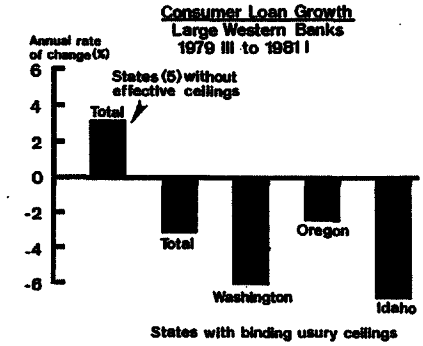
Recognizing the perverse impact of usury ceilings on the availability of consumer credit, Congress last year included several provisions in the Monetary Control Act to deal with this problem. First, the MCA preempted state usury ceilings on *mortgage* loans—unless states reinstate such ceilings by April 1, 1983. In contrast, the Act did not include an unlimited override of state ceilings on *consumer* loans. Instead, it authorized insured state-chartered banks and thrifts—national banks already had authorization—to set consumer-loan rates at a maximum of one percentage point above the basic Federal Reserve discount rate. This represented only a partial solution to the problem, however, since the discount rate typically lags behind the market during periods of rising market rates. Moreover, the discount rate—as an administered, one-day, risk-free secured loan rate—is often well below market-determined rates.

In light of this partial solution, state and Federal legislators have intensified their efforts either to rewrite usury statutes or to eliminate them altogether. Two Western states with rigid rate ceilings, Washington and Idaho, have just taken actions to liberalize their usury statutes, while the third, Oregon, is expected to do so soon.

Recent and proposed legislative changes may result in higher fixed usury ceilings, variable-rate usury ceilings or, in some cases, no ceilings at all. But in most cases, ceilings will now move with the market, rising and falling with the general level of interest rates. During periods of high interest rates, these changes will keep consumer credit from "drying up" as it did in the past. Moreover, a potential borrower who cannot obtain a loan at an artificially low rate may certainly prefer paying a higher rate to not obtaining a loan at all.

In a wider sense, elimination of consumer-credit crunches should benefit not only consumers but also business activity generally in affected states. Finally, the shift to floating-rate usury ceilings, or even total elimination of ceilings, would be consistent with Congressional efforts to decontrol interest rates on both consumer loans and deposits.

Gary C. Zimmerman



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/17/81	Change from 6/10/81	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	149,637	– 333	12,673	9.3
Loans (gross, adjusted) — total#	127,799	– 214	12,361	10.7
Commercial and industrial	37,921	350	4,487	13.4
Real estate	52,629	118	5,876	12.6
Loans to individuals	22,958	30	– 920	– 3.9
Securities loans	1,592	– 83	578	57.0
U.S. Treasury securities*	6,425	– 18	78	1.2
Other securities*	15,413	– 101	238	1.6
Demand deposits — total#	40,730	– 923	– 2,596	– 6.0
Demand deposits — adjusted	27,869	–1,355	– 2,893	– 9.4
Savings deposits — total	30,187	– 142	2,612	9.5
Time deposits — total#	80,019	– 312	16,069	25.1
Individuals, part. & corp.	70,969	– 194	15,919	28.9
(Large negotiable CD's)	30,688	– 393	8,009	35.3

Weekly Averages of Daily Figures	Week ended 6/17/81	Week ended 6/10/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	n.a.	n.a.	– 73
Borrowings	135	173	1
Net free reserves (+)/Net borrowed(–)	n.a.	n.a.	– 73

* Excludes trading account securities.
# Includes items not shown separately.

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