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Usury Laws and the Housing Market:
The Minnesota Experience

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Much of this paper is a review of work I did in collaboration with Stanley L. Graham and David S. Dahl.

Minnesota has had a usury law of one kind or another since 1877, yet only in the last ten years has the law had any impact. The impact, however, has been far different from that intended either by the original lawmakers or by those who support such legislation today. It has neither protected borrowers from usurious rates of interest nor made low-interest loans available to residents of the state. While some lawmakers might be surprised by these results, many economists would be surprised by another. Unlike the usury law in some states, the Minnesota law has never significantly reduced residential construction. Its major impact, instead, has been on mortgage financing and in particular on the supply of conventional mortgages.

The purpose of this paper is to review these findings on Minnesota's usury laws and point out some implications for other studies. Section I contains a brief history of such laws in Minnesota, defining periods when the usury ceiling would be expected to have its greatest impact. Section II then analyzes housing market data for these periods, comparing Minnesota to states without usury ceilings or with ceilings well above market rates, "nonusury" states. The last section examines previous research on usury laws in light of the Minnesota results. Because these studies failed to distinguish between laws that cover all mortgages and laws that exempt government-insured loans, they misstate the impact ceilings can have on residential construction.

I. Minnesota's Usury Laws

The original intent of the Minnesota usury law was to protect borrowers from paying exorbitant rates of interest. The law was first passed when information about market rates was not readily available and lenders could easily take advantage of the uninformed or naive borrower. When the law was first formalized in 1877, therefore, the ceiling rate was set at 12 percent, roughly 5 percentage points above market rates.

Since then the maximum ceiling has been lowered several times to reflect a changing concept of usury. The ceiling was lowered in 1899 to 10 percent and then in 1923 to 8 percent where it remained until a floating ceiling was adopted in May 1976. While the ceiling was being lowered, market rates were rising. Eventually the market rates became usurious.

Most businesses whose transactions were affected by the 8-percent ceiling were successful in getting exemptions. By 1947 when the Minnesota Legislature passed a number of statutory exemptions, the only major loans still covered by the law were those secured by real estate. But even these had exemptions. Not covered were Federal Housing Administration-(FHA) insured and Veterans Administration-(VA) guaranteed loans, loans to corporations, and loans in excess of \$100,000. This essentially made the law a usury ceiling on conventional mortgages under \$100,000. The intent of the law had, thus, changed from protecting the uninformed borrower to securing low-rate conventional mortgages for Minnesota residents.

When the housing industry declined sharply in 1973 and 1974, many began to question the wisdom of such a law. They argued that when market rates rose above 8 percent, instead of protecting borrowers from high rates, it simply drove funds out of Minnesota into higher-return markets. By discouraging mortgage lending, it reduced housing construction in the state and may have been the cause of the 1973-74 decline.

It was this reasoning that led state legislators in early 1976 (when market rates were well above the 8-percent ceiling) to adopt a floating ceiling effective in May. At the beginning of each month the ceiling rate would be--and is now--set 2 percentage points above the long-term government bond rate.

What was the effect of the 8-percent usury ceiling on Minnesota's housing market? Did it protect Minnesota's residents from high rates of interest? Or did it reduce the supply of mortgage funds and start a decline in residential construction?

The usury ceiling is likely to have its greatest impact on the housing market when the market rate for loans rises above the ceiling. Then funds for mortgages could be attracted to states that have either higher or no ceiling and can therefore offer better returns. In recent history, as Chart I indicates, there were two critical periods when the interest rate on FHA-insured loans (a market determined rate on a loan that is a close substitute for conventional mortgages) exceeded Minnesota's usury ceiling. One such period extended from early 1969 to 1971, the other from mid-1973 to mid-1976. The periods are represented by the shaded areas in the chart.

If the usury ceiling distorts the housing market we would expect that the effects would be greatest during these critical periods. Since the new law became effective, the ceiling rate has generally been above or equal to the FHA rate.

II. The Impact of the Usury Laws

The 8 percent ceiling had little effect on new housing

Casual observation incorrectly suggests that in Minnesota the 8-percent ceiling had a significant impact on residential construction. In both periods, when the FHA rate was above the ceiling, new housing declined quite a bit. This appears consistent with the argument that as market rates on financial assets rise above 8 percent, lenders find it more profitable to do business outside of Minnesota.

But a decline in housing starts is generally observed in all states when interest rates are high and credit is tight. As mortgage rates rise, the cost of financing a home increases and the demand for new housing declines.^{1/} A housing decline in Minnesota, therefore, may simply be part of a more general downturn occurring throughout the country.

To isolate the effect of the usury ceiling, we compared Minnesota to those states that either have no usury law or have rate ceilings well above market rates (when state data were not available we used SMSA data). If the 8-percent ceiling really affects

the housing market, then during high-interest-rate periods, housing construction should have declined significantly more in Minnesota than in nonusury states.

Chart 2 compares the series on single-family residential units authorized by building permits in Minnesota with the number authorized in nonusury states. Notice that the series on units in both Minnesota and the other states begins to decline before the critical periods begin. This suggests that rising interest rates--not usury ceilings--are a major reason for the general housing slowdown. More importantly, notice that the series on units authorized in Minnesota closely parallels the series on units authorized in the nonusury states. The difference between Minnesota and the nonusury states varies, but the variation does not depend on the critical periods. In periods of high interest rates the difference is somewhat larger, but when tested at a 95 percent confidence level the difference is not statistically significant. In short, the usury ceiling apparently does not affect homebuilding.

How the ceiling was being avoided

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

Home financing did shift from conventional mortgages to FHA or VA loans when market rates were especially high (Chart 3). In the first critical period, when market rates were about 9 percent, the value of outstanding FHA/VA mortgages as a percent of total mortgages at savings and loans increased about the same amount in both Minnesota and nonusury states. In the second period, though, when rates were closer to 9.5 percent and the share of FHA/VA loans in nonusury states steadily declined, the share of FHA/VA loans in Minnesota rose from 22 to 25 percent. This implies that the percentage of new FHA/VA loans was almost twice the normal percentage made in Minnesota. So despite the usury ceiling, many Minnesotans did pay considerably more than 8 percent for home mortgages during the critical periods.

The terms on new conventional 8-percent mortgages also changed during these critical periods (see Charts 4 and 5).^{2/} One important change was that loans in Minnesota seem to have been granted for shorter periods. 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 in the Twin Cities 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 period, maturity lengths declined modestly in the Minneapolis-St. Paul SMSA while remaining fairly level in nonusury SMSAs.

A second important change was that down payments appear to have increased in Minnesota. 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, this time exceeding 35 percent, while changing very little in nonusury SMSAs.

In summary, when the 8-percent ceiling was effective, it did not have serious effects on new housing, as many claimed, but neither did it protect Minnesota residents from high rates of interest. Instead, it distorted mortgage financing by limiting the types of conventional mortgages that were available, and encouraged the normally less desirable FHA/VA mortgages.^{3/}

The floating ceiling is less disruptive

If the above analysis is correct, a shift to a floating ceiling should have little effect on homebuilding, but should have improved the financing situation. Yet, while the floating ceiling did not affect housing and appeared to improve the availability of conventional mortgage, some distortions still remained.

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 in Minnesota and in nonusury states (Chart 2). In late 1976, however, it declined slightly in Minnesota. If this decline was precipitated by the higher rates allowable under the new law, construction in nonusury states would have dropped off too. But housing in nonusury states continued to rise. The decline, therefore, was probably due to other factors such as Minnesota's unusually severe winter in 1976. And the dramatic increase in Minnesota housing in the spring of 1977 is consistent with this explanation. Based on this experience, then, it's doubtful that the floating ceiling increased housing.

The floating ceiling, however, did affect the types of loans made. In the last half of 1976, conventional mortgage financing increased dramatically as the amount of FHA/VA decreased. The ratio of FHA/VA loans to total loans at Minnesota S&Ls declined roughly 2 percentage points, indicating that well over 90 percent of the new loans added to S&L portfolios during this period were conventional mortgages (Chart 3). The decline in FHA/VA loans continued through 1977, following the trend in nonusury states.

But while the floating ceiling made conventional mortgages more available, the financing terms remained restrictive. By mid-1978 maturities on Minnesota conventional mortgages were again declining and downpayments increasing. In the nonusury states these financing terms have remained essentially unchanged. So while the floating ceiling has increased market opportunities for borrowers and lenders, it is still not high enough to allow lenders to offer the full range of mortgages found in nonusury states. This is because some mortgages made in nonusury states have more liberal financing terms, but at higher rates of interest than the average market rate. These types of mortgages are not available in Minnesota and won't be unless the floating ceiling is significantly above market rates.

III. Implications for Previous Research

It will come as no surprise to most economists that an effective price ceiling distorted market behavior. But what will surprise many who have researched usury laws is that Minnesota's 8-percent ceiling did not seriously affect residential construction.

Two recent studies in particular are called into question by this conclusion. The first is a study by Philip K. Robins ³ who compared housing starts in different SMSAs (including Minneapolis-St. Paul) in 1970. After taking into account population, and its rate of growth and density, he found that low usury ceilings restricted housing starts. Robins estimated that an effective ceiling made housing starts per capita 16 percent smaller than they would have been for each 1 percent the estimated free market rate exceeded the ceiling. The second study, by James R. Ostas ², compared building permits in 15 large SMSAs (including Minneapolis-St. Paul) in 1965-1970. After taking into account differences in mortgage maturities and several regional factors, he also found that a low usury ceiling depressed housing construction. Ostas estimated that building permits were reduced by 14.4 percent for each 1 percent the estimated free market rate exceeded the ceiling.

According to these studies, therefore, Minnesota's 8-percent ceiling should have significantly reduced residential construction in both 1969 and 1970. But because Minnesota's law exempts FHA/VA loans, that's not what happened. The major impact of Minnesota's ceiling was simply to change the types of mortgages that were made.

This has an important implication for the studies by Robins and Ostas. These studies lump all usury states together, not distinguishing between states that exempt government-insured mortgages and states that include them. By doing this, the Minnesota experience suggests Robins and Ostas significantly overstated the housing impact of usury ceilings in the states, like Minnesota, that exempt FHA/VA loans from the laws and significantly understated it in states that include these loans.

Chart 6 shows the quantitative importance of this implication. Using Robins data on housing starts, we have divided the sample of 77 SMSAs into three groups:

- 9 SMSAs with usury laws 8 percent or lower that include government-insured mortgages,
- 18 SMSAs with usury laws 8 percent or lower that exempt government-insured mortgages,
- 50 SMSAs without usury laws or with laws above 8 percent

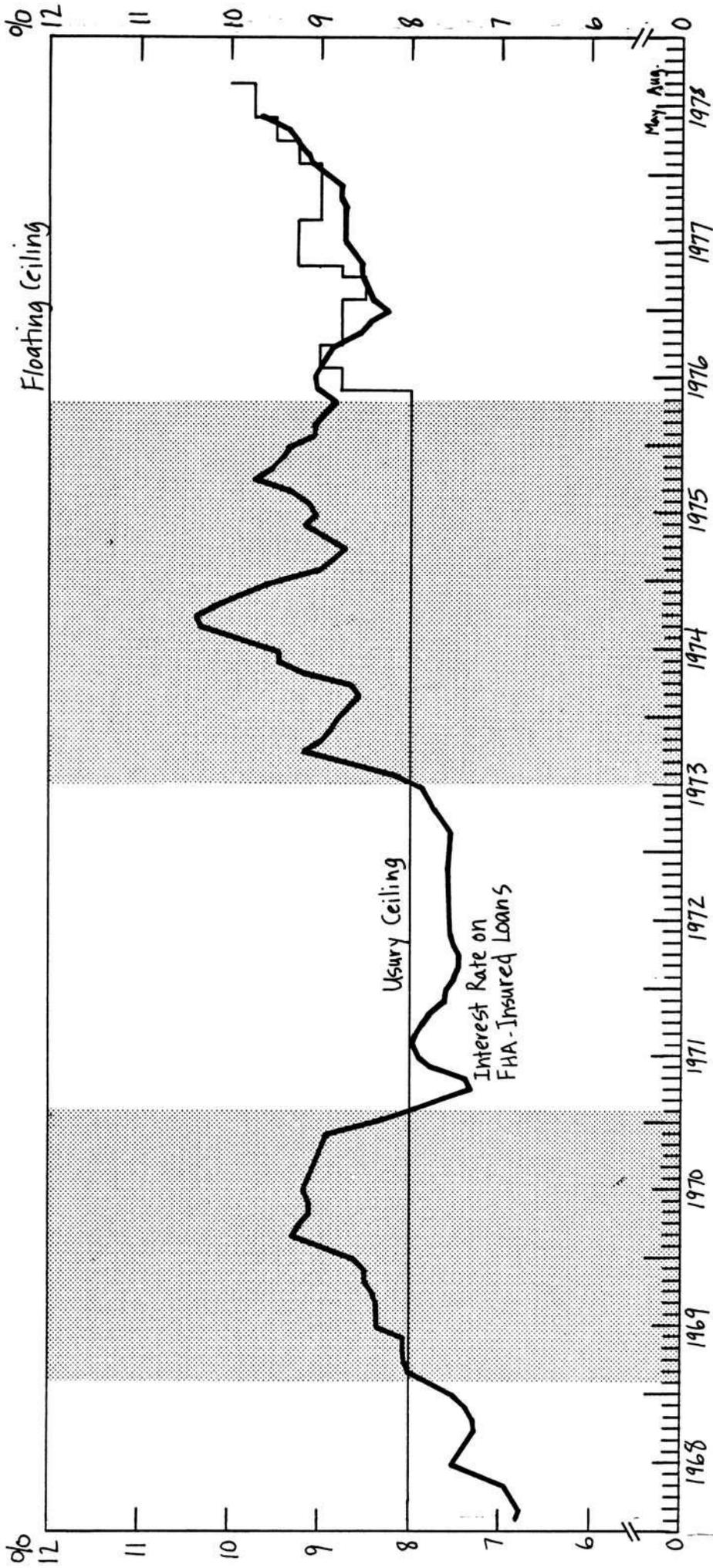
In both 1969 and 1970, when market rates were above 8 percent, housing starts fell significantly less in states that exempted FHA/VA loans than in the states that did not exempt such loans. And in 1971, when market rates fell below the ceiling, the states that did not exempt FHA/VA loans had a much larger increase in housing construction. Clearly, the impact of a usury ceiling depends on which loans are covered.

The usury law experiment in Minnesota, therefore, has important implications for both proponents of such laws and those doing research in this area. As economists have known for years, interest rate ceilings don't achieve lawmakers' objectives. They neither protect borrowers from high rates of interest nor guarantee low-interest loans. They do have an impact, however, but what it is depends critically on whether the law exempts government-insured loans. In particular, those laws that exempt government-insured loans have most of their effect on mortgage financing while those that include government-insured loans have a very big impact on residential construction. Researchers and lawmakers must distinguish between these types of laws if they hope to get an accurate estimate of a usury ceiling's effect.

Chart 1

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

▨ Market rates above 8 percent

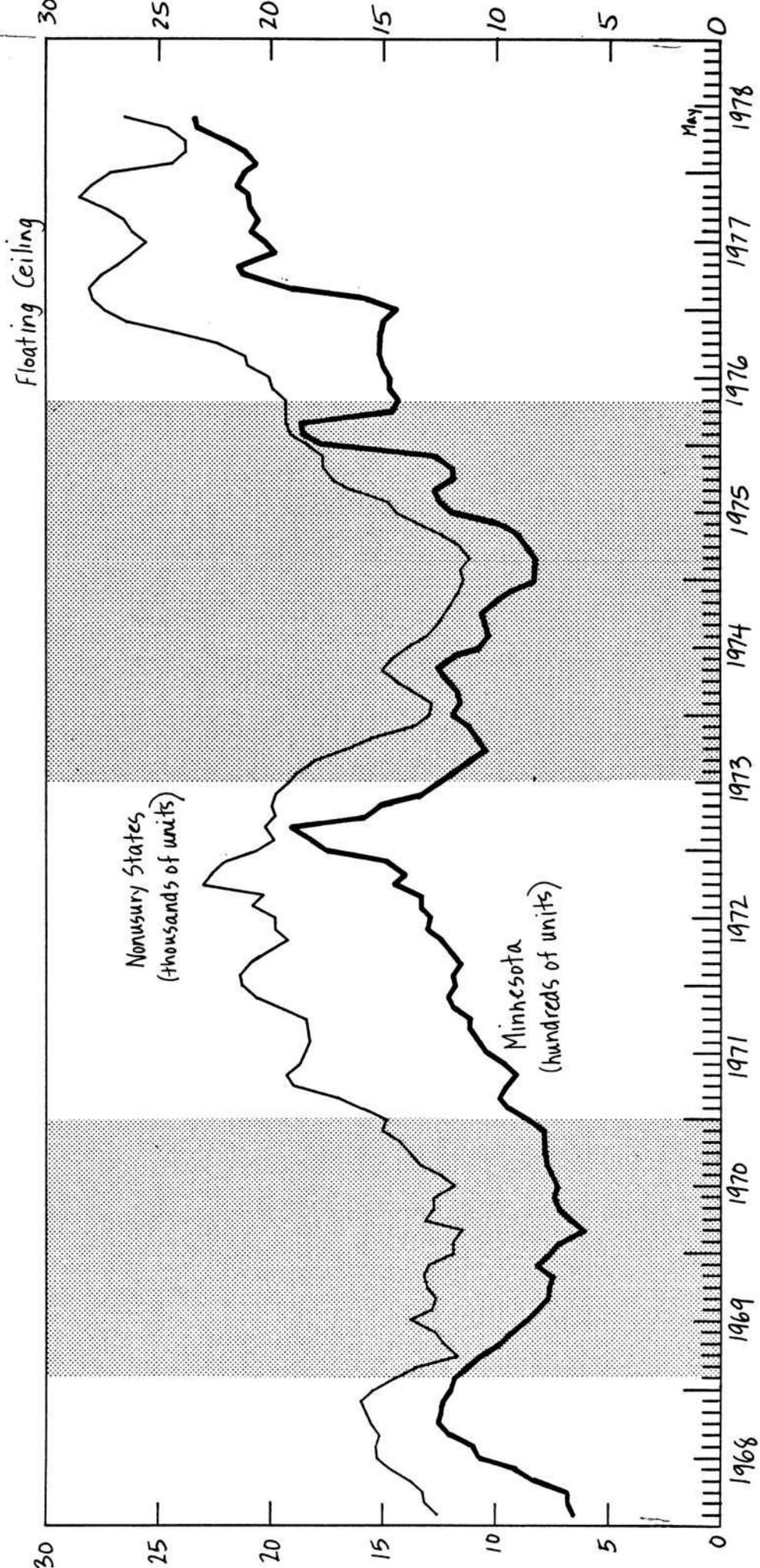


*Based on opinion reports submitted by HUD (FHA) field offices of prevailing local conditions as of the first of the succeeding months. Yields are derived from weighted averages of private secondary market prices for Section 203, 30-year mortgages with minimum down payment and assumed prepayment after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

Source: FR Board of Governors

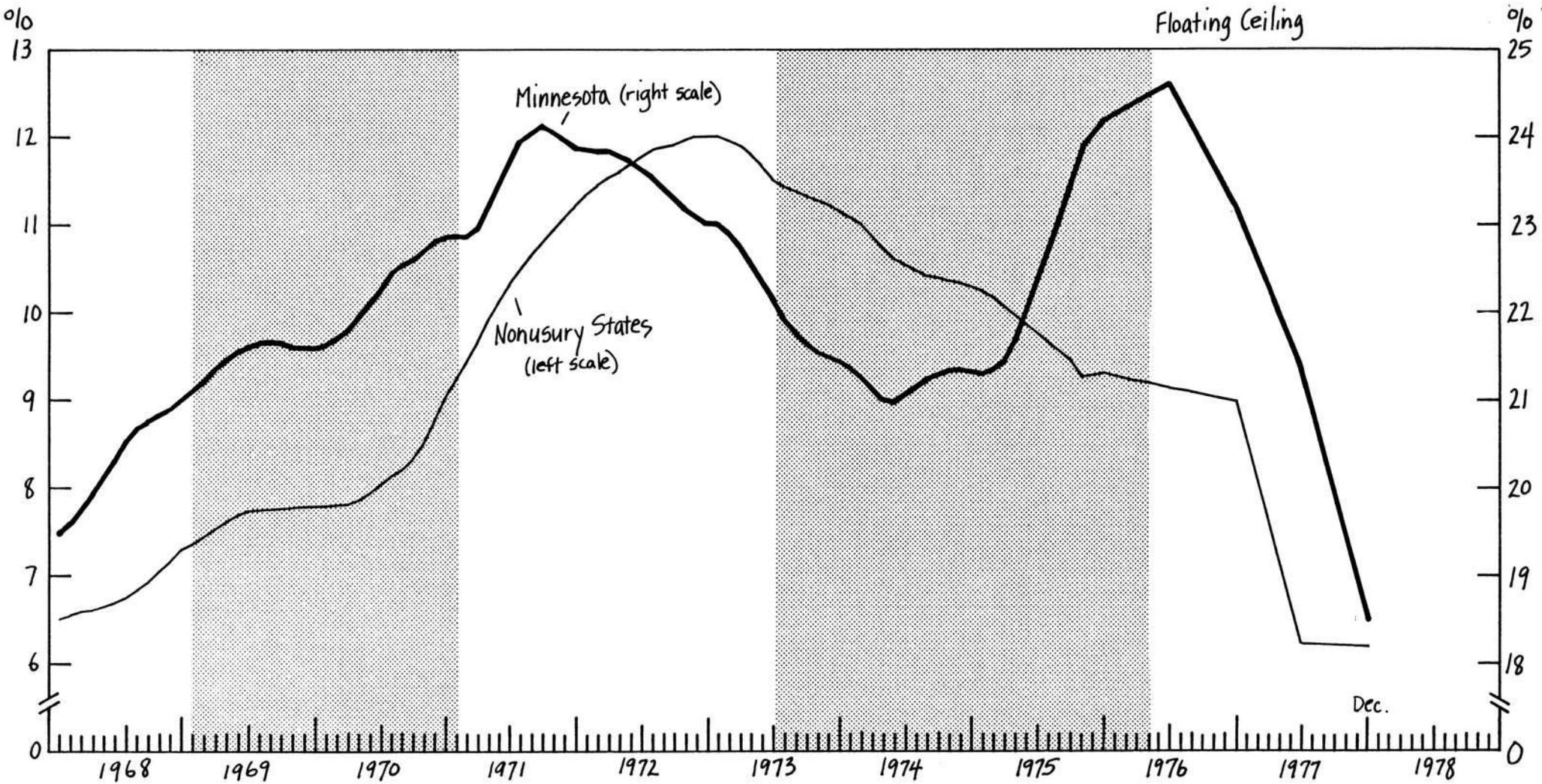
Chart 2

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

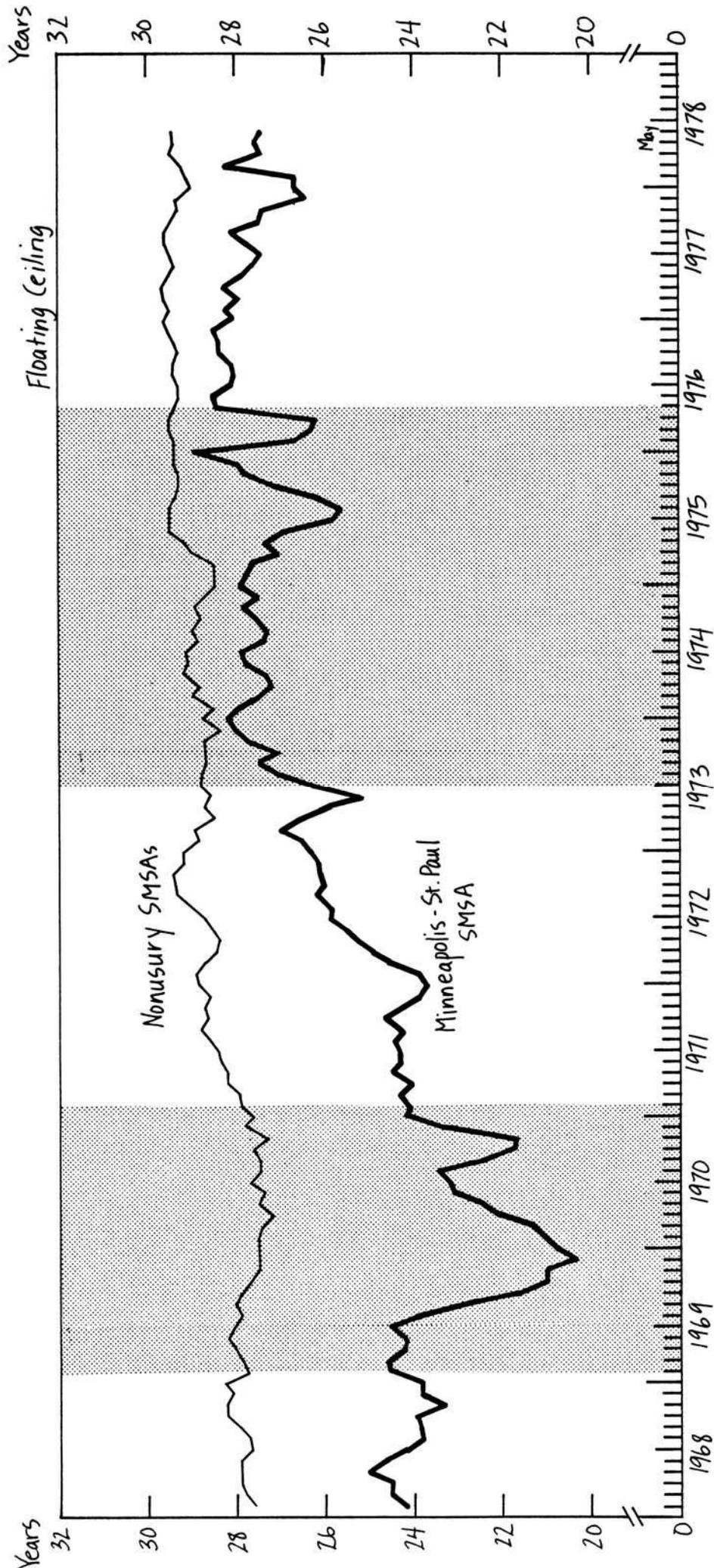
Chart 3
 Value of FHA/VA Mortgage Loans Outstanding as a Percentage of Total
 At Savings and Loans Associations*



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

Source: Federal Home Loan Bank Board

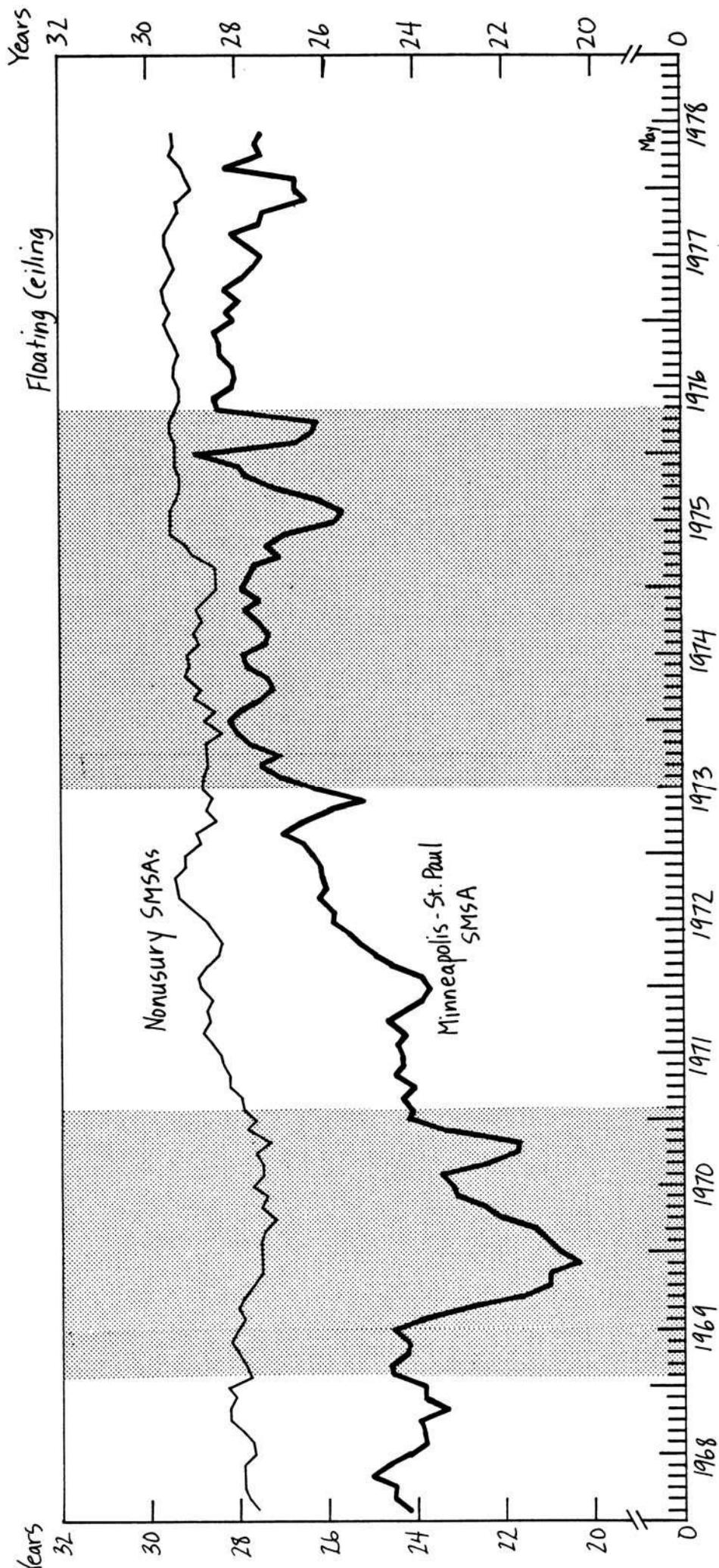
Chart 4
 Years to Maturity on New Home Mortgage Loans*



*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

Chart 4
 Years to Maturity on New Home Mortgage Loans*

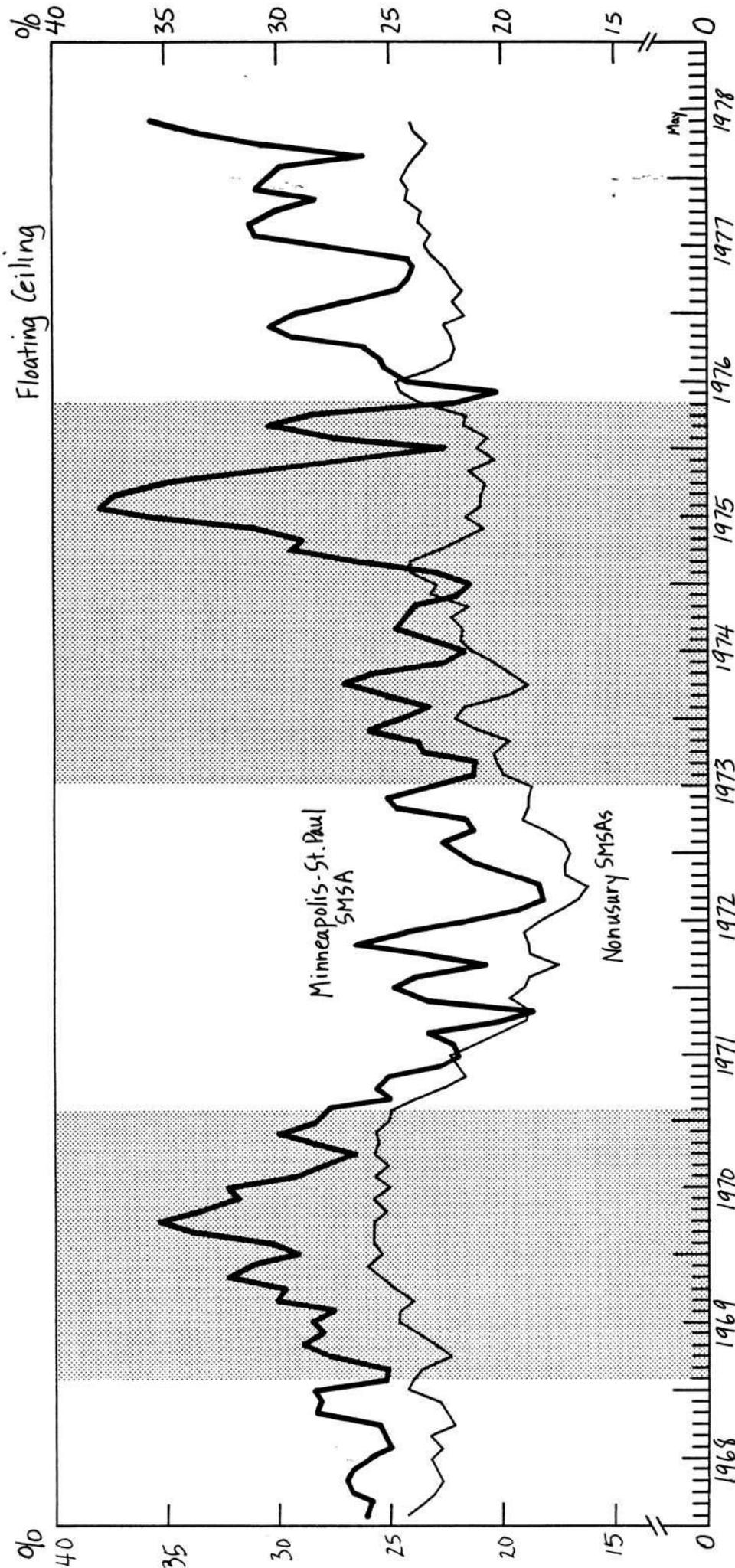


*Weighted three-month moving averages compiled from individual loan data reported by a sample of savings and loan associations, commercial banks, mutual savings banks, and mortgage bankers. Data cover fully amortized conventional first mortgage loans secured by newly built, single-family residential 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

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

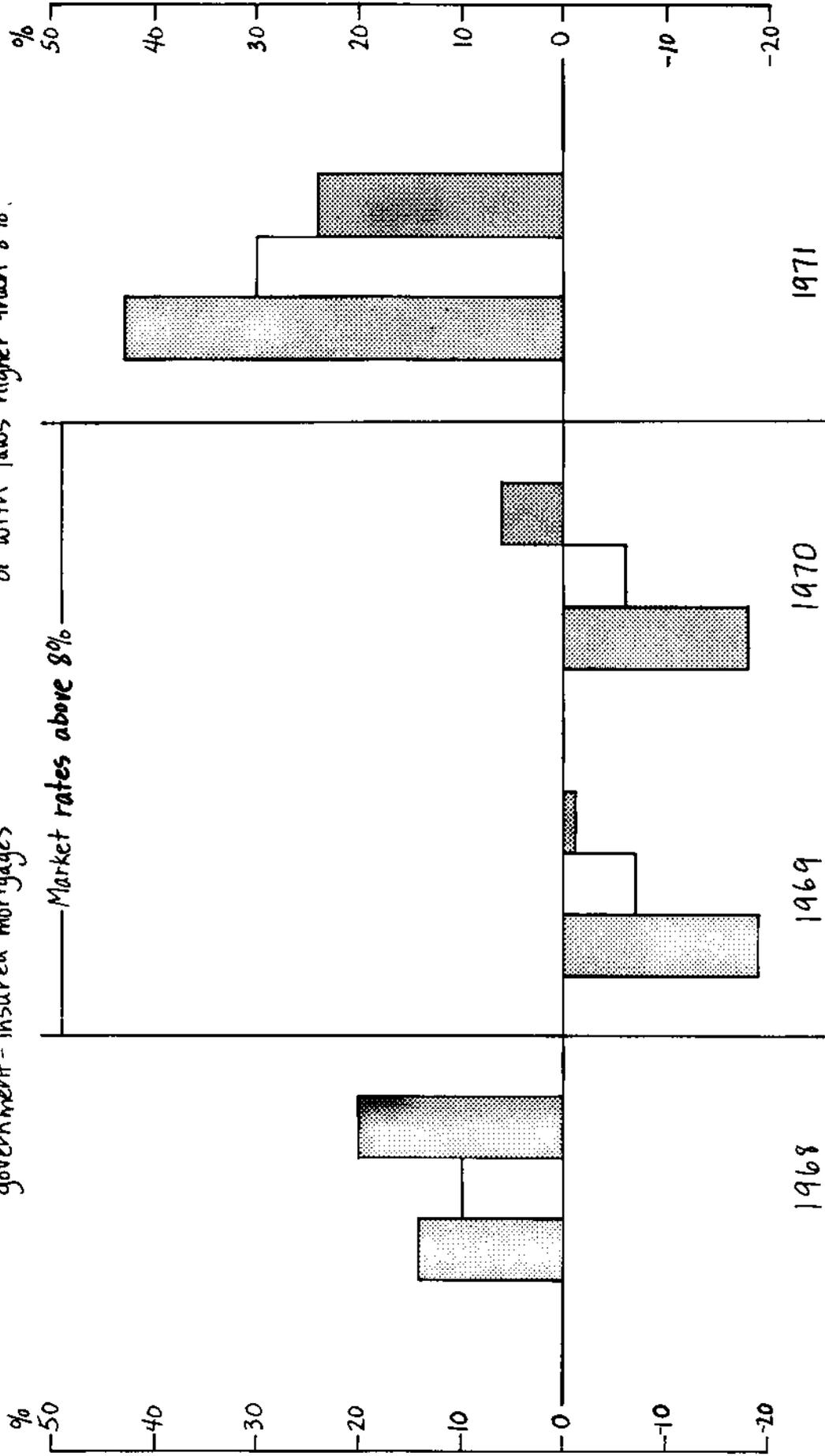
Chart 6

1968-71 Annual Changes in Single-Family Housing Starts

In 77 Standard Metropolitan Statistical Areas

SMSAs with 8% or lower usury laws that include exempt government-insured mortgages

SMSAs without usury laws or with laws higher than 8%



* Sample of SMSAs surveyed by the National Association of Homebuilders and reported in its October 1971 Economic News Notes.
 Source: National Association of Homebuilders

Footnotes

^{1/}In fact, the impact of high market interest rates on housing is probably greater than other markets. Financial intermediaries, who supply most of the credit for housing, are prevented from competing for funds because their deposit liabilities are subject to maximum rates of interest. As market rates rise above these maximum rates, depositors shift their funds to investments on which interest rates are not regulated, causing mortgage rates to rise even further.

^{2/}Chart 4 compares length of maturity, and Chart 5 compares the ratio of down payment to new-home purchase price. Since data were only available by standard metropolitan statistical area (SMSA), the comparisons are made between the Minneapolis-St. Paul SMSA and a set of SMSAs located in the nonusury states.

^{3/}As Chart 3 indicates, in Minnesota FHA/VA mortgages have never been greater than 25 percent of all outstanding mortgages. In the nonusury states FHA/VA mortgages have never been greater than 12 percent of the total.

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- [2] Ostas, James R., "The Effects of Usury Ceilings in the Mortgage Market," Journal of Finance, Vol. XXXI, No.3 (June, 1976), pages 821-834.