# Usury ceilings and DIDMCA

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Title V of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) preempted certain state usury ceilings—the legal interest limits that may be charged on loans. It provided a federal ceiling as an alternate to state ceilings on some loan transactions and left rates for other types of loans to be determined by the market. The preemptions were permanent in most cases, although in one case the preemption was temporary and has already expired. In all cases, the federal preemption could be overridden by individual states.

This paper describes the state/federal scheme of usury ceilings as it existed in 1980. It then outlines the provisions of Title V with respect to usury ceilings and discusses their motivation and consequences. Title V is seen not as a sweeping deregulation of usury ceilings, but as a limited reform targeted to immediate problem areas.

### State interest regulation

Colonial legislatures adopted usury laws based on English precedent, and the regulation of interest ceilings initially became a responsibility of individual states. These regulations grew increasingly complex over time. At first, state usury statutes set out a so-called unitary or general usury ceiling that applied to all lenders. Later, as credit markets developed, states adopted numerous special provisions to regulate credit including ones that exempted

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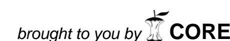
brought to you by  CORE

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maximum rates for particular types of credit transactions.

This evolution in usury legislation has left a multiplicity of state interest rate ceilings varying by location of borrower, location of lender, amount of loan, term of loan, and purpose of loan. Today, one can find on the books in various states separate provisions relating to state chartered banks, retail installment sales (with separate rates for open-end and closed-end credit), motor vehicle sales, small loans, bank credit cards, and home loans (with separate rates for first and junior mortgages). In Michigan, for example, a 1981 listing by the Financial Institutions Bureau identified 25 different loan categories subject to interest rate ceilings under state law, with effective maximum rates ranging from 5 percent on personal loans by individuals for nonbusiness purposes to 36 percent on loans by pawnbrokers. At the same time, in 1981 the state of Arkansas had a single general usury ceiling of 10 percent and the state of Arizona had no maximum rates.

### Federal interest rate ceilings

Although individual states have been the agents with primary responsibility for enacting usury ceilings, the federal government also has set forth interest rate limits. The National Bank Act and related regulatory and judicial rulings have added several more pieces to the patchwork of usury ceiling coverage.

Under the National Bank Act as originally passed in 1864, national banks were subject to individual state ceilings, being permitted to charge "a rate allowed by the law of the State . . . where the bank is located." An early Supreme Court decision determined that this Act gave national banks most-favored-lender status, allowing them to abide by either the unitary usury ceilings or special statutes for state banks, where they existed and were more advantageous. Then, in 1933 the National Bank Act was amended, authorizing national banks to charge one percent over the Fed dis-

number of different interest rate ceilings adopted by the states increased. A recent interpretative ruling by the Comptroller of the Currency reiterated the most-favored lender status of national banks, stating that national banks may "charge interest at the maximum rate permitted by state law to any competing state-chartered or licensed lending institution." This ruling sanctioned the practice of national

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banks' "borrowing" rates permitted other lenders in the state.

The ceiling options available to national banks were expanded further as a result of the Supreme Court decision in *Marquette National Bank v. First of Omaha Service Corp.* In this case, the Court ruled that national banks may charge out-of-state customers the rate allowed by the state where the bank is located even if that rate is higher than that permitted in the borrower's state. This decision legitimized the practice of "exporting" favorable rates. By allowing national banks to charge a uniform national rate, it gave them a competitive edge over retailers who were subject to the ceilings in each of the states where they transacted business.

### Title V

State and federal usury regulation was complicated further by Title V of DIDMCA. This title contained a federal preemption of state usury ceilings on mortgage loans (i.e., first mortgage loans on residential properties), business and agricultural loans (Sections 501 and 511), and loans made by federally insured institutions (Sections 521-524). The preemptions were permanent in some cases and temporary in others. Alternative federal ceilings were set out in certain cases and none of the preemptions necessarily applied nationwide since each could be overridden by legislative initiative in individual states.

The specific provisions of the usury preemptions on Title V were as follows:

- Section 501 effectively eliminated state ceilings on residential mortgage loans on real property or mobile homes. It did not abolish state usury statutes, but it mandated that they did not apply to the transactions specifically enumerated in the Act. State ceilings continued to apply when the lender was not in compliance with consumer protection regulations issued by the Federal Home Loan Bank Board. The states had the right to reject this federal preemption by acting before April 1, 1983.
- Section 511 temporarily preempted state ceilings on business and agricultural loans of $25,000 or more with a floating federal ceiling 5 percent above the Federal Reserve discount rate. This preemption expired on April 1, 1983 and it could be overridden by specific state action.
- Sections 521-523 amended the Federal Deposit Insurance Act, the National Housing Act, and the Federal Credit Union Act. It added to each a section allowing federally insured state banks, S&Ls, and credit unions to choose between state ceilings and a federal ceiling of 1 percent above the Federal Reserve discount rate. While this alternative ceiling was permanent, there was no time limit on the privilege of states to override these sections.
- Section 524 amended the Small Business Investment Act of 1958 and permitted small business investment companies to make loans at 1 percent above the Federal Reserve discount rate, or the applicable state ceiling, or the maximums prescribed by the Small Business Administration, whichever was lowest. The provisions of this section were also permanent, but they too could be overridden at any time in the future.

### The intent of the federal preemptions

The function of these preemptions was to alleviate two problems with usury ceilings that emerged in the high interest rate environment of 1978-80. First, from a lender's perspective, ceilings on certain types of credit were preventing lenders from raising rates commensurate with the increase in their cost of funds. Second, a competitive problem arose when state ceilings prevented some financial institutions from charging rates as high as national banks were permitted to charge under the National Bank Act.

Sections 501 and 511 of Title V dealt with the first problem by freeing rates on mortgage loans and certain commercial loans from state ceilings that had become restrictive. Table 1 lists the state ceiling rates on mortgage loans that existed on April 1, 1980—the effective date of DIDMCA. Eleven states had no restrictions on rates for home mortgages, but 39 states had either fixed maximum rates or ceilings that floated with some market index. Fifteen of the fixed-rate states and at least 6 of the floating ceiling states restricted mortgage lenders to rates of 16 percent or less. At that time, yields on conventional home mortgages in the ceiling-free secondary market averaged over 16.5 percent.

Table 2 shows the situation for business and agricultural loans at the time of the federal preemption. It lists those states that had ceil-

**Table 1**
**State ceilings on mortgage loans in effect on April 1, 1980**

| | Type of ceiling: | | |
|---|---|---|---|
| | Fixed | Floating | No limit |
| Alabama | 18% | | |
| Alaska | | 5 + FRDR* | |
| Arizona | 16% | | |
| Arkansas | 10% | | |
| California | | | X |
| Colorado | 13% | | |
| Connecticut | | | X |
| Delaware | | 4% + FRDR | |
| D.C. | 15% | | |
| Florida | | | X |
| Georgia | | 2½% + 20 yr bond index* | |
| Hawaii | 12%* | | |
| Idaho | 13% | | |
| Illinois | | | X |
| Indiana | 15% | | |
| Iowa | | 2% + 10 yr bond index | |
| Kansas | | 1½% + FHLMC rate | |
| Kentucky | | 4% + FRDR* | |
| Louisiana | 12% | | |
| Maine | | | X |
| Maryland | | | X |
| Massachusetts | | | X |
| Michigan | | | X** |
| Minnesota | | Prev. mo FNMA auction rate | |
| Mississippi | 10% | | |
| Missouri | | 3% + 10 yr bond yield | |
| Montana | | 17 - 18% | |
| Nebraska | 16% | | |
| Nevada | 18% | | |
| New Hampshire | | | X |
| New Jersey | | 8% + bond index | |
| New Mexico | | 1% + FNMA auction rate | |
| New York | 10½% | | |
| North Carolina | | | X |
| North Dakota | | Greater of 7% or 5% + 30-mo CD rate | |
| Ohio | | 3% + FRDR | |
| Oklahoma | 13% | | |
| Oregon | 12%* | | |
| Pennsylvania | | 2½% + long-term bond yield* | |
| Rhode Island | 21% | | |
| South Carolina | | | X if fixed rate without prepayment penalty |
| South Dakota | | | X |
| Tennessee | | Greater of 18% or 2½% + FNMA auction | |
| Texas | | Less of 12% or 10 yr bond yield | |
| Utah | 18% | | |
| Vermont | | 1¼% + average on selected securities | |
| Virginia | | | X |
| Washington | 12% | | |
| West Virginia | | 1½% + 20 yr bond yields | |
| Wisconsin | 12% | | |
| Wyoming | 18% | | |

*Indicates no limit for residential first mortgages for some loan sizes. FRDR designates Federal Reserve Discount rate.
**Indicates no limit on 1-family dwellings.
SOURCE: "Override of State Usury Laws as Related to Federal Preemption" Office of State Legislative Counsel. American Bankers Association February 12, 1981.

ings below the federal alternative provided in Title V for business and agricultural loans. On April 1, 1980, the federal ceiling was 18 percent, and 20 states restricted lenders to lower rates. Not only were legal maximum rates in these 20 states lower than the new federal ceiling, in many of these states they were lower than what lenders could obtain in the commercial paper market (16.5%) or on Treasury bills (14-15%).

Sections 521-524 of Title V addressed the second problem—inequities between national and state banks—by granting state banks ceiling rates on par with those of national banks. National banks had been given the option to charge one percent over the Federal Reserve discount rate in 1933, but before the late 1970s this alternative was rarely more advantageous than the state ceilings. However, in 1979 the discount rate hit 12 percent, making the federal ceiling more lenient than many state ceilings. The federal ceiling allowed national banks to achieve more profitable spreads than competing institutions. Title V rectified this competitive inequity by extending to state banks and other federally insured institutions the same ceiling option available to national banks.

We need now to ask why Congress sought to remedy these problems itself—by preempting state usury ceilings—rather than await state-by-state reforms. There are several pieces to the explanation. First, the combination of high interest rates and restrictive state ceilings created a situation with potentially harmful economy-wide consequences. And, from a borrower's perspective, if lenders were unwilling to extend credit at the ceiling rates, businesses could not finance their operations and builders could not sell new homes to buyers without mortgages.

Experience had shown, also, that the states probably could not be counted on to relax their ceilings quickly enough or far enough to avert these consequences. Many states had already reformed their usury ceilings during the 1970s, eliminating some, raising others, and indexing still others. But in many states, ceilings were still not flexible enough to avoid credit allocation problems in the high interest environment of 1979-80. Furthermore, several states had been unable to enact any reform because of concern that relaxing usury ceilings would leave some consumers prey to unscrupulous lenders wanting to charge exorbitant interest rates.

Third, the high interest climate that brought these problems to a head was the result

**Table 2**
**Twenty state ceilings immediately preempted by federal ceiling on business and agricultural loans on April 1, 1980**

| State | Ceilings | State | Ceilings |
|---|---|---|---|
| Alabama | Unincorp 8%, Corp 15% | New Jersey | Unincorp: 8% to $50,000 |
| Arkansas | 10% | New Mexico | Unincorp: 10%, 12% or 3% + FRDR |
| Delaware | Unincorp 4 + FRDR | North Dakota | Unicorp: 7% or 5½% + CD rate |
| Hawaii | 12% to $750,000 | Ohio | Unincorp: 8% |
| Iowa | Unincorp: 2 + 10 yr index | Oregon | 12% to $50,000 |
| Kansas | Unincorp: 10% | S. Carolina | ag: 1% + FRDR to $50,000 else: 8% |
| Louisana | Unincorp: 8% | Texas | Unincorp: 10% to 250,000 above: 18% |
| Minnesota | Unincorp: 4½% + FRDR | Washington | 12% to $50,000 |
| Mississippi | Unincorp: 10% | Wisconsin | 12% to $150,000 Corp: 15% |
| Missouri | Ag: 3% + long-term bond index | | |
| Montana | 10% or 4% + FRDR | | |

SOURCE: "Override of State Usury Laws as Related to Federal Preemption" Office of the State Legislative Counsel, American Bankers Association February 12, 1981. FR Discount rate was 13% on 4/1/80. Table lists only those state ceilings that were under the federal alternative ceiling as of 4/1/80.
FRDR means Federal Reserve Discount Rate.

of federal policies to stop inflation. Finally, with the deregulation of interest rates payable by federally insured depository institutions on deposits, Congress was leaving the liability side of financial institutions' ledgers open to market forces. It may have seemed fair and prudent for Congress to loosen restrictions on the asset side as well.

Despite this rationale for federal action, Congress acceded to the states' historical role in regulating usury ceilings and their concerns about the consumer protection function of ceilings by giving states the opportunity to override any or all provisions of Title V. To date, 15 states have exercised this option. Table 3 lists those states and indicates the sections of Title V to which the override applies. The mortgage preemption—which left mortgage rates completely open to the market—was overridden by all fifteen states while the other preemptions—which did provide for a federal ceiling—were rejected less often. Five states re-

**Table 3**
**States enacting override of federal usury preemptions as of March 1985**

| State | Date Override Effective | Sect. 501* Mortgages | Sect. 511 Business & Ag. Loans** | Sect. 521-24 Other Loans |
|---|---|---|---|---|
| Colorado | 7/1/81 | X | X | X |
| Georgia | 3/31/83 | X | X | — |
| Hawaii | 5/30/80 | X | X | — |
| Idaho | 3/31/83 | X | — | — |
| Iowa | 5/10/80-7/1/83 | X | X | X |
| Kansas | 5/17/80 | X | — | — |
| Maine | 9/1/81 | X | — | X |
| Massachusetts | 9/2/81 | X | X | X |
| Minnesota | 6/2/81-8/1/87 | X | — | — |
| Nebraska | 7/17/82 | X | — | — |
| Nevada | 6/14/81 | X | X | — |
| North Carolina | 3/21/83 | X | — | X |
| South Carolina | 6/30/82 | X | X | — |
| South Dakota | 12/31/80 | X | X | X |
| Wisconsin | 11/1/81 | X | X | X |

*The deadline for overriding the mortgage preemption was April 1, 1983.
**The federal preemption of state ceilings on business and agricultural loans expired on April 1, 1983.
SOURCE: Commerce Clearing House, *Consumer Credit Guide*.

## The economics of usury ceilings

Usury ceilings have existed in various forms for many centuries. Their fundamental intent is to prevent the taking of "excessive" interest by setting a legal maximum rate. However, keeping lenders from charging more than acceptable rates is not the only effect of usury ceilings. Usury ceilings may also restrict the availability of credit.

When a usury ceiling is above the market rate of interest—the rate which lenders would charge based on the market forces of supply and demand—the ceiling has no effect on either the price or availability of credit. On the other hand, when the ceiling is binding—that is, when the legal limit is lower than the market rate of interest—it does reduce the price which law-abiding lenders may charge for loans. However, these lenders will be less willing to supply credit at the ceiling rate than if they could charge the higher market rate of interest. Therefore, when the legal limit does hold down the price of credit to the ceiling rate, it also has the effect of reducing the availability of credit or obliging would-be borrowers to seek (higher-cost) retailer credit.

This view of the way usury ceilings work has been borne out in numerous empirical studies over the last 20 years. These studies have found that when usury ceilings are binding, lenders reduce loan volumes and/or raise noninterest charges and terms to allocate credit.*

A multiplicity of interest ceilings—as is found in the United States—can also have undesirable economic consequences by misdirecting available credit among alternative uses. With credit transactions in a single state subject to rate ceilings ranging from 5 percent to 36 percent, it is apt to happen that market interest rates will be above the ceiling for some credit transactions and not for others. Faced with a situation in which rates on some transactions are constrained by ceilings while rates on others are not, rational lenders will prefer to make those types of loans on which they can obtain market rates. Moreover, since credit markets are not confined by state boundaries, the diversity of ceilings among states will have a similar effect on the distribution of credit across states. When the current market rate of interest for a given type of credit transaction is above one state's ceiling and not another's, again, rational lenders will allocate credit to those states where they can obtain market rates. Thus, the existence of a variety of interest rate ceilings creates incentives for lenders to allocate credit where market rates prevail or where ceilings are most favorable. This allocation is not the one that puts scarce funds to their most efficient use, in a purely economic sense.

In summary, the economic view of usury ceilings is that they cannot effectively bind interest rates below market levels without at the same time causing lenders to limit credit availability. Therefore, in formulating policies to protect borrowers from exorbitant rates, the benefits of specifying a legal maximum rate need to be weighed against the demonstrated adverse effects of usury ceilings on credit availability and distribution.

*For a review of these studies, see Donna Vandenbrink, "The effects of usury ceilings," *Economic Perspectives*, (Midyear, 1982), pp. 44-55.

jected all of the preemptions. It is not possible here to attribute a motive to each individual state, but it is clear that at least some overrides were motivated by something other than the desire to maintain restrictive ceilings. Some states that overrode the mortgage preemption, such as Massachusetts, had no existing regulations on mortgage loan rates to be preempted. And other states that rejected this preemption—Hawaii, Idaho, and Wisconsin, for example—concurrently or subsequently removed their legal limits on these loans.

## Conclusion

The best way to summarize Title V of DIDMCA is in terms of what it was not. First, it was not an attempt to shift the locus of re-

sponsibility for usury ceilings from the states to the federal government. The federal government already had a long-standing role in regulating certain lending rates. Title V extended the scope of federal jurisdiction of mortgage loans, business and agricultural loans, and loans by federally insured institutions[1] but it permitted the states to override the federal action and reassert their jurisdiction.

Second, Title V did not simplify the existing scheme of usury regulations. The provisions of the Title itself were complicated, and their enactment generated additional jurisdictional issues. For example, one question yet to be resolved is whether the federal preemption applies to a loan made by a lender in a state which has opted out of Title V to a borrower in a state which has not opted out.

Finally, and most importantly, Title V was not the lending counterpart to the elimination of interest rate ceilings on deposits. Rather than imposing interest rates on credit to the forces of the market place, as was being done with deposit rates, Title V merely preempted state usury ceilings on certain loans or certain lenders. Only on mortgage loans were interest rates permanently freed from all ceilings. And here, as elsewhere, states could reimpose ceilings if they so chose. Title V of DIDMCA was regulatory reform directed toward the immediate credit allocation and competitive problems created by state ceilings during a period of generally high interest rates. It was not regulatory reform guided by an overarching goal of eliminating regulation of usury ceilings.

[1] Even here there was precedent for federal action. State ceilings on mortgage loans and business and agricultural loans had been preempted as a temporary emergency measure in December 1979 (Public Law 96-161). In addition, Public Law 93-501 preempted business and agricultural loans of $25,000 or more from October 29, 1974 until July 1, 1977.