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Every legal statute must be judged by how well its intention is realized in actual events. In the case of the Minnesota usury law,[1/] its intention is to protect consumers from paying "unreasonably high" interest rates. Thus, the usury limit must be interpreted as being the absolute maximum reasonable loan charge. By considering the role which interest rates play in the economy, this paper will investigate whether the Minnesota usury law has had the protective effect that was intended.

Prices are a means of rationing goods in a market economy. When the price mechanism is operating correctly, prices are set so that the supplies of goods are equal to the demands for them. Interest rates are also prices--the price for borrowing funds. However, although we are in general against

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[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 twelve dollars per hundred per year. In 1923, that limit was reduced to eight dollars per hundred per year. However, as the law now stands that eight dollar limit is binding only on consumer mortgage loans. All other classes of loans have been either exempted or have a higher limit. For instance, bank installment and credit union loans have a maximum limit of approximately twelve percent.

restricting price movements, an interference with the price rationing mechanism, we must interpret the usury law as a statement of 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. Implicit in this 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 is not restricted. There is the further assumption that the restriction of interest rate movements will not restrict the flow of credit.

Since the law dictates a maximum allowable rate, it is only when that rate is exceeded that the law is binding and thus would affect the credit market. Using the national FHA mortgage rate as a proxy for the mortgage rate in Minnesota, we find from Table I that previous to 1969 the FHA rate never reached or surpassed the eight percent limit.[2/] If bankers are unreasonable, then why did they not charge the maximum allowable rate throughout the entire period? Banks can only partially control the rates they charge on loans and deposits.

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[2/] It is assumed here that the national FHA rate is a reasonable approximation of the mortgage rate in Minnesota. This can be supported by the fact that the mortgage rate quoted in Sylvia Porter's column in the Minneapolis Tribune, May 18, 1970, of 9.29% was only four-hundredths of a percent higher than the rate quoted to me by a leading Twin Cities mortgage lender on May 15, 1970.

TABLE I

THE INTEREST RATES ON NEW FHA MORTGAGE LOANS AND Baa CORPORATE BONDS, YEARLY AVERAGES, 1961-1969*

| | FHA Yield (1) | Baa Corporate Bond Yield (2) | (1) - (2) (3) |
|---|---|---|---|
| 1961 | 5.80 | 5.08 | .72 |
| 1962 | 5.61 | 5.02 | .59 |
| 1963 | 5.47 | 4.86 | .61 |
| 1964 | 5.45 | 4.83 | .62 |
| 1965 | 5.46 | 4.87 | .59 |
| 1966 | 6.29 | 5.67 | .62 |
| 1967 | 6.55 | 6.23 | .32 |
| 1968 | 7.13 | 6.94 | .19 |
| 1969 | 8.19 | 7.81 | .38 |

*Source: The Economic Report of the President, February, 1970, pp. 242-243.

Since banks are only one of many financial institutions, they must charge a rate which is competitive with what is available in other markets. Otherwise they risk losing their customers to other competitive institutions.

The yield on Baa corporate bonds, a competitive long term rate, is presented alongside the FHA rate in Table I. Over the period of the 1960's, yields on Baa bonds and FHA loans have moved largely in the same direction. Over the period 1961-1969, the average annual rate differential between the FHA yield and the Baa corporate bond yield is .51. However, the differential narrows significantly from .71 in 1961 to .38 in 1969. The 1968 and 1969 differentials were influenced by the fact that the maximum allowable yield on FHA loans was 7.5% up to March 1969. Only then was it raised to 8.5%. Consequently, the monthly differentials in 1969, presented in Table II, reflect the fact that the FHA rate was restrained by law while the Baa Corporate Bond Rate was not. This would imply that the rate differentials in the early and late months of 1969 were below the competitive rate.

An estimate of the competitive mortgage rates in 1969 can be determined by adding the .51 average differential to the monthly Baa rates presented in Table II. Considering this competitive rate, it can be seen that starting in June of 1969, and continuing up to the latest available data, the mortgage yield has been above the usury limit of eight percent. Since this limit is only binding on consumer mortgage credit, its impact should be observed in the housing market. Thus we will now turn our attention to trends in housing starts over the 1960's.

The number of yearly housing starts more than doubled between 1961 and 1969, from 13,077 to 26,273 (See Table III).

TABLE II

THE NEW FHA MORTGAGE YIELD, THE COMPETITIVE FHA MORTGAGE YIELD, AND THE Baa CORPORATE BOND YIELD, MONTHLY AVERAGES, 1969*

| Month | FHA Yield (1) | Baa Corporate Bond Yield (2) | (1) - (2) (3) | Competitive FHA Yield (4) |
|---|---|---|---|---|
| Jan | 7.50 | 7.32 | .18 | 7.83 |
| Feb | 7.50 | 7.30 | .20 | 7.81 |
| March | 7.79 | 7.51 | .28 | 8.01 |
| April | 8.05 | 7.54 | .51 | 8.05 |
| May | 8.06 | 7.52 | .54 | 8.02 |
| June | 8.06 | 7.70 | .36 | 8.21 |
| July | 8.35 | 7.84 | .51 | 8.35 |
| Aug | 8.36 | 7.86 | .50 | 8.37 |
| Sept | 8.36 | 8.05 | .31 | 8.56 |
| Oct | 8.40 | 8.22 | .18 | 8.73 |
| Nov | 8.48 | 8.25 | .23 | 8.76 |
| Dec | 8.48 | 8.65 | -.17 | 9.16 |

*Source by column:
(1) and (2): Ibid., p. 243.
(3): The Difference between column (1) and (2).
(4): Column (1) plus .51.

TABLE III

THE TOTAL NUMBER OF HOUSING STARTS, AND THE NUMBER OF ONE- AND TWO-FAMILY HOUSING STARTS IN MINNESOTA, 1961, 1965, 1968 AND 1969*

| Years | Number of Housing Starts (1) | Number of One- and Two-Family Housing Starts (2) | Percentage (2) of (1) (3) |
|---|---|---|---|
| 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 |

*Source by column:

(1) and (2): The Federal Reserve Bank of Minneapolis, Building Permits, Annual Summary.
(3): Column (2) as a percent of column (1).

Although the number of starts of private one-and two-family homes increased from 7,323 in 1961, to 11,480 in 1968, an increase of 57%, by 1969 they had decreased to only 8,790 new starts. Private one- and two-family housekeeping units have thus fallen as a percent of all new housing starts over the period, from 56% to 33%. Between 1969, when the usury law became binding on mortgage credit, and 1968 the number of new housing units declined by 4.48%. This is entirely explained by the 27.40% decline in one- and two-family homes. The number of new apartment building starts, whose financing would not be subject to the usury law, increased 9.11%. Throughout 1969, 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.

This indicates that far from protecting the consumer, the impact of the Minnesota usury law has been to severely reduce the amount of funds available for private home buyers, while expanding that 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 lead to the drastic reduction in one- and two-family housing starts. In Table IV, the monthly percentage change for one- and two-family housing starts is presented for 1969. The decline in new home starts in the second six months of the year was 33.26% when the usury law was binding compared to the 7.05% decline in the first half of the year. However, other factors must be considered in the reduction of private housing starts, in addition to the usury limit.

The mortgage lenders, unable to use the interest rate to equilize the supply and demand for mortgage funds, have developed other legal systems of achieving a competitive

TABLE IV

THE NUMBER OF ONE- AND TWO-FAMILY HOUSING STARTS MONTH, 1968 AND 1969 IN MINNESOTA*

| | The Number of One- and Two-Family Housing Starts 1968 (1) | 1969 (2) | Percentage Change (1) - (2) (3) |
|---|---|---|---|
| Jan | 480.89 | 458.65 | - 6.29 |
| Feb | 587.96 | 424.13 | -27.87 |
| March | 829.73 | 734.09 | -11.53 |
| April | 1262.06 | 1046.66 | -17.07 |
| May | 1259.40 | 723.43 | -42.56 |
| June | 694.71 | 1132.73 | +63.05 |
| July | 978.05 | 819.39 | -16.23 |
| Aug | 815.10 | 611.87 | -24.94 |
| Sept | 1079.48 | 817.05 | -24.32 |
| Oct | 1274.69 | 1024.56 | -19.63 |
| Nov | 1018.62 | 646.72 | -36.52 |
| Dec | 905.22 | 448.31 | -50.48 |
| Total | 11,185.91 | 8,779.59 | -27.40 (average) |

*Source by column:

(1) and (2): The monthly totals were derived from monthly total housing starts for Minnesota by assuming that the yearly percentage held for each month.

(3): Percentage difference of (1) minus (2).

return. Since they are inhibited by law from charging more than the 8% limit, the mortgage lenders have resorted to charging points to the seller of the home and raising the downpayment requirements to the buyer. This has two effects: the seller knowing that he must pay points raises the price of his home to offset the cost of the points, and secondly, the higher downpayment requirement prevents many people from buying a home who would otherwise do so. Recent requirements in Minnesota have been for a 25-30% downpayment. Thus, for instance, on a $30,000 home not financed under FHA or VA, between 7.5 and 10-thousand dollars is needed for a downpayment. Very few of even the most affluent families have that amount of liquid capital available.

Therefore, given the situation which has existed since the middle of 1969, the average family cannot buy a home. Since the price of homes rise between five and ten percent a year, a delay in the purchase of a $30,000 home for even one year causes an additional cost of between $1,500 and $3,000. If you multiply this by the 2600-unit reduction in the building of new private homes between 1968 and 1969, this gives a total cost to Minnesota residents of $3,900,000 to $7,800,000 in 1969 alone.

Further, there are other interest regulations restricting the rate that can be paid on time and savings deposits. Since interest rates on competitive financial assets in the national bond market have continued to go up while the savings and time rates have been at their maximum rate, this has caused an outflow of savings and time deposits into these markets.[3] One reason of this, the ratio of time to total deposits in commercial banks (presented in Table V) rose from an average of 35.8% in 1960 to 51.1% in 1968, but dropped to 47.6% in 1969. The fact that the loan to deposit ratio rose indicates that banks partially offset the loss in deposits by utilizing a higher percentage of total deposits for loans.

However, in addition to the outflow of funds from Minnesota into the national capital markets, there has even been a reverse movement of funds through the correspondent banking system. Although net correspondent balances held by Minnesota banks almost doubled from 1964 to 1968, they decreased between 1968 and 1969. This has been an additional force to restrict the increase in credit in the state.

The very large increase in interest rates is one other factor which has played a role in the severe reduction of new home starts in 1969. With a fixed interest rate over the mortgage term, the cost of taking out a mortgage at current rates if you anticipate that interest rates will fall, is high. A one percent decrease in interest rates on a $30,000 mortgage constitutes a savings of approximately $3,000 over twenty years. Thus there is a great inducement,

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[3] The savings rate was limited to 4.50% until early this year when it was raised to 5.50% and more on various categories of savers. At the same time, rates of over 8% were available in the national bond markets. That is enough of an incentive to make even the smallest saver move into the bond market.

TABLE V

THE LOAN TO DEPOSIT RATIO, TIME DEPOSIT RATIO, AND NET CORRESPONDENT BALANCES OF MINNESOTA BANKS, 1960 1964, 1968 and 1969*

| Year | Total Loans to Total Deposits (1) | Time Deposits to Total Deposits (2) | Net Correspondent Balances (3) |
|---|---|---|---|
| 1960 | 50.7 | 35.8 | 92.00 |
| 1964 | 51.7 | 45.2 | 77.95 |
| 1968 | 55.9 | 51.1 | 138.15 |
| 1969 | 63.1 | 47.6 | 136.20 |

*Source by column:

(1) and (2): Call Reports for all commercial banks as of December of the year indicated.

(3): Average call report data for June and December of the year indicated. The net figure was obtained by taking total demand balances with other banks and subtracting demand deposits of commercial banks in the United States.

as interest rates rise, to reduce the demand for funds.

## Conclusions

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 since the usury limit was not binding, it had no effect at all. During the period when the competitive mortgage rate was greater than the 8% limit, there was a noticeable reduction in funds available to home buyers implying the reduction in consumer home purchases. This unnecessary postponement of home purchases resulted in the computed high cost to Minnesota residents. Since this law neither protects the interests of the consumer nor permits a rational allocation of the resources of Minnesota, it should not be retained.