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The Federal Monetary Control Act of 1980: A Step toward Deregulation of State Usury Laws

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STUDENT NOTES

THE FEDERAL MONETARY CONTROL ACT OF 1980: A STEP TOWARD Deregulation OF STATE USURY LAWS

I. Introduction

The Depository Institutions Deregulation and Monetary Control Act of 1980 is perhaps the most comprehensive and far reaching piece of banking legislation to have been enacted since the 1930's New Deal era. Title V of the Act represents the most serious Congressional attempt to date to control the amount of credit extended by national and state lending institutions by establishing new interest rate limitations on loans made by these lenders. The focus of the Act, however, is not so much on federal regulation of interest rates as it is on federal deregulation or preemption of state law restricting interest rates. Under the new federal system of basing interest rate ceilings largely on flexible market rates, lenders in those states which do not choose to override the federal provisions will now be able to contract for and receive interest at rates that are generally higher than those rates allowed under many state usury laws. The drafters of the Act had two primary objectives in enacting the more liberal interest rate provisions contained therein: first, to allow for more credit availability for certain types of loans in those states where the availability of credit is reduced because the lenders in the state are subject to overly restrictive usury statutes and second, to create more funds that will need to be generated by depository institutions that are now offering interest on checking or NOW accounts and higher market rates of interest on time and demand savings accounts.

West Virginia is one of many states which early in their statehood incorporated tough usury limits directly into their

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constitutions. Within the past several years, however, this state has been among the leaders in easing restrictions on interest rates that may be charged by state lending institutions. States such as West Virginia, with usury provisions similar to those promulgated in the Act, have liberalized their usury statutes in order to ease the credit crunch within their states. Those states which have refused to follow the lead of the MCA or its predecessor laws may have done so in the belief that there are no substantial credit shortages within their boundaries. However, even these states may be forced to re-evaluate what their credit position might be in light of the very real possibility that the growing inflation in this country will eventually force their lenders to cut back on their volume of lending when they can no longer make a fair return on loans bearing interest at the maximum rate permitted by state law. Finally, even though arguments as to the necessity of lifting or easing of interest rate restrictions may prove to be unconvincing, some states may be persuaded to adopt the new federal provisions (in toto, or in part) by the practical aspects of allowing lenders a greater return on their "investments." Specifically, the idea that such extra income may be applied to interest now payable on checking or NOW accounts lends impetus to the trend toward easing interest restrictions.

II. AN HISTORICAL REVIEW OF USURY LEGISLATION

Go with me to a notary, seal me there
Your Single bond. And, in a merry sport
If you repay me not on such a day,
In such a place, such sum or sums as are
Expressed in the condition, let the forfeit
Be nominated for an equal pound
Of your fair flesh, to be cut off and taken
In what part of your body, pleaseth me.2

Ever since man first began lending money, the idea of exacting an interest for the lending of or forebearance of money has been widely and loudly criticized. The Mesopotamian civilization, which made use of credit and paid interest as early as 3000 B.C., placed regulations on the taking of interest.3 The Old

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3 Frierson, Changing Concepts on Usury: Ancient Times Through the Time of John Calvin, 7 AM. BUS. L.J. 115, 118 (1969). These ideas were summarized in
Testament is replete with warnings against those who intend to loan on a usurious basis. This abhorrence intensified during the early Christian era and out of it grew a combination of legal and theological restrictions. As the Church gained power, it imposed an absolute restriction on the practice of exacting interest.

The church and others who have supported strong usury laws have traditionally urged one or both of the following arguments in support of their views. The first contention is that it is morally reprehensible to loan money for interest in any amount, to any person. The second argument is premised on the idea that the market place is imperfect in the sense that complete knowledge of all conditions and prices is not immediately available to all participants, and that even if it were, such participants would not necessarily use that information to the best of their advantage. The concern is over the inequitable relationships that are likely to result in dealings between the "unsophisticated Borrower" and the "unscrupulous lender"; the "Shylock" in the days of Shakespeare, the "big impersonal lender" in the modern corporate world.

These views continued in Europe throughout the Middle Ages. But as trade and commercial enterprises started to increase in size and number so did the need for commercial loans and, subsequently, the need for interest bearing loans. The legal prohibitions on interest began to weaken, although strong moral and religious objections remained. The focus of criticism shifted from the taking of any interest to the exaction of unreasonable or excessive interest. By the seventeenth cen-

the Code of Hammurabi (1800 B.C.) which set maximum interest rates at 33% on loans of grain and 20% per annum on loans of silver.

4 See Ezekiel 18:13, which states: "He has lent on Usury; has taken interest; he shall surely not live . . . He shall surely suffer death; his blood is upon him." Deuteronomy 23:19-20, states: "Thou shall not lend upon usury to thy brother; usury of money; usury of victuals; usury of anything . . . . Unto a stranger thou mayest lend upon usury, but unto thy brother thou shall not lend upon usury."


7 Frierson, supra note 3, at 120-21.

8 Note, supra note 5, at 200, 201.

9 Hershman, Usury and the Tight Mortgage Market, 22 Bus. Law 333, 335 (1967). England, in 1545, became the first modern European country to adopt a legal maximum rate of interest. The law was entitled "A Bill Against Usury" and
tury, interest charges were considered an acceptable function of business as long as maximum rates were set by legislation.10

In America, usury regulation was largely relegated to the state legislatures.11 Although most states enacted usury ceilings by legislative action, is some states public sentiment against high interest rates was so strong that usury limits were incorporated directly into the states' constitutions.12 The usury statutes in effect in most states, even as late as the mid-1970's, could be traced back to the American colonies where English precedents were adopted soon after the settlements' formation.13 Usury legislation, it was believed at first was necessary to protect the average consumer from oppressive contracts with lenders who would otherwise take advantage of their necessitous condition and to insure the availability of credit for business purposes.14

As early as the late 1700's, arguments that there was no logical economic support for general statutory ceilings on interest rates were beginning to be heard.15 But the drive to repeal the states' usury statutes was short lived. The United States Supreme Court, in Munn v. Illinois,16 affirmed the constitutional power of the states to regulate business "devoted to a public use." The decision established that it is within the province of the legislature to enact limitations on the rate of charges "for services rendered in public employment or for the use of property in which the public has an interest."17 Apparently, the

provided from maximum interest at ten percent. In 1713, the rate was lowered to five percent.

10 Note, supra note 5, at 201.
11 Giles, supra note 6, at 527.
12 See Ark. Const. art. 19, § 13 (1947); Cal. Const. art. XV (Deering Supp. 1981); Tenn. Const. art. 11, § 7 (1870, amended 1978) (maximum limitation on interest rates the legislature may remove).
13 S. Homer, A History of High Interest Rates 274-75 (2d ed. 1977). Massachusetts adopted a legal maximum rate of eight percent in 1661 and Maryland a rate of six percent in 1692. These rates were a general legal maximum applying to all extensions of credit.
15 Note, supra note 5, at 201-02.
16 94 U.S. 113 (1887).
17 Id. at 134.
Court reasoned that the market place, above certain limits, is not to be trusted.\textsuperscript{18}

III. USURY LEGISLATION IN THE TWENTIETH CENTURY

Although all the states, with three exceptions,\textsuperscript{19} refused to repeal their general usury ceilings, most states began to create some exceptions to these laws. A common exception, which appears in many forms and concerns a great number of loans made, provides for less restrictions on business credit.\textsuperscript{20} Some states achieve this by denying corporations and partnerships the defense of usury,\textsuperscript{21} or simply by removing such business entities from coverage of the state’s usury provisions.\textsuperscript{22} Other states apply different rate limitations for loans made to individ-

\textsuperscript{18} Giles, supra note 6, at 528.


\textsuperscript{22} E.g., La. Rev. Stat. Ann. § 12:703 (West Supp. 1979); N.D. Cent. Code § 47-14-09 (Supp. 1979); Ohio Rev. Code § 1701.68 (Page 1978). For a consideration of the abuses of the corporation exception, see Note, Stemming Abuses of Corporate Exceptions From the Usury Laws: A Legislative and Judicial Analysis, 59 Iowa L. Rev. 91 (1973). This note considers whether the purpose of usury laws to protect the individual borrower is being circumvented in many states because of the ease of incorporation.
uals and to businesses. In several states, if the loan exceeds a certain amount there are no restrictions on the interest rates. West Virginia specifically excludes loans made for business purposes from coverage of its laws limiting interest rates; provided that if the debt is incurred by a natural person, the principal amount of the loan must exceed $20,000.

Further relaxation of state usury laws began just after the turn of the century as the vast majority of state legislatures adopted special consumer credit laws that regulate particular types of loans and often remove them entirely from coverage of the usury laws. The first such consumer credit legislation considered and adopted by many states was modeled on the Uniform Small Loan Law. This Act recognized the need for small, expensive but regulated lending facilities. Under then existing usury laws, legitimate lenders could not feasibly make small loans to the growing class of wage earners who could only offer income from their jobs as security. The result was that many borrowers turned to unregulated loan sharks for their borrowing needs. Under the Uniform Small Loan Law, certain approved and licensed lenders, usually personal finance companies, were permitted to charge higher than the legally permitted rate. In return for this privilege, participating lenders agreed to abide by state consumer credit protection regulations.

23 Mississippi's usury law provides for a ten percent ceiling for loans, but for loans over $250,000 to partnerships and over $2,500 to corporations there is a fifteen percent ceiling. Miss. Code Ann. §§ 75-17-1(3), (5) (Supp. 1978). See also Mo. Rev. Stat. §§ 408.030, 408.035(1), (2) (Supp. 1979).
26 See Id. §§ 46A-4-101, 107, 111, 113.
27 See generally Hubachek, The Development of Regulatory Small Loan Laws, 8 LAW AND CONTEMP. PROBS. 108 (1941). The Uniform Small Loan Law (USLL) was originally recommended by the Department of Consumer Credit Studies of the Russell Sage Foundation in 1916. Other drafts of the USLL were written in 1918, 1919, 1928, 1932, and 1935.
28 Seidl, Lets Compete with Loan Sharks, HARV. BUS. REV. 69 (May/June 1970).
29 West Virginia's Small Loan Law is largely incorporated into its Consumer Credit Protection Act. See generally W. VA. Code §§ 46A-2-101 to 138 and 46A-4-101 to 113 (1980 Replacement Vol.) and specifically §§ 46A-2-105 and 115 with respect to balloon payments and limitations on default charges.

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This model Act was received very favorably and was quickly followed by a number of similar laws. These special statutes established new rate ceilings for particular types of loans and exempted the transactions from coverage of the general usury statute. The most common examples are statutes regulating the practices of pawnbrokers, credit unions and installment sales finance companies. Many states also adopted special statutes providing for bank installment loan regulation. Proponents of usury law reform believe that all these exceptions reveal a tacit admission by state legislatures that the lines of protection of the all inclusive statutory ceiling were drawn too broadly for the relevant public purposes for which they were enacted.

Where the states did not make statutory modifications or exemptions to the general usury rates, the common law did. In *Hogg v. Ruffner*, the Supreme Court held that the so-called time-price differential was not usurious. The time-price doctrine draws a distinction between interest for cash advances and higher prices paid for merchandise sold on credit. In essence, the seller of goods is allowed to fix one price for an immediate cash sale and another price if the purchaser decides to buy the same goods on credit. The time-price doctrine has survived for

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30 See Jordan & Warren, *The Uniform Consumer Credit Code*, 68 Colum. L. Rev. 387 (1968). In the late 1960's criticism of the inconsistencies in and complexity of the web of state consumer credit legislation resulted in a drive to formulate a uniform consumer credit law to address the problem of consumer credit on a comprehensive basis. The Uniform Consumer Credit Code (hereinafter referred to as UCCC) emphasized regulation of credit practices while allowing a reasonable rate of return to lenders. It provided for graduated ceiling rates on consumer loans (0-$300, 36%; $301-$1,000, 21%; $1,000-$25,000, 15%). Unfortunately, the UCCC did not achieve the same support the Uniform Commercial Code received. The following states have adopted the UCCC: Colorado, 1971; Idaho, 1971; Indiana, 1971; Iowa, 1974; Kansas, 1974; Maine, 1974; Oklahoma, 1969; South Carolina, 1975; Utah, 1969; Wisconsin, 1973; and Wyoming, 1971.


32 It has also been suggested that these exceptions represent an unconscious acceptance by legislatures that establishing an interest rate ceiling does not control the actual market price of credit.

33 66 U.S. (1 Black) 115 (1861).

34 See generally Sporn, *How to Avoid Usury Problems in Sales of Business Purpose Goods*, 25 Prac. Law. no. 6, at 73-85 (1979). The time-price doctrine per-
the most part, but it has been overruled in a number of jurisdictions.\textsuperscript{35} Although West Virginia neither expressly recognizes or rejects the validity of the doctrine, it, like many other jurisdictions, has enacted a retail installment sales act in an attempt to control the doctrine and its potential for abuse.\textsuperscript{36}

By prescribing a maximum rate to be charged for finance charges on consumer credit sales, the West Virginia Legislature in no way meant to imply that credit sales and loans are conceptually alike. It merely rejected the idea that because the two are different, sales of consumer credit goods should not be subject to any restrictions on finance charges. It is noted, however, that West Virginia Code section 47-6-11 removes all interest rate restrictions for “any debt that is incurred by a loan, \textit{installment sale}, or other similar transaction and is incurred primarily for a business purpose. . . .”\textsuperscript{37} But even in respect to sales of business purpose goods it cannot be said that West Virginia has adopted the time-price doctrine for the very simple reason that this provision exempts both loans and credit sales made for business purposes, making no distinction between the two.

\textsuperscript{35} See \textit{generally}, Giles, \textit{supra} note 6, at 537-44.
\textsuperscript{36} W. Va. Code \textsection 46A-3-101 (1980 Replacement Vol.) provides that with respect to a consumer credit sale, other than a sale of real estate or a sale pursuant to a revolving charge account, a seller may contract for and receive as a finance charge a rate not exceeding 18\% per annum on that part of the unpaid balance of the amount financed which is $1,500 or less and 12\% per annum on that part of the unpaid balance which is in excess of $1,500. \textit{Id.} \textsection 46A-3-102 prescribes a maximum rate of 8\% per annum for finance charges in connection with a consumer credit sale of real estate. With respect to sales finance charges for revolving charge accounts, section 46A-3-103 permits a seller to charge 18\% per annum on the first $750 and 12\% per annum on that part of the unpaid balances which are in excess of $750. The West Virginia Code also provides that credit sales guaranteed or insured by certain federal agencies are not subject to state laws on finance charges. \textit{Id.} \textsection 46A-3-105. For a survey of other states’ treatment of the time-price doctrine see Sporn, \textit{supra} note 34, at 81.
\textsuperscript{37} W. Va. Code \textsection 47-6-11 (1980 Replacement Vol.) (emphasis added).
A. Economic Effects of Restrictive Usury Legislation

The runaway inflation that began to grip this country in 1973 and 1974 and that has continued until this very day has "depreciated the value of money faster than it could be compensated for by most traditional hedges and nearly all widely accepted investment media."\(^{38}\) This trend has produced two distinct and pronounced effects on the economy. First, those who had money withdrew billions of dollars out of traditional depository institutions and reinvested such monies in nontraditional areas. One major result of this was that in many sectors of the economy there were no loans to be had at any price.\(^{39}\) Second, those who did not have surplus funds to invest saw their real disposable income shrinking.\(^{40}\)

Inflation, then, has caused an immense pressure to purchase consumer goods before prices go any higher. This pressure to purchase goods before prices go up and the tendency of most people to naturally place a high value on the present use of goods have combined to produce a very profound effect upon the economy. Historically, it has been shown that high interest rates do not deter borrowing when the price of goods is expected to increase and loans obtained can be repaid with devalued dollars.\(^{41}\) This phenomenon can be seen today, especially in the housing and home mortgage industry. Interest rates on mortgages and housing prices are at record highs, but there has been no appreciable decrease in buyer demand.\(^{42}\)

As inflation continues, it has become apparent that restrictive usury legislation has lost touch with economic realities. Because of the higher rate of inflation, and because many of the borrowers could only offer the shrinking earnings from their salaries as security, lenders everywhere had little choice but to either invest their monies in some other area or increase the interest rates on loans made by them. These interest rates con-

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\(^{38}\) Giles, supra note 6, at 527.

\(^{39}\) FED. RES. BULL. A14, A15, and A16 (November, 1976).

\(^{40}\) Giles, supra note 6, at 528.

\(^{41}\) Living With High Interest Rates, FORTUNE, (October 23, 1978) at 9.

continued to rise and approach or surpass the return permitted lenders by many state usury laws. These states had to raise their usury ceilings or else suffer severe credit restrictions adversely affecting their economies. In those states where interest rates remained artificially low (by legislation), banking institutions had no choice but to cut back on their volume of lending. Any benefits of lower interest rates in these states were offset by a decreased availability of funds for lending. The result was, and still is, that high risk borrowers, typically those lower income persons whom the laws are intended to protect and who are often the most willing to pay high interest rates, are denied credit altogether. Such persons have been forced to take their business to neighboring states that have less restrictive usury laws or to go through informal and illegal channels in order to obtain the money they need.

B. Current Trends

Faced with the need for changing its interest and usury laws, a state legislature has several alternative courses of action: It may repeal existing usury statutes and cease regulation of interest rates altogether; it may simply raise the general usury ceiling to a rate at or near the current market rate; or it may attempt to create a flexible floating interest rate ceiling. In five states, the contract rate of interest is subject only to the limits of the Uniform Consumer Credit Code or Small Loan laws enacted in those states. The other states that have adopted the

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44 Long, supra note 20, at 328.
45 Note, supra note 5, at 199.
46 See Giles, supra note 6, at 530. This article notes that in those states where the standard method of supply and demand allocation is restricted, i.e., where the price of money is not allowed to the point where supply just equals demand, some non-price criteria such as credit history or perceived riskiness is used to decide who will get the loan. See also Avio, An Economic Rationale for Statutory Interest Rate Ceilings, 13 Q. REV. ECON. & BUS. 61, 67 (1973). Although it may be argued that such laws which restrict the money available for credit, actually serve to protect the poor from high interest rates, most economists and legislators have rejected this overly-paternalistic view.
48 5 CONS. CRED. GUIDE (CCH) § 510 at 1301-309. (Sept. 18, 1979).
UCCC retain contract interest ceilings for loans not covered by the UCCC.\(^4^9\) It seems that the tendency of most states has been to create a hybrid form of usury legislation, raising or completely eliminating interest rate ceilings for certain types of loans or lenders and establishing some kind of floating interest rate ceiling for others. The combinations vary greatly from state to state.

Those states which have adopted floating interest rates do so on the premise that if the market is left to respond to natural forces of supply and demand, the optimum allocation of resources will occur, arguing that misallocation, distortion and cross-subsidization will occur in the absence of such freedom.\(^5^0\) By basing the maximum interest rate on various changing economic indicators, states provide flexibility to keep state lenders competitive with the national market rate and also provide protection to borrowers against being charged an excessive rate of interest out of line with current economic reality.

States with floating interest rate ceilings use several different economic indicators as indices. These different indices yield a range not only of rates, but also of stability for the rates set.\(^5^2\) Some economic indicators change more in response to federal government activity, while others are more sensitive to changes in the money market caused by actual commercial transactions. "The problem facing state legislatures when choosing an appropriate index for interest rates, is to select one which is neither so volatile that it becomes inflationary, nor so unresponsive that it is as restrictive as the fixed rates it is intended to replace."\(^5^3\)

At present, six states index interest rates to long term (ten years or more) United States government bond yields.\(^5^4\) On the


\(^5^0\) See Goldberg, Effect of State Banking Regulations on Bank Credit Card Use, 7 J. Money Credit & Banking 105 (1975).

\(^5^1\) Long, supra note 20, at 325.

\(^5^2\) Id. at 334.

average, these states allow lenders to charge about two percent above the bond yield rates.\textsuperscript{54} Four of these states, including West Virginia, apply the rates so derived only to home mortgage loans. The two other states, New York being one of them, apply it generally.\textsuperscript{55}

Long term government bond yields are almost risk-free rates. They are, therefore, a more stable economic indicator than short term money market rates which vary more widely in response to changing economic forecasts.\textsuperscript{56} Mortgage loans are also usually long term and are affected similarly by factors affecting bond yields. Thus, states which distinguish between commercial and home mortgages loan rates usually use bond yields as the index for mortgage interest rates.\textsuperscript{57} Historically, long term bonds have a higher yield than short term bonds.\textsuperscript{58} At the present, however, the reverse is true.\textsuperscript{59}

In general, interest rates indexed to bond yields are lower than those indexed to short term money market indicators such as the Federal Reserve discount rate, the commercial bank

\textsuperscript{54} The additional percentage gives the lender compensation for the added risk of lending funds to people who are less secure than the federal government.

\textsuperscript{55} W. VA. CODE § 47-6-5b(1) (1980 Replacement Vol.). This provision contemplates that maximum interest rates on non-precomputed loans secured by mortgages or deeds of trust should be prescribed from time to time to reflect changed economic conditions, current interest rates, and the availability of credit within the state for construction and purchase of adequate housing, improvements, and the establishment and expansion of business and agricultural enterprises situate in the state. The same section authorizes and directs the State Banking Commissioner to prescribe each month, by order, a maximum rate of interest for the next month for loans made for the purposes mentioned above that are secured by a mortgage or deed of trust. The Banking Commissioner is directed to use as an index for such interest rates the monthly index of long term twenty year United States government bond yields. The effective maximum rate of interest that may be charged is not to exceed this index rate plus an additional one and one-half percent per year. The rate so derived is to be valid for the term of the contract.

\textsuperscript{56} Long, supra note 20, at 334.

\textsuperscript{57} See text accompanying notes 103-08 infra.

\textsuperscript{58} "Yield" refers to the investment rate of return of a bond; the net income if held to maturity.

\textsuperscript{59} Living with High Interest Rates, supra note 41, at 9. When short term rates rise above the long term rates, it is due to a general expectation that either inflation or growth are going to increase.
prime lending rate, or the discount rate for ninety-day commercial paper at the district Federal Reserve Bank. States using these kind of indices generally allow their lenders to charge three to five percent above the money market rates.60

Alaska and Delaware index interest rates for all loans (up to $100,000) to the Federal Reserve discount rate.61 This rate is the fee charged by Federal Reserve district banks to member commercial banks for advances and is adjusted by the Federal Reserve to conform to other money market rates.62 States basing interest rates on commercial banks' prime rates (i.e., interest rates on short term loans charged by commercial banks to their most credit worthy customers) apply such rates only to a limited extent.63 Many states imposing floating interest rate ceilings use as an index the local district Federal Reserve bank discount rate on ninety-day commercial paper.64 This rate is based on actual commercial transactions, and is thus more directly responsive to changes in the economy than bond yields. It is also the least speculative of the short term money market rates.65 National banks have their interest rates indexed to this discount rate.66 In Montana, interest on all loans is indexed to the ninety-day commercial paper discount rate.67 West Virginia uses this in-

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60 E.g., MONT. REV. CODE ANN. § 47-125 (Supp. 1977); OHIO REV. ANN. § 1343.01(d) (Page Supp. 1978).
61 ALASKA STAT. § 45.45.010(b) (Supp. 1978). DEL. CODE tit. 6, § 2301 (Supp. 1980).
62 Prime Rate Charged by Banks, FED. RES. BULL. A26 (August, 1979).
63 NEV. REV. STAT. § 99.050(2) (1975).
64 KY. REV. STAT. § 287.214 (Interim Supp. 1977); Although Kentucky's usury statutes do not expressly provide that maximum interest rates are to based on the discount rate on ninety-day commercial paper, this particular statute authorizes banks and trust companies to charge what national banking associations are allowed, and section 85 of the National Bank Act provides, in part, that national banks may charge interest at a rate of one percent in excess of the discount rate on ninety day commercial paper.
65 See G. MUNN, ENCYCLOPEDIA OF BANKING AND FINANCE 948 (7th ed. 1973). Federal Reserve Board Regulation A ensured that this "eligible paper" is not speculative in nature and has the endorsement of the bank presenting it for discount.
67 This index is used for all loans made within the state, but the maximum percentage allowed in excess of this rate increases from four percent to five percent for loans exceeding $500,000. MONT. REV. CODE ANN. § 47-125 (Supp. 1977).
dex to set an alternate rate for all lenders.68

Fixed legal contract rates of interest range from seven percentum per annum in Michigan to twenty-one percentum per annum in Rhode Island, to an unlimited rate of interest in Massachusetts, New Hampshire, Maine and the District of Columbia. Among the states retaining fixed contract interest ceilings, eight percent, ten percent, and twelve percent simple interest per annum are the rates most frequently adopted.69 Florida has recently adopted an eighteen percent general usury ceiling.70 In West Virginia, parties may contract in writing for payment of interest for the loan or forebearance of money at a rate not to exceed eight percent per annum or for some other rate authorized by other provisions of the West Virginia Code.71

It should be noted that in all these states, as well as in all those using a floating interest rate ceiling, the laws provide exceptions that allow higher rates for certain lenders or transactions.72 Several states, while retaining a general fixed rate, have removed interest ceilings entirely from large loans. The threshold varies from state to state.73 Some states exempt just business purpose loans,74 while others exempt all loans made by financial institutions which are secured by first mortgages on real estate.75

These last exceptions include provisions: excluding VA-FHA loans;76 exempting Savings and Loan associations;77 providing

See also KY. REV. STAT. § 287.214 (Interim Supp. 1978) which permits state banks and trust companies to charge interest at the rate allowed national banking associations which is one percent in excess of the discount rate for all loans made for less than $15,000.

68 See text accompanying notes 124-25 infra.
69 5 Cons. CRED. GUIDE (OCH) § 510 at 1302-309.
70 FLA. LAWS 1979, c. 79-274 § 13 (amending FLA. STAT. § 687.03-1978).
71 W. VA. CODE. § 47-6-5 (1980 Replacement Vol.).
72 See text accompanying notes 19-25 supra.
74 W. VA. CODE § 47-6-11 (1980 Replacement Vol.).
75 Id. § 47-6-5b; ME. REV. STAT. ANN. tit. 9-B, § 432.2 (1978).
76 IOWA CODE ANN. § 682.46 (West 1946); OHIO REV. CODE ANN. § 1343.01(3) (Page Supp. 1979).
special higher rates for realty mortgages; and eliminating limitations on conventional home loans. The result of all these exceptions is that in many states the percentage of the total private debt subject to the general usury ceiling is less than that percentage that is not subject to the general ceiling.

IV. THE DEPOSITORY INSTITUTIONS DEREGULATION AND MONETARY CONTROL ACT OF 1980

Unfortunately, some states have been very slow in advancing changes in their usury legislation, while others have made only negligible changes in the rates they allow. Starting in 1974, Congress began to consider the problems caused by overly restrictive regulation of interest rates in some states and preempted state usury laws with regard to certain loans made by certain lenders. Congressional efforts culminated in the Depository Institutions Deregulation and Monetary Control Act

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80 See Benfield, Money, Mortgages, and Migraine—the Usury Headache, 19 Case W. Res. L. Rev. 819, 856 (1968). Of a study made as long ago as 1968, it was found that out of the fifteen states studied, in only one was more than 50% of the total private debt subject to the general usury statute.
81 See Act of October 29, 1974, Pub. L. No. 93-501, 88 Stat. 1557 [1974]. This law permitted national banks and federally insured state banks and savings and loan associations to charge interest on business and agricultural loans, in the amount of $25,000 or more, at a rate of up to five percent in excess of the Federal Reserve discount rate in the district in which the lending institution is located, regardless of any state provision. The law expired in July, 1977, but similar legislation, although limited in its application to Arkansas, was enacted November, 1979. Act of November 5, 1979, Pub. L. No. 96-104, 89 Stat. 789 [1979] Fed. Banking L. Rep. (CCH) ¶ 58,900. The legislation applied only in those states with constitutional provisions limiting interest to ten percent and has an expiration date of July 1, 1981.

In December, 1979, Congress enacted Public Law No. 96-161, temporarily preempting all state interest rate restrictions on business and agricultural loans over $25,000. Act of December 28, 1979, Pub. L. No. 96-161, 89 Stat. 1557 [1979] Fed. Banking L. Rep (CCH) ¶ 58,080. For a six month period ending July, 1980, Congress substituted a federal standard in place of the state restrictions, permitting interest charges up to a maximum of five percent in excess of the prevailing federal discount rate. This bill also preempted state restrictions on interest rates for residential loans and mortgages. Id.
of 1980, signed into law by President Carter on March 31, 1980. Title V of the Act preempts can be traced back to exemptions contained in Public Laws 93-501, 96-104, and 93-501, the MCA respresents Congress’ intention to include more types of lenders within the scope of these earlier exemptions and to establish some degree of permanancy for the exemptions.

A. Section 501

Section 501 of Title V of the MCA preempts state usury ceilings on loans, mortgages, or credit sales secured by a first lien on residential real property, all stock in a residential housing cooperative, or residential mobile homes. State usury ceilings applicable to residential manufactured home financings are only covered by this federal preemption if the financing is in accordance with consumer protection provisions promulgated by the Federal Home Loan Bank Board and section 103c of the Truth in Lending Act. The preemption provisions in section 501 apply to mortgage loans and credit sales made by financial institutions and to the sale or exchange of real property which is financed by the individual who owns and occupies such property as his principal residence. Congress also removed state usury ceilings on rates paid on deposits, accounts, or other obligations by depository institutions (defined as federally insured commercial banks, national savings banks, credit unions, savings and loan associations and certain other lending institutions). Interest rates paid by these institutions are still subject to federal regulation.

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83 Id. § 501(a)(1)(A).
84 Id. § 501(c) and (d).
85 Id. § 501(a)(2)(A).
86 Id. § 501(a)(1)(C)(vi).
87 Id. § 501(a)(2). In the Senate discussion concerning this provision, Senator Cranston remarked that in addressing this problem this bill exempts deposit accounts from state usury laws so savers may receive a fair return on their deposits.
88 See, e.g., 12 C.F.R. § 217 (1979) with respect to interest rates paid by insured banks. Title II of the MCA, however, mandates the gradual removal of such federal interest rate regulation.
It must be noted that the preemption provisions created by section 501 apply only to state laws expressly limiting interest, discount points and similar charges. Interest rates paid and charged by these institutions are still subject to consumer protection provisions contained in state law and federal regulations promulgated by the Federal Home Loan Bank Board, and include those provisions with respect to balloon payments, prepayment penalties, late charges and other provisions as the Federal Home Loan Bank Board or states may thereafter provide.69

Section 501(b)(2) of the MCA provides that states affected by the preemptions of this section have the express right to override the preemptions by reenacting or reasserting their own affected usury laws within three years after the enactment of the Act. Otherwise, the preemptions are permanent. A state override, either by action of the legislature or the voters, in order to be effective, must explicitly and by its terms refer to the federal preemption statute.

B. Sections 511 and 521 to 524

Section 511 of the MCA preempts state usury ceilings on business and agricultural loans for $1,000 or more made by any person69 until April 1983, subject to the right of the states to immediately override the preemption.91 Such a preemption occurs only if the new federal ceiling for such loans is greater than the applicable state ceiling.92 The new federal ceiling is five percent in excess of the Federal Reserve discount rate, including any surcharge thereon, on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve District where the person or institution making the loan is located.93

Sections 521 through 524 of Title V of the MCA provide that state chartered insured banks,94 federal and state chartered in-

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91 Id. § 512(a).
92 Id. § 511(a).
93 Id.
94 Id. § 521.
sured savings and loan associations, small business investment companies, and federal and state chartered insured credit unions may charge one percent over the Federal Reserve discount rate on ninety-day commercial paper (or the rates permitted by state law if higher) on all loans notwithstanding state usury laws. This preemption is also permanent, subject to reimposition of usury ceilings by the states.

C. Policy Considerations

The objectives in including Title V in the MCA are clear. They have found partial expression in earlier federal and state legislation involving interest rates. No doubt, the severity of mortgage credit crunches in recent years, in some states, prompted the preemptions included in section 501 of the Act. The drafters of this section sought to prevent the artificial disruption of funds availability and the frustration of national housing policies and programs which occur when state usury laws require mortgage rates below market levels of interest and, subsequently, mortgage funds in those states flow to other states where market yields are available to lenders. It was also thought this particular modification of state usury law was needed to facilitate functioning of a national secondary market in mortgage lending. Section 511 of the MCA marks an attempt on the part of Congress to increase the availability of funds for business and agricultural loans in certain states. Sections 521 to 524, which establish generally a new floating interest ceiling for certain state and federal chartered institutions, represent an attempt to bring parity in this area to the regulation of national banks and other lending institutions.

But there is yet another, albeit not so obvious, reason behind enacting all these preemptions. Title II of the MCA pro-

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95 Id. § 522.
96 Id. § 524.
97 Id. § 523.
98 These provisions are similar to the ones found in Section 85 of the National Bank Act governing the rate of interest that can be charged by national banks. 12 U.S.C.A. § 85 (West Supp. 1980). See text accompanying notes 118-19 infra.
100 Walker, supra note 48, at 30-38.
vides for a gradual phaseout (over a ten year period) of ceilings on interest rates payable on time and demand savings deposits. By allowing lenders to receive a fairer return on their "investments" in the form of higher interest yields on loans they make, it is hoped the same can improve their earnings enough to pay depositors market rates on savings accounts, as well as to begin to offer interest now payable on checking or NOW accounts. This would allow depository institutions to be more competitive with unregulated (and usually uninsured) money market instruments offering market interest rates. To this aim, Subsection two of section 501 seeks to ease prohibitions of those usury laws that prohibit not only lending at a usurious rate, but also prohibit a consumer from knowingly receiving such a rate; i.e., provisions which prohibit depository institutions from paying the increased interest when the interest ceiling phasein required under Title II exceeds the state's usury ceilings.


There can be little doubt that all these goals are desirable in and of themselves. It is also safe to assume that the provisions contained in Title V of the MCA can contribute to the accomplishment of these goals if they are followed by those states to whom they are especially directed. But it still remains to be seen whether these states will, in fact, decide to reassert or reenact their own usury laws affected by the preemptions of Title V. Some states may view the ambiguities inherent in some of the exemptions so compelling as to necessitate the need to revert back to their own usury provisions. Still other states may view the rates prescribed by Title V as so repugnant or so in excess of what they deem necessary to accomplish their goals that they reassert their own rates.

103 Harroch & Frasch, The New California Usury Law, 35 Bus. LAW 1058-59 (1980). It is important to note that to the extent state law is more liberal to the lender, such law governs rather than the rates provided for by the MCA. However, some states with higher yielding rates may, as a matter of suggestion,
Section 501 of the MCA provides, in essence, for unlimited interest rates on home mortgage loans. This section takes into consideration two key elements which the majority of state laws do not consider: the degree of the borrower's business sophistication or bargaining power and the degree of risk assumed by the lender in making the loan. Because home mortgage loans are generally fully secured by real estate, the lender assumes less risk than when making general consumer loans. Consequently, there is a more constant market rate and less opportunity for taking advantage of a naive borrower. Stated another way, the lender cannot take advantage of the needy borrower when the borrower has the option of transacting in an open market with other lenders who would charge virtually the same rate. The fact that a person is in a position to purchase a home indicates he should be sophisticated enough to need only the protections usually accorded the normal consumer.

No doubt, this preemption represents some improvement and provides for more credit availability in those states where the maximum rate of interest, whether fixed or based on some sliding scale, is so artificially low that lenders are discouraged from making home mortgage loans. At the same time, there are those who would argue that unlimited interest rates are appropriate only in business loans, and not in general consumer or home mortgage loans. People who take this position advance the opposite arguments of those made by persons who favor unlimited interest rates in this area. They contend that the marketplace is imperfect and not truely indicative of the state of the economy; that unconscionable contracts may arise out of unregulated dealings between the lender and the borrower; that even though borrowers are still protected by the common law principal that equity will not enforce an unconscionable contract, needy borrowers may be too afraid to complain of unreasonable interest charges, or may not, despite state and federally mandated disclosure of interest charges, even be aware of the reasonableness of the interest rates charged. Finally, it is argued that since there is less risk for the lender in home mortgage

cut back on their own liberality and decide not to give the lender the option of lending at the higher state regulated rate.

104 Note, supra note 5, at 221-24.
105 Long, supra note 20, at 337.
loans he should not expect such a high rate of return for his "investment."\(^{106}\)

Those states which wish to increase the availability of credit for home mortgage loans over that level presently allowed under their usury laws, but, for some reason or another, desire not to allow an unlimited rate of interest, have the option of selecting some new compromise rate they feel is both high enough to provide lenders a competitive return on their money and low enough so as not to place an undue burden on the borrower. While it is true that even a floating interest rate ceiling may still be too restrictive if set at or only slightly above a single unresponsive economic index, many economists have urged that it is desirable to distinguish between rates for short term business or consumer loans and long term home mortgage loans when deciding what is the most appropriate index on which to base interest rates.\(^{107}\) Georgia, Illinois, Pennsylvania and West Virginia have all distinguished between commercial and home mortgage loans and have based interest rate ceilings for the latter on long term United States government bond yields.\(^{108}\)

Even if those states with restrictive mortgage usury laws decide to reject section 501 of the MCA, and instead decide to employ some compromise maximum rate that is higher than the rates previously allowed by the individual states, it still may be said that section 501 succeeded in fulfilling its drafters' objectives. The possibility that some states will retain the section as part of their own laws brings pressure on the other states to modify their own rates to the point where they become fairly comparable with the free market rate. Indeed, it is possible that many states have already been forced to proceed in this direction because some of the states surrounding them have already

\(^{106}\) This argument is premised on the fact that most home mortgage loans are fully secured by the realty concerned.

\(^{107}\) See generally, Giles, supra note 6 at 544. A good argument may be made that because the government holds weekly auctions of bonds and notes and decides, via the Federal Reserve Open Market Committee, how many and what types of issues will be offered, the Treasury bond rate is a managed rate, and therefore it is not representative of the economy.

chosen, on their own accord, to make certain exceptions for residential mortgage loans in their usury laws.

While in the area of residential home mortgage loans it is not possible that a state have an interest rate ceiling any more liberal than the "no ceiling rate" prescribed by section 501 of the MCA, such is not the case with regard to loans made for business or agricultural purposes. Some states, while retaining a fixed general interest rate ceiling, have removed interest ceilings entirely from large loans. The threshold varies from state to state. For example, Alaska, Delaware and Ohio exempt loans in excess of $100,000. In Kentucky, the threshold is only $15,000; in South Carolina it is $500,000. Certainly, some business and agricultural loans exceed these thresholds and can thus be included in the exemptions. Other states specifically exempt business purpose loans over a certain amount. Again, the threshold varies from state to state. It should also be noted that in any state which preempts from its usury laws loans made to corporations and/or partnerships, certain loans made for business or agricultural purposes may fall within the scope of the preemption. West Virginia's usury laws do not apply to loans to corporations or partnerships, or to loans to natural persons if the loan is made for $20,000 or more and is primarily for a business purpose. A business purpose, however, does not include agricultural purposes.

Of course, section 511 of the MCA will have no effect at all on states that already use the federal discount rate on ninety-day commercial paper as the index for the maximum rate of interest to be allowed on business and agricultural loans over $1,000. Nor will it have any significant impact on states which totally exclude from their interest rate ceilings business and agricultural loans made for over $1,000. Thus, this particular federal preemption is of little significance in West Virginia, except as to loans made for agricultural purposes.

109 ALASKA STAT. § 45.45.010(b) (Supp. 1978); DEL. CODE ANN. tit. 6 § 2301(c) (Supp. 1980); OHIO REV. CODE ANN. § 1343.01(B)(1) (Page Supp. 1978).
110 KY. REV. STAT. § 360.010(1)(b) (Supp. 1978).
113 Id. §§ 47-6-10 and 47-6-11(2).
114 Id. § 47-6-11(2).
Section 501 should, however, have an impact on states that have more restrictive interest rate ceilings on business and agricultural loans as well as home mortgage type loans. It will pressure states that have low fixed interest ceilings to raise their maximum permitted rate so that they are more competitive with the rates set in states where credit for business and agricultural purposes is more widely available. It will have the same effect on states that use some other floating index besides the discount rate on ninety-day commercial paper as the basis for the maximum rates they allow on business and agricultural loans if the index rate so used is generally lower than the discount rate. The discount rate on ninety-day commercial paper is neither the highest nor lowest of the short term money market indicators. But it is the most riskless short term market rate, and because it is based on actual commercial transactions, it is one of the most indicative of a fair price for money under existing business conditions. Finally, the federal preemption contained in section 511 will also exert this pressure on states that already exclude these kinds of loans from their usury statutes and even states that use higher index rates than the discount rate on ninety-day commercial paper, where the threshold these loans must exceed in order to be so exempted is greater than the $1,000 requirement of section 511.

Those who contend that sections 521-524 of Title V of the MCA will create automatic parity between national banks and certain state chartered financial institutions may not be correct. Section 55 of the National Bank Act prescribes the maximum interest that may be charged on loans made by national banks. That section reads in part:

Any association may take, receive, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of one percentum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve Bank in the Federal Reserve district where the bank is located, or in the case of business or agricultural loans in the amount of

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115 MUNN, supra note 65, at 950.
116 Id.
117 Id. at 952.
$25,000 or more, at a rate of five percentum in excess of the discount rate on ninety-day commercial paper..." 118

In the past, the language of this section permitting national banks to charge "interest at the rate allowed by the laws of the State" 119 has been open to several different constructions. One possible interpretation is that whenever a rate is specifically set by state law for state chartered banks, national banks will also be limited to that rate, even though other creditors in that state may be permitted to charge a higher rate. This interpretation has been called the "parity doctrine." 120 Under the second interpretation, national banks may charge the highest rate of interest permitted to be charged by any person, except that if an even higher rate is permitted to state chartered banks, the national banks may charge those higher rates. This construction is called the "most favored lender doctrine" and was adopted by the United States Supreme Court in Tiffany v. National Bank of Missouri. 121

Although there has been no Supreme Court decision directly on point on this subject since 1873, beginning in the 1970's, several federal courts and at least two state supreme courts have decided cases in which they have recognized the "most favored lender doctrine." 122 More important, the Comptroller of the Currency's Interpretive Ruling 7.7310 states that:

A national bank may charge interest at the maximum rate permitted by State law to any competing State-chartered or licensed lending institution. If State law permits a higher interest rate on a specified class of loans, a national bank making such loans at such higher rate is subject only to the provisions

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119 Id.
120 Higgs, Rate Limitations, Interest and Usury, 33 Bus. Law 1043, 1056 (1978).
121 85 U.S. (18 Wall.) 409 (1873).
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of State law relating to such class of loans that are material to the determination of the interest rate.\(^{123}\)

Pursuant to this interpretation, a national bank may charge the highest rates of interest permitted by state law to state chartered or licensed lending institutions such as small loan companies and savings and loan associations.

It is of great significance that the provisions of the MCA, while permitting certain state lending institutions to charge interest at a rate not exceeding one percent above the discount rate, do not limit those institutions to this prescribed rate. Because these institutions can still charge applicable state rates (where the state rate is greater than the discount rate) and because some states do allow credit unions, small investment companies and the like to charge greater interest rates than permitted state banks, the argument can be made that in those states which follow the "most favored lender doctrine," sections 521 to 524 of the MCA will have little effect in establishing parity between national and state chartered banks. National banks still have the option of charging interest in excess of what their own state prescribes for its own state chartered banks.

At this point, it should be noted that several states have already enacted "parity" bills on their own accord. During the 1980 session of the West Virginia Legislative, such a parity bill was enacted.\(^{124}\) It authorizes the West Virginia State Banking Commissioner to prescribe a maximum rate of interest on loans made by, in effect, all lenders, which rate may not exceed one percent above the discount rate on ninety-day commercial paper. This "maximum" rate, however, serves only as an alternative to the interest rates authorized by other provisions of the West Virginia Code. West Virginia's alternative rate statute permits state lenders making any consumer loan to charge the highest of rates permitted by code section 31A-4-30a (the parity statute) section 47-6-5b or section 47-6-5c.\(^{125}\) By permitting state banks to charge what other state lenders are permitted, the West Virginia Legislature has effectively resolved the national state bank parity issue without having to disturb the most

\(^{123}\) 12 C.F.R. § 7.7310(a) (1980).
\(^{125}\) Id. § 46A-3-117 (1980 Replacement Vol.).
favored lender doctrine. Whether section 85 of the National Bank Act is construed to mean that national banks could, as an alternative to the rate prescribed therein, choose rates permitted by state banks, or whether it is interpreted to mean that they may charge the highest rates permitted other state lenders, national banks in West Virginia no longer have any more options than state chartered banks are now allowed to choose from.

In states that have adopted parity or alternative rate statutes similar to West Virginia's, it is doubtful that sections 521 to 524 of the MCA will have any additional effect in creating parity between federal and state chartered lending institutions. But because these provisions do not prevent state lenders from charging interest at even higher rates, where state law so provides, it is doubtful whether in those states which allow some lenders, but not state banks, to charge more than one percent in excess of the discount rate, that parity will result between national and state chartered banks. Of course, these sections will create the desired parity in those states which, by their own laws, do not allow any lenders, banks or otherwise, to charge interest in excess of one percent above the discount rate or ninety-day commercial paper.

CONCLUSION

Loans and interest rates are no longer purely local phenomena. While banks generally are prohibited from lending across state lines, other lending institutions are not subject to such restrictions. In addition, most major banks have offices in almost every state from which they can generate loans. Because the credit industry is no longer just a local phenomenon, and because federal efforts at controlling the nation's money supply by targeting reserve requirements have mostly failed, it seems certain that the trend at the national level toward federal regulation of interest rates will continue. And in most likelihood, it will continue along the same lines with which it has proceeded since Public Law 93-501.126

It appears that Congress is sold on the idea that permitting lenders to charge higher interest rates will ease the credit crunch on home mortgages, business, and agricultural loans currently existing in many states. That Congress will not waiver in this belief is evidenced by the logical progression of the various preemption provisions Congress has enacted since 1974. It is evidenced most recently by some of the amendments Congress has just recently attached to the MCA, specifically, that provision lowering the threshold over which business and agricultural loans must exceed in order to be exempted, from an original figure of $25,000 to $1,000, and the provision now preempting financings by individuals on sales or exchanges of real property.127

Although several states have already seen fit to reject some or all of the preemption provisions of Title V,128 this may not deter Congress' future attempts to regulate in this area. Because the credit industry has a significant impact on the national economy, any future federal legislation of interest rates should withstand scrutiny under the commerce clause.129 In order to forestall future federal preemptions, or in the event that such preemptions become inevitable, states should enact usury laws conforming to the rates most likely to be adopted by federal law so that they may minimize the disruptive effects of such federal law.

Peter Daniel Levy

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127 Pub. L. No. 96-399, §§ 324(d), (e) [amending the MCA].