Trends in Usury Legislation-Current Interest Overdue

Maxine Master Long

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The author describes the general usury statutes found in the United States. After explaining the basic indices used to compute the rates, the author proposes that the trend must continue to favor floating interest rates.

I. INTRODUCTION

Usury is a concept as old as human society, dating at least from biblical times.[1] In order to understand and put current trends in usury legislation into proper perspective, it is necessary to understand the evolution of such legislation and the rationale behind it. Only then can it be determined whether usury laws still serve a valid purpose, or whether a radical modification, or perhaps a total abandonment, is appropriate.[2]

The word "usury" is derived from the same Latin root as "use" and refers to a charge imposed for the use of money.[3] Throughout history money has been regarded with suspicion and has not been treated like other commodities, resulting in a "moral taint" on

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1. *See, e.g., Leviticus* 25:35-37; *Deuteronomy* 23:19-20.

2. Franklin Ryan notes in the preface in his 1924 book, *Usury and Usury Laws*, that when he began his study in 1921, he was advised to drop the subject and turn to a more fruitful field of inquiry because "there was no problem; . . . all economists were agreed that usury laws are a dead letter and that the laws had gotten on the statute books simply because legislators could not understand the economic principles worked out by Jeremy Bentham in 1787 in his 'Letters in Defense of Usury.'" F. RYAN, *Preface* to USURY AND USURY LAWS at x (1924). Nevertheless, Ryan found enough new material to fill a book. Fifty-eight years later, upon talking to local attorneys about the present article, I received essentially the same advice. I too have proceeded with my inquiry and hope I have made a useful contribution to a subject whose demise, like Mark Twain's, has been greatly exaggerated.

3. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2525 (1966).

the charging of interest on the use of money.

Originally, any charge for the use of money or its equivalent was forbidden.[4] As society and economic concepts developed, a distinction was made between loans with interest made to strangers and loans to needy persons within the community.[5] The former was permitted and was recognized as preferable to letting the money lie idle.[6] Even though society's economic need for sources of capital, along with the corresponding interest costs of maintaining a supply of capital, was recognized, money lending was still generally a practice shunned by the dominant classes in society and relegated to minority group members.[7] This attitude persists today toward those in the loan industry, such as pawnbrokers and small loan companies, who make consumer loans and charge the highest rates.

Interest rates are historically as much a moral as an economic issue, and usury laws must be considered in this light. The perceived social justification for setting interest rate ceilings must be balanced against economic reasons for abandoning regulation of interest rates. Purely economic arguments have not often prevailed over a deep-seated and ancient distrust of those who make money on others' need for money.[8]

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4. Even today, Sharia, the Moslem religious and legal code followed in a number of Islamic countries such as Saudi Arabia, entirely prohibits the collecting of interest on loans. Lenders in these countries avoid the problem by the imposition of "service charges." Wall St. J., May 11, 1979, at 1, col. 1.

5. The Bible, for example, offers evidence of this evolution. Old Testament references prohibiting usury or the charging of interest to neighbors rank it with bestiality and oppression of widows and orphans. *Leviticus* 25:35-37.

6. By New Testament times the usefulness of usury was recognized. In the parable of the talents, the servant who buried the money he was given to safeguard was criticized for not having put it out to earn interest. *Matthew* 25:14-28.

7. For an entertaining study of interest through the ages, see S. HOMER, A HISTORY OF INTEREST RATES (1963) and highlights from the book in Homer, *An Informal History of Interest Rates*, 11 INSTITUTIONAL INVESTOR 109 (Aug. 1977).

8. F. RYAN, *supra* note 2. Jeremy Bentham's pamphlet set out his economic arguments against regulating interest rates by means of usury laws instead of allowing free trade in the money market to set the rates. *Id.* at x (citing J. BENTHAM, LETTERS IN DEFENSE OF USURY (1787)). These arguments were urged upon a state legislature as long ago as 1836 when the New York Legislature considered a bill to repeal the New York usury law. *Introduction* to M. SILK, THE USURY DEBATE AFTER ADAM SMITH (1972). The opposing view prevailed; *i.e.*, "money is *unlike* any other article, and so unlike it that the possessor has neither the legal nor the moral right to take for it all that he can get." J. Whipple, *Free Trade in Money, or Note-Shaving, the Great Cause of Fraud, Poverty and Ruin: Stringent Usury Laws, the Best Defense of the People Against "Hard Times," reprinted in id.* at 18.

Economist Milton Friedman, in referring to LETTERS IN DEFENSE OF USURY, *supra*, notes that "During the nearly two centuries since Bentham's pamphlet was published, his arguments have been widely accepted by economists and as widely neglected by politicians." Friedman, *Defense of Usury, in* READINGS IN ECONOMICS 36 (7th ed. Samuelson 1973). Recent changes in many state usury laws are encouraging signs that this long neglect may be ending.

Franklin W. Ryan, in his 1924 study of *Usury and Usury Laws*,[9] distinguished between moral and legal usury, as well as between juristic and economic rationales for usury laws. Legal usury has been defined as "simply taking more than the law allows."[10] Moral usury has been defined as "taking advantage of the ignorance or necessitous condition of the needy borrower so as to get him into a hard bargain and exact from him unduly high charges."[11]

Criticism by economists that usury laws are inefficient and unnecessary is only partly justified. Usury laws are ineffective when they set legal usury limits in an effort to eliminate moral usury. But usury laws are necessary, juristically, if not economically, because moral usury is perceived by most legislatures as a social evil that must be eradicated.

II. State Usury Laws

The loans which usury laws regulate have been regarded as essentially local transactions and, as such, have always been a subject of state regulation. In today's national economy, however, this may no longer be accurate. Many borrowers and lenders are engaged in businesses of national scope. If interest rates are economically prohibitive in one state, lenders will tend to locate elsewhere and businesses requiring loans will either follow or stagnate. Restrictive usury laws are, therefore, not in the economic best interest of either the state or the nation because they tend to create a dislocation of financial resources.[12]

The first usury laws were adopted by the original colonies and patterned after English law.[13] The typical usury law in this country, based on the Statute of Anne, provided that excessive interest could not be charged on "any loan or forbearance of any money, goods or things in action."[14]

Every state has enacted laws governing permissible interest rates for various types of loans, and no two statutes are exactly

9. F. Ryan, *supra* note 2.

10. *Id.* at xii.

11. *Id.*

12. Giles, *The Effect of Usury Law on the Credit Marketplact*, 95 Banking L.J. 527, 540 n.54 (1978).

13. The Statute of Anne, 1713, 12 Anne, c. 16. This statute sets interest at a maximum rate of five percent. It is ironic that the elements of usury and other provisions set forth in this act are still a part of most American usury laws, more than a century after all usury laws, including the Statute of Anne, were repealed in England by 17 & 18 Vic., c. 90 (1854). F. Ryan, *supra* note 2, at 25, 45; Lowell, *A Current Analysis of the Usury Laws—A National View*, 8 San Diego L. Rev. 193, 195 (1971).

14. Lowell, *supra* note 13 (citing Cal. Const. art. XX, § 22 (presently art. XV)).

alike. Not only do the rates differ widely, but there are also wide variations in the methods of setting rates, the exceptions to statutory rates, the applicable penalties and the allowable defenses.

A. *Constitutional Interest Ceilings*

Although most states enacted usury ceilings by legislative action, in some states public sentiment against high interest rates was so strong that usury limits were incorporated into the state constitution.[15] Such limits make the interest rate inflexible and render legislative or judicial exceptions to the rate subject to constitutional challenge.

Recently these constitutional provisions themselves have come under attack as interest rates have approached and exceeded the mandated ceiling. In 1977, a California lower court ruled that article XV of the California Constitution,[16] which imposes a ten percent per annum interest rate ceiling on some lenders but exempts others,[17] was in violation of the due process and equal protection clauses of the fourteenth amendment, as well as in violation of the commerce clause because it acted as a restraint on the free flow of capital into California.[18] On appeal, however, the California Second District Court of Appeal reversed,[19] holding that "California's Usury Law is constitutional as applied to all loans."[20] If there is an appeal and the Supreme Court of California finds exemption for certain lenders to be unconstitutional, it will have a far-reaching effect on similar exemptions and exceptions in other states' laws, even if these exceptions are not of constitutional status.

In 1977, the Supreme Court of Tennessee struck down as unconstitutional a 1968 act which authorized interest rates on consumer loans higher than the ten percent ceiling imposed by the state con-

15. ARK. CONST. art. 9, § 13; CAL. CONST. art. XV (1976, amended 1978); TENN. CONST. art. 11, § 7 (1870, amended 1978) (maximum limitation on interest rates removed).

16. CAL. CONST. art. XV (adopted in 1934 as art. XX, § 22, subsequently modified to become art. XV in 1976 and further amended in 1978).

17. The lenders exempt from the 10% interest rate ceiling in California are: state and federal banks and building and loan associations, credit unions, agricultural cooperatives, personal property brokers and industrial loan companies. CAL. CONST. art. XV, § 1 (adopted 1934, modified 1976, amended 1978).

18. Committee Against Unfair Interest Limitations v. California, [1977] 5 CONS. CRED. GUIDE (CCH) ¶ 98,039 (Cal. Super. Ct., 1977).

19. Committee Against Unfair Interest Limitations v. California, 95 Cal. App. 3d 801, 157 Cal. Rptr. 543 (Ct. App. 1979). As of this writing the committee has until Oct. 31, 1979 to file an appeal with the Supreme Court of California. *See also* Boerner v. Colwell Co., 21 Cal. 3d 37, 557 P.2d 200, 145 Cal. Rptr. 380 (1978).

20. 95 Cal. App. 3d at 805, 157 Cal. Rptr. at 547.

stitution.[21] Fearing tight consumer credit and high prices, Tennessee voters repealed the constitutional usury ceiling in March 1978, thereby empowering the legislature to set interest rates.[22]

Arkansas and California are the only states which still have a constitutional usury limit. The Arkansas Constitution sets a maximum interest rate of ten percent.[23] The economic effects of this limit are notorious and have been the subject of a number of studies and articles.[24] The severe penalties for usury in Arkansas make the interest ceiling even more onerous.[25]

On February 28, 1979, the Arkansas delegation introduced a bill in the United States House of Representatives to alleviate the "credit crunch" until a new state constitution is presented to Arkansas voters in 1980.[26] The bill, H.R. 2515, was enacted as Public Law 96-104, on November 5, 1979. It applies to business and agricultural loans in the amount of $25,000 or more and temporarily preempts state constitutional or statutory usury ceilings, allowing insured banks and other insured institutions and small business investment companies to charge a maximum of five percent above the discount rate on ninety-day prime commercial paper that is in effect at the Federal Reserve bank in the Federal Reserve district where the financial institution is located.[27] State interest rate ceilings on other

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21. Cumberland Capital Corp. v. Patty, 556 S.W.2d 516 (Tenn. 1977) (striking down the 1968 Industrial Loan and Thrift Act because it permitted charging interest in excess of the 10% maximum allowed under the state constitution); *see* Causey, *How Tennessee "Usury" Fight Was Won,* 70 BANKING 104 (Apr. 1978).

22. *Id.* at 108.

23. ARK. CONST. art. 9, § 13.

These states mention a maximum contract rate of interest only in the section dealing with the UCCC. COLO. REV. STAT. § 5-3-201 (1973); IND. CODE ANN. § 24-45-2-201 (Burns 1974); OKLA. STAT. ANN. tit. 14A, § 2-201 (West 1972), tit. 15, § 266 (West Supp. 1979); UTAH CODE ANN. § 70B-3-605 (1979); WYO. STAT. § 40-14-212 (1977).

24. *See* Giles, *supra* note 12, at 537-42; *A Federal Usury Law—Uniformity at Any Rate,* IV U. CAL. D. L. REV. 421, 423 (1971); *An Empirical Study of the Arkansas Usury Law: "With Friends Like That . . . ,"* 1968 U. ILL. L.F. 544, 546-69.

25. For example, in Universal C.I.T. Credit Corp. v. Stanley, 225 Ark. 96, 279 S.W.2d 556 (1955), a buyer was allowed to cancel a usurious conditional sales contract *and* keep the car which was the subject of the contract. In United-Bilt Homes, Inc. v. Knapp, 239 Ark. 940, 396 S.W.2d 40 (1965), homebuyers were permitted to keep the house as well as cancel all indebtedness evidenced by a usurious note for the balance due on the building contract under ARK. STAT. ANN. § 68-609 (repealed 1957). The court stated that to hold otherwise "would render the Constitutional provision against usury practically ineffective. If the seller of an article on a usurious contract knew he could, if caught, repossess the same, he obviously would be more inclined to take a chance." 239 Ark. at 944, 396 S.W.2d at 42.

26. 125 Cong. Rec. 4993 (daily ed. Feb. 28, 1979) (remarks of Reps. Alexander and Anthony).

27. *Id.* This is the rate allowed to national banks under 12 U.S.C. § 85 (Supp. IV 1974) (amending 12 U.S.C. § 85 (1970)).

types of loans, such as consumer loans and home mortgages, are not affected under this legislation.

The Act is limited to "those States having a constitutional provision which provides that all contracts for a greater rate of interest than 10 per centum per annum shall be void," and expires on the earlier of July 1, 1981, or the rejection of the Act by either the state legislature or the voters.[28] Thus, although the legislation appears at first glance to be national in scope, it is restricted in its application to Arkansas alone, and is subject to the approval of that state's voters and legislators. With the limitations deleted, however, this Act could serve as a model for a truly national usury law.

B. *Economic Effects of Usury Laws*

The rationale behind most state usury laws is basically unchanged from that of the biblical prohibition: to protect the needy from those who would take advantage of their position. Very little attention has been paid by legislatures to whether the laws actually fulfill their purpose. Extensive study of usury laws by economists shows that any benefits of lower interest rates are offset by decreased availability of funds for lending,[29] with the result that would-be borrowers at the higher-risk end of the credit spectrum, typically those lower-income persons whom the laws are intended to protect, are denied credit.[30] They must either do without goods until they have accumulated enough money to pay cash, or turn to illegal lenders, *i.e.*, loansharks who charge a high rate of interest in order to cover the risk of default and the risk of being caught while engaged in an illegal activity.

Most people tend to place a high value on the present use of goods, and thus prefer to pay a high rate of interest in order to obtain the immediate benefit of goods.[31] The high rate of inflation

28. Pub. L. No. 96-104, §§ 107, 301, 93 Stat. 789 (1979).

29. A. ALCHIAN & W. ALLEN, UNIVERSITY ECONOMICS 471 (3d ed. 1972); Greer, *Rate Ceilings, Market Structure, and the Supply of Finance Company Personal Loans*, 29 J. FINANCE 1363 (1974), analyzed the effect of usury ceilings on the output of the personal loan market under both competitive and monopolistic conditions and predicted that credit rationing would occur even when usury ceilings are set *above* competitive levels.

30. Although it may be argued that such laws, which restrict the money available for borrowing, actually serve to protect the poor from high interest rates, most politicians, at least outwardly, would reject this overtly paternalistic view. Avio, *An Economic Rationale for Statutory Interest Rate Ceilings*, 13 Q. REV. ECON. & BUS. 61, 67 (Autumn 1973).

31. In fact, people of lower income are more likely to "buy now, pay later" than those with higher incomes. According to Kenneth Avio, "[T]he smaller disposable income is, the greater is the weight given to present consumption vis-a-vis future consumption in the family's plan of consumption allocation over time." *Id.* at 66.

in the economy, which is expected to continue, makes this tendency even more likely. Historically, 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.[32]

This phenomenon can be seen today 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 even though prices and interest rates are expected to rise even higher in coming months. These expectations have been encouraged by the economic policies of the last several administrations, which have feared a recession even more than continued inflation, and have felt that a recession would be the price of any effective attempt to curb inflation.[33]

Inflation has led to greatly renewed interest in usury laws in the last few years, as interest rates have soared past the statutory ceilings in many states. These states have had to raise the ceiling or suffer severe credit restrictions adversely affecting their economies.

In a recession, with or without continued inflation, the economies of states with restrictive usury laws may suffer more than those with more liberal laws and may also take longer to recover.[34] Restrictive rates of interest in themselves tend to cause economic stagnation, discouraging businesses from borrowing for expansion and encouraging lenders to invest elsewhere. The present predictions of an imminent national recession should give added impetus to usury law reforms.

III. TRENDS

Faced with the need for changing its interest and usury laws, a state legislature has several alternative courses of action. It may simply raise the usury ceiling to a rate above the current market rate. It may repeal existing usury statutes and cease regulation of interest rates. Or it may attempt to create a flexible, floating interest rate. Each of these approaches has been tried, and each has advantages and disadvantages which will be discussed below.

32. *Living with High Interest Rates*, FORTUNE, Oct. 23, 1978, at 9.

33. Wildstrom, *Carter's Call for Lowered Expectations*, BUS. WEEK, Apr. 24, 1978, at 33.

34. Giles, *supra* note 12, at 533-34. Giles' article contains an excellent discussion of the economic effects of usury laws and concludes that usury statutes should be indexed to some appropriate economic indicator. He does not, however, recommend any particular one. *Id.* at 546-47.

A. *General Structure of Usury Laws*

All state usury laws provide for a fixed rate of interest in the absence of a contract or express agreement. This maximum rate is usually quite low, from five percent to eight and one-half percent, with most states, including Florida, setting the rate at six percent simple interest per annum.[35]

This paper focuses on state laws regulating the contract rate of interest. Consumer loans regulated by special acts, such as the Uniform Consumer Credit Code (UCCC), Small Loan Acts, and Retail Installment Sales Acts, are exceptions to general state usury laws and are therefore referred to only in passing.

Most state usury laws also create exceptions for certain types of loans, such as large loans and corporate loans, although the definitions and thresholds for these exceptions vary widely. The laws generally set regulations for conventional mortgage loans and small business loans. One study estimated that in 1968 only thirty-five percent of the total private debt in Florida was subject to the general usury statute of the state.[36] Of fifteen states studied, in only one was more than fifty percent of the total private debt subject to the usury statute.[37] It is likely that this general pattern still prevails. Lenders and borrowers who cannot take advantage of any of the exceptions believe that their fourteenth amendment rights to due process and equal protection have been violated.[38]

B. *Fixed or No Interest Ceiling*

As of September 1979, the legal contract rate of interest (the maximum interest rate to which parties may agree) ranged from seven percent per annum in Michigan, to twenty-one percent per annum in Rhode Island,[39] to an unlimited rate of interest in Massachusetts, New Hampshire, Maine and, just recently, the District of Columbia.[40] In five states the contract rate of interest is subject only to the limits of the UCCC enacted in those states.[41] The two other states that have adopted the UCCC,[42] retain contract interest ceilings for loans not covered by the UCCC.

35. FLA. STAT. § 687.01 (1977).

36. Benfield, *Money, Mortgages, and Migraine—the Usury Headache*, 19 CASE W. RES. L. REV. 819, 856 (1968).

37. *Id.* at 857.

38. *See* notes 18 & 19 and accompanying text *supra*.

39. 5 CONS. CRED. GUIDE (CCH) ¶ 510 at 1301-09 (Sept. 18, 1979).

40. *Id.* at Report 285 (Aug. 8, 1979).

41. Colorado, Indiana, Oklahoma, Utah and Wyoming.

42. IDAHO CODE § 28-22-105 (Supp. 1979); KAN. STAT. ANN. § 16-207 (Supp. 1978).

Among the states retaining fixed contract interest ceilings, 8%, 10% and 12% simple interest per annum are the rates most frequently adopted.[43] Florida has recently adopted an eighteen percent general usury ceiling.[44] All of these states provide exceptions that allow higher rates for certain lenders or transactions.

Several states, while retaining a general fixed rate, have removed interest ceilings from large loans. The threshold varies from state to state. For example, Alaska,[45] Delaware[46] and Ohio[47] exempt loans in excess of $100,000. In Kentucky the threshold is only $15,000;[48] in South Carolina it is $500,000.[49]

Other states exempt business purpose loans over a certain amount. In Iowa the threshold is $500,000 for agricultural loans and $200,000 for business loans.[50] In North Dakota any corporate loan over $35,000 is exempt from the usury ceiling.[51]

New Jersey allows any agreed upon rate of interest for loans over $50,000, other than residential mortgages.[52] New York permits corporate loans over $250,000 and demand notes of $5000 or more with collateral security to be made at any rate up to the twenty-five percent criminal usury threshold.[53]

C. *Floating Interest Ceiling*

A number of other states have enacted statutes permitting a floating interest rate tied to various economic indicators. Usually a special state committee or the state banking commissioner has authority to change the interest rate in response to changes in the economy, following a prescribed procedure.[54] This type of legislation provides flexibility to keep state lenders competitive with the national market rate and also provides protection to borrowers against being charged an excessive rate of interest out of line with current economic reality. All of these provisions have been enacted within the past ten years.

States with floating interest rates use several different eco-

43. 5 CONS. CRED. GUIDE (CCH) ¶ 510 at 1302-09.
44. 1979 Fla. Laws, ch. 79-274, § 13 (amending FLA. STAT. § 687.03 (1978)).
45. ALASKA STAT. § 45.45.010(b) (Supp. 1978).
46. DEL. CODE ANN. tit. 6, § 2301(c) (Supp. 1977).
47. OHIO REV. CODE ANN. § 1343.01(B)(1) (Page Supp. 1978).
48. KY. REV. STAT. § 360.010(1)(b) (Supp. 1978).
49. S.C. CODE § 34-31-30 (Supp. 1978).
50. IOWA CODE ANN. § 535.2(2) (West Supp. 1979).
51. N.D. CENT. CODE § 47-14-09 (Interim Supp. 1979).
52. N.J. STAT. ANN. § 31-1-1(b)(1) (West Supp. 1979).
53. N.Y. GEN. OBLIG. LAW § 5-501(1)-(6) (McKinney 1978).
54. *See, e.g.*, W. VA. CODE § 47-6-5b (Supp. 1979).

nomic indicators as indices, yielding a range not only of rates, but of stability for the rates set. Some economic indicators are very sensitive to changes in the money market, while others are more stable. 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.

Most of the states with a floating interest rate ceiling use one of two general types of economic indicators as an index for interest rates: either the monthly index of long term (ten years or more) United States government bond yields or a short term money market indicator, such as the Federal Reserve discount rate, the commercial bank prime rate or the discount rate for ninety-day commercial paper at the district Federal Reserve bank. To each of these indices is added a fixed percentage as compensation for the lender. On the average, states allow lenders to charge about two percent above the government bond yield rates and three to five percent above the money market rates.

At present six states index interest rates to United States government bond yields.[55] Three of these states[56] apply the rate so derived only to specified loans; the others apply it generally.

Long term government bond yields are almost risk-free rates.[57] They are therefore a more stable economic indicator than short term money market rates which vary more widely in response to changing economic forecasts. Mortgage loans are also usually long term and are affected similarly by factors affecting bond yields. Thus, states which distinguish between commercial and home mortgage loan rates use bond yields as the index for mortgage interest rates.

Historically, long term bonds have a higher yield than short term bonds.[58] At present, however, an inverse yield condition exists, so that shorter term government notes and bonds have a higher yield than those with longer maturities.[59] Among long term government

55. *See* GA. CODE ANN. § 57-101-1 (Supp. 1979); ILL. ANN. STAT. ch. 74, § 4, 2(a) (Smith-Hurd Supp. 1979); IOWA CODE ANN. § 535.2, 3(a) (West Supp. 1979); N.Y. BANKING LAW § 14-a (McKinney 1979); N.Y. GEN. OBLIG. LAW § 5-501(1) (McKinney 1979). 41 PA. CONS. STAT. ANN. § 301 (Purdon 1979); W. VA. CODE § 47-6-5b (Supp. 1979).

56. GA. CODE ANN. § 57-101-1 (Supp. 1979); ILL. ANN. STAT. ch. 74, § 4, 2(a) (Smith-Hurd Supp. 1979); 41 PA. CONS. STAT. ANN. § 301 (Purdon 1979); W. VA. CODE § 47-6-5b (Supp. 1979).

57. G. MUNN, ENCYCLOPEDIA OF BANKING AND FINANCE 948 (7th ed. 1973).

58. "Yield" refers to the investment rate of return of a bond, the net income derived if the bond is held to maturity. It is a function of the price, interest rate and term of the bond. *Id.*

59. When short term rates rise above long term rates, it is due to a general expectation that either inflation or growth is going to increase. Since no significant recession is forecast

securities, the yield rate on ten-year government bonds is slightly higher than on all long term government bonds, including the twenty-year bonds.[60]

In general, the interest rates indexed to bond yields are lower than those indexed to short term money market indicators. According to the August 1979 Federal Reserve Bulletin, United States Treasury notes and bonds with a ten-year maturity had an average yield rate of 8.95% in July; twenty-year bonds had a yield rate of 8.92%; and the long term composite yield rate was 8.35%.[61] In contrast, the Federal Reserve discount rate for July was 9.69%[62] and the prime rate charged by banks on short term business loans was 11.54%.[63] Lenders were allowed to add from 1.5 to 3% to the bond yield rates and up to 5% to the short term money market rates, depending on state law.[64]

The Federal Reserve discount rate is the fee charged by Federal Reserve district banks to member commercial banks for advances.[65] This rate is adjusted by the Federal Reserve to conform to other money market rates and is used to control what member banks charge their customers.[66] Alaska[67] and Delaware[68] index interest rates for all types of loans up to $100,000 to the Federal Reserve discount rate.

Another index used, the prime rate, is the interest rate on short term commercial loans charged by commercial banks to their most credit-worthy customers.[69] The prime rate, being set by the banks, is the rate least subject to direct federal management and in theory the rate most reflective of the true state of the economy. Banks, however, tend to follow closely variations in the Federal Reserve discount rate, setting their prime rates about two percent higher.

Use of the prime rate results in the highest interest rate of the economic indicators discussed. Only two states use it, and then only to a limited extent. Nevada indexes interest rates to the lowest daily

at the moment, present expectations are that both kinds of rates will probably increase. *Living with High Interest Rates*, *supra* note 32, at 9.

60. "Long term" is defined in the Federal Reserve Bulletin as being all bonds maturing in more than 10 years.

61. *Interest Rates, Money and Capital Markets*, FED. RES. BULL. A27 (Aug. 1979).

62. *Monetary Aggregates and Interest Rates*, FED. RES. BULL. A3 (Aug. 1979).

63. *Prime Rate Charged by Banks*, FED. RES. BULL. A26 (Aug. 1979).

64. *Id.*

65. G. MUNN, *supra* note 57, at 784-86.

66. *Prime Rate Charged by Banks*, *supra* note 63.

67. ALASKA STAT. § 45.45.010(b) (Supp. 1978).

68. DEL. CODE ANN. tit. 6, § 2301(a) (Supp. 1977).

69. *See* G. MUNN, *supra* note 57, at 749-50.

prime rate at the three largest domestic banks.[70] This rate takes effect only after Nevada's statutory ceiling of twelve percent has been reached.[71] Puerto Rico ties interest rates to the prime rate prevailing at major New York City banks, but only for commercial loans in excess of $1 million.[72]

Of the three short term money market indicators used by various states, the one most often employed as an index is the local district Federal Reserve bank discount rate on ninety-day commercial paper. This "eligible" paper consists of notes arising out of commercial transactions which are discounted to a bank and rediscounted to the Federal Reserve bank.[73]

Four states and national banks[74] have interest rates indexed to the discount rate on ninety-day commercial paper. Minnesota lim-

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70. NEV. REV. STAT. § 99.050(2) (1975).

71. *Id.*

72. Act No. 1 of Oct. 15, 1973, 1973 P.R. Laws 849. By this act, the Legislative Assembly of the Commonwealth of Puerto Rico created the Board for Regulating Rates of Interest and Financing Charges, empowered to raise interest rates above the maximum prescribed in other parts of the Civil Code of Puerto Rico. This power is to be exercised:

> when it can be reasonably anticipated that because of disagreements between the rates of interest prevailing in the market and the maximum ones permitted by law in Puerto Rico, there is the risk that the investment of capital in determined economic sectors or activities in Puerto Rico might be halted or reduced.

Id. at 850.The factors to be considered in setting the rate are:

> the prevailing market cost for the money available to finance different economic lines or activities and the damage which might occur to the economy in general, to any of its sectors or to the citizen, if no action is taken to change, by increasing or decreasing, the effective rates of interest or charges at a given moment.

Id.

This legislation provides great flexibility in interest rate setting because it considers and harmonizes both prevailing market conditions in various segments of the economy and "the right of the debtor to protection against the imposition [of] excessive charges." *Id. as amended by* Act No. 120 of June 2, 1976, 1976 P.R. Laws 349. The board acts by promulgating regulations from time to time which take effect after being filed in the legislature and state department and being published for three days in Puerto Rican newspapers of general circulation. The board has established various fixed interest rates, *e.g.*, 10% on first mortgages, but has also provided for a variable rate as noted in the text.

73. Federal Reserve Board regulation A defines obligations which are eligible for rediscount at a Federal Reserve bank. 12 C.F.R. § 201.4 (1979).

74. The rate that national banks may charge in the absence of contrary state law is set out in 12 U.S.C.A. § 85 (West Supp. 1979).

> When no rate is fixed by the laws of the State, or Territory, or District, the bank may take, receive, reserve, or charge a rate not exceeding 7 per centum, or 1 per centum 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 $25,000 or more, at a rate of 5 per centum 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, whichever may be the greater . . . .

Id.

its use of this index to business and agricultural loans,[75] while Ohio restricts its use to real estate loans.[76] In Montana interest on loans up to $150,000 is indexed to the ninety-day commercial paper discount rate.[77] Kentucky ties interest rates charged by state chartered banks and trust companies to this index in order to achieve parity with national banks in the state.[78]

The usefulness of the ninety-day commercial paper discount rate is due to the fact that it is based on actual commercial transactions, and is thus more directly responsive to changes in the economy than bond yields. It is also the most riskless short term money market rate; in effect, it is the prime rate of the Federal Reserve System. Federal Reserve Board regulation A ensures that this "eligible" paper is not speculative in nature and has the endorsement of the bank presenting it for discount.[79]

IV. Analysis of Trends

Changing an existing usury law by merely raising the maximum rate of interest permitted in order to preserve the underlying rationale for the law is deceptively simple. If people are conditioned to think that any rate over a certain magic number is per se illegal, it will be very difficult to convince anyone that the new rate is fair. If a rose by any other name smells just as sweet, interest at a rate higher than the old maximum will still stink of usury. This illustrates the basic problem of usury laws: trying to solve the problem of moral usury by means of legal interest rates. In addition, if the rate is raised high enough above current rates to make unnecessary frequent amendments if inflation continues, the effect is as if the interest ceiling had been abolished altogether. In such cases, the rate will not be a factor considered by lenders or borrowers, because it is unlikely to affect them.

A possible solution is to follow the British and European example of not setting legal interest rates at all.[80] Massachusetts, New Hampshire and the District of Columbia have followed this route. Any rate of interest is permissible if agreed to in writing by the parties. Borrowers are protected, however, by the common law principle that equity will not enforce an unconscionable contract. In

75. Minn. Stat. Ann. § 334.01(1) (West Supp. 1978).
76. Ohio Rev. Code Ann. § 1343.01(B) (Page 1978).
77. Mont. Rev. Codes Ann. § 47-125(5) (Cum. Supp. 1977).
78. Ky. Rev. Stat. § 287.214 (Interim Supp. 1979).
79. G. Munn, *supra* note 57, at 289, 341.
80. Great Britain and most of the European countries repealed their usury laws in the 19th century. Benfield, *supra* note 36, at 821.

most instances, courts in Great Britain and the European countries have the power to remake a contract by setting a fair rate of interest.[81]

Some disadvantages to this solution are that needy borrowers may be afraid to complain of unconscionable charges or that borrowers may not even be aware of the unreasonableness of interest rates charged. Despite federally mandated disclosure of interest and finance charges,[82] most consumers probably either ignore or do not understand the information disclosed in the agreements they are signing. Unlimited interest rates are therefore appropriate only in business loans and not in consumer loans.

The best solution for consumer loans is one that realistically attempts to harmonize society's competing goals of freedom of contract and protection of the needy. Such harmony is best achieved by means of a floating interest rate which is high enough to provide lenders a competitive return on their money but not so high as to place an undue burden on borrowers.

Even a floating interest rate may still be too restrictive if set at or only slightly above a single unresponsive economic measure. Because some indicators do not always respond with sufficient speed or accuracy to changes in the economy, the market rate of interest may occasionally exceed the floating rate. This fact causes lenders to either increase the number of loans not subject to the interest rate ceiling, or to tighten credit requirements, or to stop lending entirely. The Pennsylvania and New York usury laws, tied to long term United States security yields, have been criticized for being too restrictive in this fashion.[83] The index used to set a variable interest rate must therefore be carefully chosen.

The most generally accepted rate used as an interest index appears to be the discount rate on ninety-day commercial paper. It is neither the highest nor the lowest rate, and it is flexible in responding to economic changes.[84] If all types of loans were to be tied to one rate, the discount rate on ninety-day commercial paper is perhaps the best choice, for it is the one most indicative of a fair price for money under existing business conditions. It is neither inflationary nor recessionary. It may be desirable, however, to distinguish between rates for short term business loans and for long

81. *Id.* at 821 n.7.

82. Truth in Lending Act, 15 U.S.C.A. §§ 1601-1692 (West 1974 & Supp. 1979).

83. McNulty, *The Impact of Usury Ceilings on Home Financing*, 8 REAL EST. REV. 68, 70-72 (Summer 1978).

84. *See* text accompanying notes 74-79 *supra*.

term mortgage loans.[85] In that case, it would be preferable to follow Illinois and Minnesota in basing home mortgage rates on long term government bond yields and business loans on the ninety-day commercial paper discount rate.

Florida's usury statute is fairly typical of states with "fixed ceiling" rates.[86] In 1977, however, the Florida Legislature amended the statute by adding section 687.12, the Interest Parity Act. This equalization amendment presumably was intended to allow all lenders making the same type of loan to charge the same rate of interest. The language of the section, however, refers only to licensed lenders, or lenders or creditors lending through a licensee.[87] Not included in the preceding categories are insurance companies and mortgage banking companies, both of which provide financing for residential real estate mortgages, just as do thrift institutions. The effect of the section thus falls short of placing all lenders on an equal footing in making the same type of loan.[88]

The Supreme Court of Florida has recently handed down two decisions upholding the constitutionality of sections of the Florida usury statute. In *Cesary v. Second National Bank*[89] the court upheld the exception allowing industrial savings (Morris Plan) banks to charge in excess of ten percent against the allegation that the sections[90] violated the constitutional prohibition against enactment of special laws.[91] In *Catogas v. Southern Federal Savings & Loan Association,*[92] decided the same day, the court upheld the higher interest rate exception for state building and loan associations and construed it as applying to federally chartered savings and loan associations as well.[93]

In neither case did the supreme court refer to the Interest Parity Act, section 687.12; thus, the constitutionality of the act remains untested. Given the tenor of the two recent decisions, however, in sweeping away constitutional challenges to the interest rate structure, "the assumption [is] that, in any review of the Parity Act by the present Supreme Court, the economic utility of [the Act] would

85. *See* text accompanying notes 57-64 *supra*.

86. *See* FLA. STAT. § 687 (1977 & Supp. 1978), *as amended by* 1979 Fla. Laws chs. 79-90, 79-138, 79-274.

87. FLA. STAT. § 687.12 (1977).

88. Sanders, *Florida's Usury Law in Transition—the Aftermath of the Supreme Court Decisions*, 53 FLA. B.J. 315, 317-18 (1979).

89. 369 So. 2d 917 (Fla. 1979).

90. FLA. STAT. §§ 656.17(1), 687.031 (1977).

91. FLA. CONST. art. III, § 11(a)(9).

92. 369 So.2d 922 (Fla. 1979).

93. FLA. STAT. §§ 665.395, 665.511 (1977).

be given at least equal consideration with any constitutional shortcomings which might be asserted."[94] Therefore, any further extension of exceptions allowed, or any liberalization of the usury laws to permit higher interest rates to all lenders making real estate loans, would probably be upheld by this supreme court.

In the 1979 session of the state legislature, several changes were made in Florida's usury laws.[95] The most important were those made by Session Law 274 (S.B. 1262),[96] which took effect July 1, 1979. The changes effect substantial increases in the maximum interest rates allowed on various types of loans. Most consumer loans made on or after July 1, 1979, will have an interest ceiling of eighteen percent instead of the confusing 10%, 12%, 14%, 15% and 16% rates formerly applicable to different types of consumer loans. Allowable finance charges are also increased by the legislation. The law applies to loans by licensed lenders and financial institutions for new car, home improvement, mobile home and credit card loans.

The most controversial provision of the new law allows retail stores, offering installment financing mostly on durable consumer goods such as major applicances, to charge up to 21.5% annual interest. According to lobbyists for retail finance interests, retailers were having difficulty selling their installment contracts because of the low interest rate ceiling.[97]

This increase was sought last year in the so-called "Phoenix Bill,"[98] which was defeated several times by the Commerce Committee of the Florida House of Representatives before finally being brought to the floor and defeated there also.[99] Although the present statute cleared legislative hurdles, it met with some gubernatorial resistance. The bill became law without Governor Graham's signature.[100] A related bill, S.B. 331, which was passed in both houses of the legislature and which would have lifted interest ceilings for large corporate loans, was vetoed by Governor Graham.[101] Like the "Phoenix Bill," S.B. 331 is likely to be reintroduced in the 1980

94. Sanders, *supra* note 88, at 317.

95. One change provided for remedial avoidance of penalties for usury. *See* 1979 Fla. Laws, ch. 79-90. Another change provided that the usury rates would not apply to loans made to nonresident aliens. *See* 1979 Fla. Laws, ch. 79-138.

96. 1979 Fla. Laws, ch. 79-274 (amending §§ 516.02, 516.031(1), 516.18(1), 516.21, 657.14, 659.18, 659.181, 687.02, 520.34(5), 687.04 (1977), and §§ 520.08(1)(a), 656.381(4)-(5), and 687.03(1) (Supp. 1978), and repealing § 687.11 (1977)).

97. Miami Herald, May 10, 1979, § A, at 28, col. 1.

98. *Id.*, May 18, 1979, § A, at 14, col. 1.

99. *Id.*

100. *Id.*

101. 1979 Fla. Digest of General Laws liv.

legislative session. Also to be considered during the coming session are changes in the Interest Parity Act. The comptroller was mandated to make an extensive study of the act and make recommendations to the legislature.[102]

At the same time the 1980 legislature should consider changing the Florida interest rate structure itself. Despite the increases in permissible rates this year, it is only a matter of time until the rates for some types of loans must be increased again. Rates for short term loans should be indexed to an appropriate short term money market rate, to obviate the need for piecemeal tinkering with the usury statute. Similarly, rates for long term loans should be indexed to an appropriate long term indicator.

V. Conclusion

Florida should adopt an interest rate tied to an appropriate economic indicator or set of such indicators, at least for mortgage loans and other personal loans. The interest rate for business loans should be unregulated, regardless of the amount of the loan. If some regulation is unavoidable, the threshold amount for unregulated loans should be set at a very low figure, such as $5000.

Just as in the area of securities regulation, full disclosure of all material information to a knowledgable borrower should be sufficient protection.

The question then is what factors should be considered in setting a floating interest rate? At least two states with floating rates on mortgages have been criticized for choosing formulae which are too restrictive.[103] Both Minnesota and Pennsylvania tied their interest rates to the monthly index of yields on United States Treasury securities, a figure which is lower than other indicators because of the inclusion of certain classes of very low yielding bonds. Illinois ties its rates to the same figure and is therefore subject to the same criticism.

It is suggested that Florida adopt a floating interest rate ceiling on conventional consumer loans, applicable to all lenders, based on a fixed percentage above the discount rate on ninety-day prime commercial paper at the Federal Reserve Bank of Atlanta for the preceding or second preceding month. This ceiling would provide an interest rate neither excessive nor restrictive and in accord with federal legislation.[104]

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102. Miami Herald, *supra* note 98.
103. McNulty, *supra* note 83.
104. *See* note 74 *supra*.

The trend at the national level is increasingly toward federal regulation of interest rates. Already existing are federal laws that regulate other aspects of the loan industry, such as criminal loansharking and disclosure,[105] which have withstood scrutiny under the commerce clause.[106] Loans and interest rates are no longer purely local phenomena, any.more than loansharking is, and thus the reality of a national economy should enable federal legislation of interest rates to pass muster under the commerce clause.[107] If the trend in state legislatures toward flexible interest rates does not continue, the states may well find themselves preempted by federal usury laws within a few years. Therefore, in order to forestall federal preemption, or in the event that preemption becomes inevitable, to minimize its disruptive effects, Florida should pass a usury law conforming to the usury rate most likely to be adopted by federal law.[108]

105. Truth in Lending Act, 15 U.S.C.A. §§ 1601-1693 (West 1974 & Supp. 1979); Extortion Credit Transactions, 18 U.S.C. § 891-96 (1974).

106. Perez v. United States, 402 U.S. 146 (1971).

107. *See generally A Federal Usury Law—Uniformity at Any Rate, supra* note 24.

108. The rates set in 12 U.S.C.A. § 85 (West Supp. 1979) are the most probable candidates for such adoption of a new federal law. *See* note 74 *supra.*