MONEY AND INTEREST

REPORT OF THE
MONEY AND INTEREST STUDY COMMISSION
To
THE GOVERNOR
And
THE GENERAL ASSEMBLY OF VIRGINIA

COMMONWEALTH OF VIRGINIA
Department of Purchases and Supply
Richmond
1967

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MONEY AND INTEREST

REPORT OF THE

COMMISSION TO STUDY MATTERS RELATING TO MONEY AND INTEREST

To:

HONORABLE MILLS E. GODWIN, JR., *Governor of Virginia*

and

THE GENERAL ASSEMBLY OF VIRGINIA

The resolution creating the Money and Interest Study Commission, printed in the Acts of Assembly, 1966, at page 1596, is as follows:

HOUSE JOINT RESOLUTION NO. 101

Creating the Money and Interest Study Commission.

Whereas, Virginia is in the midst of an expansion which involves every portion of her social and economic composition; and

Whereas, an adequate supply of funds is essential to the continued growth and prosperity of Virginia; and

Whereas, the laws regulating the cost of money in this Commonwealth have from time to time been modified in regard to varying financial and lending institutions; and

Whereas, Virginia is one of only eleven states which has a contract interest rate of as low as six dollars per one hundred dollars per annum; and

Whereas, the economic activities in our Commonwealth are affected by national developments as well as those occurring within our boundaries; and

Whereas, it is vital to the citizens of Virginia that an adequate supply of money is available in this State in order for builders to be able to construct the buildings and homes necessary to meet the need of our expanding economy and population;

Whereas, it is possible that many funds otherwise available for loans to Virginia's citizens leave our Commonwealth to seek higher earnings in other states where such is possible under their laws; and

Whereas, such out-flow of funds may have an adverse effect on the people of this Commonwealth and the business community herein; now, therefore, be it

Resolved by the House of Delegates, the Senate concurring, That a Commission is hereby created to be known as the Money and Interest Study Commission. The Commission shall consist of nine members of whom three shall be appointed by the President of the Senate, three shall be appointed by the Speaker of the House of Delegates and three shall be appointed by the Governor, one of whom shall be a member of the State Corporation Commission. Insofar as practicable, all interests concerned shall be afforded representation upon the Commission.

The Commission shall make a study and report upon the following matters:

(a) The economic impact of the different kinds of financial institutions on the Virginia economy and their need and position in the development of the State economy for the future; and

(b) The export and import of money out of and into Virginia during the past ten years and the reason for these movements; and

(c) The true relevance and effect of the statutory rate as it now stands in light of all of the special exceptions; and

(d) The inequities, if any, which exist in the present laws of Virginia as a result of varying interest rates; and

(e) The future need for money in Virginia considering our economic growth, both actual and desired, and the relationship of the interest rate structure to this consideration.

The members of the Commission shall receive no compensation for their services but shall be paid their necessary expenses for which, and for such secretarial, technical and other assistance as may be required, there is hereby appropriated the sum of five thousand dollars to be paid from the contingent fund of the General Assembly.

All agencies of the State shall assist the Commission upon request. The Commission shall conclude its study and make its report to the Governor and the General Assembly not later than November one, nineteen hundred sixty-seven.

The members appointed by the President of the Senate are Leroy S. Bendheim of Alexandria, J. C. Hutcheson of Lawrenceville and William P. Kellam of Virginia Beach.

The members appointed by the Speaker of the House of Delegates are C. Hardaway Marks of Hopewell, C. W. Cleaton of South Hill and Charles K. Hutchens of Newport News.

The members appointed by the Governor are Shirley T. Holland, Edwin B. Brooks, Jr., and Ralph T. Catterall.

At its organization meeting the Commission elected C. Hardaway Marks chairman and Shirley T. Holland vice-chairman, and appointed G. M. Lapsley secretary, and Robert L. Masden Staff Attorney.

The Commission commenced its study by inviting seven experts in the field of money and finance to present evidence before a well-attended public meeting. Prepared statements were presented by Richard C. Chewning, Associate Professor of Business Administration, University of Richmond; H. Harland Crowell, Jr., President of the Virginia Real Estate Association; Kenneth I. Doran, President of the Virginia Mortgage Bankers Association; S. S. Flythe, President of the First National Bank of Martinsville and immediate past president of the Virginia Bankers Association; Glen T. Hastings, President of the Home Builders Association of Virginia; Mark W. Saurs, Executive Vice President of the Virginia Savings and Loan League; and John B. Siegel, Jr., Senior Vice President and Chairman of the Investment Committee of the Life Insurance Company of Virginia.

At its second public hearing the Commission solicited the views of all who wished to speak. Twenty-three of those who made oral statements advocated higher interest rates and two opposed. The hearing room was crowded. When the audience was asked to express its views by a show of hands about 250 favored higher interest rates and two opposed.

The arguments against raising interest rates were twofold. First, it was asserted that if the permissible contractual rate were increased it would necessarily follow that interest rates would soon rise to the new ceiling. Second, it was asserted that the present emergency would soon be over and interest rates would of their own accord fall below six percent.

The second of the two arguments cancels the first. The second argument recognizes that in a free market the price of the use of money, like the price of everything else, is governed by the law of supply and demand.

If a maximum price is fixed by statute it does not mean that borrowers pay the maximum price during periods when the law of supply and demand dictates a price *below* the statutory maximum. It does, however, mean that when the law of supply and demand dictates a price *above* the statutory maximum would-be borrowers cannot borrow.

That interest rates do not automatically soar like balloons to the highest ceiling is nowhere more clearly demonstrated than by the experience of the savings and loan associations. Until 1960 there was no limit whatever on the interest rates that savings and loan associations could charge. This was pointed out in the report of October 1, 1959, of the State Corporation Commission to the Governor and General Assembly on page 4 of House Document No. 19, which recited:

> "The present §6-156 deals with interest charges but the section does not contain the word 'interest'. Instead it begins: 'Every association may fix by its by-laws the premiums or bonus at which it will dispose of the money in its treasury . . .' The money so disposed of is described as 'the disposal, loan or award.' Obviously, this is not the terminology used by modern businessmen."

The State Corporation Commission was directed by H. J. R. No. 100 (Acts of 1958, p. 1109) to revise the laws applicable to savings and loan associations. It made its study in close collaboration with representatives of the savings and loan associations who agreed that the right to charge unlimited interest rates ought to be given up. During all the years when savings and loan associations could charge as much as they pleased of them did charge more than six percent.

The argument that nothing should be done now because the present emergency will soon go away, ignores the possibility that the future may hold new emergencies. And it ignores the fact that many lenders are permitted by various statutes to charge more than six percent.

Presently permitted maximum interest rates are:

Banks can charge 12% on daily or monthly balances on contracts for "revolving credit." ("Revolving Credit" is a euphemism for overdrafts agreed on in advance.) A rate based on maximun monthly balances would be higher than a rate based on daily balances and would exceed 12%.

Banks can charge between 11 and 12% on installment loans. Most banks do not make such loans secured by real estate although the law permits it.

Industrial Loan Associations have the same privilege and customarily make installment loans secured by real estate.

All lenders making loans secured by second mortgages were given the same privilege of charging up to 12% by Chapter 285 of the Acts of Assembly of 1966.

Also in 1966, by § 38.1-740 Insurance Premium Finance Companies were allowed to charge effective rates between 20 and 30 percent.

Credit unions are authorized to charge 12% on unpaid balances.

Various statutes permit various lenders to charge rates in excess of 6% per annum but less than 12%.

The maximum small loan company rate is 30%.

The maximum pawnbroker rate is 120%.

Since the purpose of usury laws is to prevent the exaction of exorbitant rates it is hard to understand the reasons for allowing banks, industrial loan associations, second mortgage companies, premium finance companies and credit unions to charge twice as much as savings and loan associations, insurance companies and other lenders.' Nobody has come forward with a suggestion that all lenders should be limited to 6%. And of course the biggest exception to the time-honored 6% rate is the exception that places no limit on the rate of interest that can be charged to corporations. Many a small partnership has been obliged to go to the expense of incorporating in order to qualify for a loan necessary to carry on its business. In order to extend to all lenders the privileges that have heretofore been extended to some, we propose the following:

RECOMMENDATION

That all lenders be permitted to charge the lower of the two alternative rates that banks are permitted to charge by § 6.1-320. The lower of those two rates has been in effect for many years and produces a true annual interest rate of 11.9%. The higher of those two rates, authorized by Acts of 1960, p. 97, produces a rate of 12% if computed on daily balances. (If computed on maximum monthly balances, the true interest rate would be higher and could be 365%.) If this recommendation is adopted, § 6.1-320 would be amended to read as follows:

> § 6.1-320. Any **person* may loan money or discount bonds, bills, notes or other paper at a rate not exceeding one half of one per centum for thirty days, and may charge a minimum loan or discount fee of one dollar on loans or discounts, and may receive such interest in advance; provided, however, that any **person* may charge in advance the legal rate of interest upon the entire amount of any loan payable in *equal* weekly, monthly or other periodical installments, and any note evidencing such an installment loan may provide that the entire unpaid balance thereof, at the option of the holder, *in the event of default in the payment of any installment for a period of thirty days,* shall become due and payable *without impairing the negotiability of such note, if otherwise negotiable; and provided further, that any bank may charge a rate not exceeding one per centum per month on daily balances, or on maximum calendar or fiscal monthly balances, under a written contract for revolving credit on any plan which permits an obligor to avail himself of the credit so established, and may also charge as a service fee a sum not exceeding twenty-five cents for each check, draft or other order on the credit so established.*
>
> *As used in this section and in § 6.1-234 the phrase "charge in advance" when applied to installment loans means that the interest may be added to the principal amount of the note but may not be deducted from it.*

Notwithstanding any other provision of this Chapter, any loan contract (for whatever period and whether or not payable in equal or other installments) in which interest is neither charged in advance nor received in advance by payment or discount shall be lawful if the annual interest rate contracted for and stated in the contract does not exceed the maximum effective annual interest rate which is allowed by the first proviso of this section on a loan on which the interest is charged in advance and which is payable in equal monthly installments over a period of ten years.

The reason for making this recommendation in the form of an amendment of § 6.1-320 is to bring out and emphasize a fact that might otherwise be overlooked; namely, that the Commission does not propose that an existing ceiling on interest rates be raised; but that savings and loan associations, insurance companies and other lenders be given equal treatment under a ceiling that has been lawful in Virginia for many years. The same substantive result could be achieved with fewer words by amending §§ 6.1-318 and 6.1-319 to read as follows:

§ 6.1-318. Legal rate of interest.—Legal interest shall * be at the rate of six * *percent per annum.*

§ 6.1-319.—*No* * contract * *shall be made* for the loan or forbearance of money at a greater rate of interest than * *twelve percent per annum except as otherwise permitted by statute.*

If the General Assembly should be of the opinion that banks, industrial loan associations, second mortgage companies, premium finance companies and credit unions ought to be permitted to charge higher rates than insurance companies and savings and loan associations it can substitute for the number "twelve" in the proposed amendment of § 6.1-319 a lower number.

FINDINGS AND REASONS FOR THE RECOMMENDATION

I. *The Existing Law is Allocative Rather Than Protective*

An Act of December 8, 1786, fixed the interest rate in Virginia at 5% and an Act of November 23, 1796, raised the rate to 6%. In 1849 the Revisors of the Code recommended that the contract rate be raised to 8%, but the General Assembly did not agree. Since 1849 all Codes of Virginia have used the words: "Legal interest shall *continue* to be at the rate of" 6%. So many exceptions have been made since 1849 that the only lenders presently limited by the old 6% contract rate are those who have not succeeded in obtaining an exception.

The purpose of the original law was to protect the people of Virginia from paying exorbitant rates of interest for the use of money. At the beginning of our economic development such a law was appropriate because of the monopoly conditions that could and often did exist in a local market. In addition, the control of the volume of money and bank notes was under the control of the individual states, while now such control is in the hands of our Federal Government through the Federal Reserve System.

The current effect of the law is not so much to protect citizens of Virginia from borrowing money at rates higher than 6% as it is to keep them from borrowing money to purchase homes. The effect of the law has become one of allocating available funds to those lenders in whose favor the laws discriminate and away from those against whom the laws discriminate.

II. *Statutory Rates and Market Rates*

The fear most commonly expressed is that interest rates in the market place will be increased to the new statutory limit if the limit is raised. There is no evidence to support such a claim and all the evidence indicates that such fear is unfounded. Only two conditions could exist which would justify such a fear. (1) If the new statutory limit were raised so slightly as to still be lower than market forces dictate that it must be, then rates would rise to the new limit. (2) If monopoly conditions existed where money could be obtained from only one source and that source were protected by law against competition, then rates could be pushed beyond the economic rate that would ordinarily be set by free market conditions. Such conditions obviously do not exist in Virginia.

The historical evidence shows clearly that such a fear as expressed above is completely unfounded as demonstrated by the transactions that have taken place in the last twenty-five years. The statutory law that is now causing the trouble has been on the books of Virginia since 1796. Mortgage money in Virginia during the past twenty-five years has been available to the public at a rate less than 6% because the laws of supply and demand have been such as to make it available at less cost. If the fears were justified, all money for mortgages would have been costing the people of Virginia 6% ever since 1796. Such is not true.

In Washington. D. C., the statutory limit is 8% and money may be borrowed to purchase a home at a rate between 6½% and 6¾%. The laws of supply and demand set that rate. The market rate today in our sector of the country is ½ to ¾ of a percent above the Virginia statutory limit, and hence money is not available in Virginia in sufficient quantity to satisfy the need for homes.

III. *Precedent*

The Legislature of Virginia has already established a precedent for exempting specific areas of our economy from the 6% statutory rate by doing this very thing on many occasions. This Commission is merely suggesting that all lenders be treated with greater uniformity.

IV. *Virginia in Relationship to the Nation*

The economic and social growth of the State of Virginia and flow of money within the state are dependent to a large extent upon Virginia's relative attractiveness to individuals and industry when compared with other states. Virginia is not an island nor is it self-contained.

During this time of tight money. Virginia is not getting its historic share of funds because of our existing law fixing the price of money. Foreign Mutual Savings Banks and foreign and domestic life insurance companies are not sending the same proportion of their money into Virginia now that they have during the last decade. Why? Opportunities are better elsewhere to make a higher return. Are the people of Virginia not willing to pay the "going" rate for money? The people are willing, but the law denies them the right to bid for money according to the law of supply and demand. The law is out of step with the reality of the market place.

If the economy of Virginia is to continue to compete for people and industry with other states, the people must be given the opportunity to compete for funds with the people and industries of other states. To want all the benefits of growth and to deny our citizens the opportunity to operate on an equal footing with people of other states is not sound reasoning.

V. *Home Building Industry*

All facets of the home building industry have been especially hard hit in Virginia during this period of "tight money" because it is one of the few sectors of the economy still restricted by the 1796 statute which denies the entire home building industry the opportunity to compete with other industries for money.

The Commission recognizes the fact that the housing industry is suffering throughout the entire nation as a result of the "tight money" conditions. The Commission further recognizes the fact that a change in the laws of Virginia will not solve all the problems facing the housing industry. However, the evidence clearly indicates that the conditions in the Virginia housing industry would not be as severe or critical if the law did allow this sector of our economy to compete freely for money in the open market. It is impossible to say exactly how much better off the housing industry would be, but the evidence indicates that the decline would have been reduced by between 10 and 20 percentage points. Expressed another way, the industry would be about 25% more active than it currently is. The preciseness of the figures can be questioned within limits, but there is no question in the minds of the members of the Commission about the fact that a change in the law would benefit the housing industry in particular and the economy of the state in general.

Investigation of this problem shows that those who deprecate an increase in the cost of money with which to purchase a home are thinking of only one side of the problem. Families trying to sell their homes because of a company or government transfer or a better job-opportunity elsewhere are now being forced to sacrifice their equity in their existing homes in order to find a purchaser. The law can't force a man to lend money. If the buyer is legally prevented by the 6% rate from persuading a lender to lend, the seller of the house has to pay the lender enough so-called "points" to induce the lender to make the loan. A law which protects (by intent if not in effect) the buyer, but harms the seller (unintentionally, to be sure) needs to be revised. Buyers and sellers should receive equal protection under the law, as should institutions trying to serve the home building industry.

VI. *Industry Efficiency*

The evidence received by the Commission shows that those institutions which supply funds to the housing industry are efficiently managed. Their very efficiency has made it possible for them to keep from appealing to the state earlier for legisative relief. They have done all they can effectively do and now relief can come only from the legislature. The only relief the industry is asking for is one of releasing them from artificial restrictions which have already been removed from other sectors of our economy so that they can compete in a free and open market.

SPECIFIC AREAS OF INVESTIGATION
DIRECTED BY HOUSE JOINT RESOLUTION NO. 101

The Commission was asked to make a study of five specific areas and this has been done with detailed comments being offered only in the areas that effect the home building industry as this is the area of distress that initiated the study.

A. *The economic impact of the different kinds of financial institutions on the Virginia economy and their need and position in the development of the State economy for the future . . .*

At the end of 1965 savings accounts in Virginia banks and savings and loan associations totalled around 3.5 billion dollars and the outstanding mortgage loans on Virginia homes totalled about 5.5 billion dollars. Of the savings in savings and loan associations over 90% were invested in home mortgages. In the case of banks only about 35% of their savings accounts were so invested. The rest of the mortgage money comes from other sources. Nearly two billion dollars came from Virginia and out-of-state insurance companies, and nearly one billion from out-of-state mutual savings banks. The clear lesson of these figures is that Virginia has to attract money from outside the state; and money is not attracted unless the interest rate is attractive.

B. *The export and import of money out of and into Virginia during the past ten years and the reason for these movements . . .*

The Savings and Loan industry has historically been comprised of associations which draw savings deposits from a specific geographic area and lend the funds to borrowers who will spend them in the same geographic area. They have not historically figured in either exportation or the importation of funds, but have been domestic in character. They do have the opportunity, however, to participate in mortgage loans with other institutions outside of the state and there is evidence that some of the savings and loan associaions are now beginning to participate for the first time by exporting funds to take advantage of the higher returns offered in other states. This has been slow, to date, because of prior commitments which have kept the funds in the local market. If the inequity continues too long, more participation can be expected in the form of exported dollars.

The commercial banks, like savings and loan associations, tend to receive and lend money in a geographic region, but they differ in one basic aspect. The savings and loan associations are by their very nature primarily restricted to the home building industry, while the banks are free to lend in almost all types of markets. The result is that when yields on home mortgages reach the 6% statutory ceiling while other types of loans offer higher returns, the commercial banks merely shift their lending to the other types of loans.

The only time banks would become exporters of funds would be when they have a surplus of funds and the purchase of "governments" was attractive. There is little if any indication that the commercial banks of Virginia have been doing much importing or exporting of funds directly in the past ten years.

The activity in the Virginia mortgage bankers business is the most sensitive barometer of the importation and exportation of money into and out of Virginia. These institutions place money in the mortgage market that is allocated to them by out-of-state mutual savings banks and foreign and domestic life insurance companies. During the past ten years the Virginia home-builders market has been able to grow and meet the requirements of our people because Virginia has been an importer of money from the two above-mentioned sources.

During the tight money market conditions of 1960, the amount of imported funds was cut, but the crisis did not last long enough to cause a severe problem in the market place. The story of 1966 is entirely different, however. Virginia's historic share of money from mutual savings banks has all but dried up and the same is true of funds received from life insurance companies. Their opportunities are better *out* of the state of Virginia so long as our statutory interest ceiling is so low in comparison to market opportunities out of the state. Life insurance companies out of Virginia have cut the flow of funds into Virginia to a trickle. Our domestic insurance companies are beginning to export more funds than premiums collected in the state.

C. *The true relevance and effect of the statutory rate as it now stands in light of all the special exceptions . . .*

See sections I, II, IV, V and B above.

D. *The inequities, if any, which exist in the present laws of Virginia as a result of varying interest rates*

See sections I and III

E. *The future need for money in Virginia considering our economic growth, both actual and desired, and the relationship of the interest rate structure to this consideration.*

All federal and State agency forecasts predict a population expansion in Virginia during the next decade that will be slightly above the projected expansion of the nation as a whole, and at a slightly faster rate than Virginia herself has experienced during the last twenty years. Since there is a direct correlation between population growth and the demand for money in the building industry, the conclusion is obvious. If Virginia is to realize her growth potential in the next decade, money must be made available to all sectors of the economy on a free and equal basis. Virginia's interest-rate structure does not encourage free and equal competition in the home-mortgage market, because of the lower ceiling placed on the rate that may be charged by insurance companies and various other lenders, When nation-wide conditions cause interest rates to rise above the statutory limit set by a few states, mortgage money naturally tends to stop flowing into those states.

MEMORANDUM

on

THE PENALTIES FOR USURY

We append to our report this memorandum commenting on the penalties imposed by law for charging usury. Those penalties are so ineffective that it is possible for usurers to compete profitably with lenders who do not charge usury. The only criminal statute punishing usury is § 6.1-308, which protects licensed small loan companies against competition from unlicensed lenders in amounts under $600.00. The civil penalties are so slight that the victim cannot in most instances afford to hire a lawyer to plead usury. When the lender is the plaintiff he can recover the full amount of the principal. (§ 6.1-325.) If the borrower is the plaintiff he can get back only the part of the interest that he has paid in excess of the legal rate (§ 6.1-326), in which case the usurer has already got his money back with legal interest. If realistic interest rates are to be adopted it occurs to us that realistic penalties for usury appropriately be adopted at the same time.

No penalty for usury will be effective unless it makes the business unprofitable. The business will never be unprofitable unless the law makes it financially worth while for the victims to plead usury. Should it be desired to make usury unprofitable, a new statute like the following would make it impossible for a usurer to stay in business long:

> § 6.1-325.1—A borrower of money who has contracted interest at a greater rate than is allowed by law shall be entitled to recover from the lender twice the amount of the entire interest contracted for in addition to whatever interest he has paid, and to the immediate release and return of any security he has given. A transferee of the obligation (unless he is a holder in due course as defined in § 8.3-302) shall be jointly and severally liable to the borrower to the same extent as the lender. The borrower's cause of action shall accrue on the day the contract is executed and the statute of limitations shall not bar his claim against the lender until it bars the lender's claim against him. If the lender is a corporation each of its stockholders shall be secondarily liable for the full amount of any judgment recovered against it by the borrower, his executors, administrators or assigns, provided the defendant, at the time the loan was made, was a stockholder having knowledge that the corporation was engaged in the business of lending money at greater rates than are allowed by law.
>
> In addition to the amount that the borrower is entitled to recover under the foregoing provisions of this section, he shall, if he employs an attorney, be entitled to recover as attorney's fees 15% of said amount or $250, whichever is greater.
>
> § 6.1-325. Repeal
>
> § 6.1-326. Repeal

Although the proposed remedy is less drastic than making usury a crime, it is obviously more effective. It can properly be characterized as "self-executing" because of the financial motive it gives the injured party to seek redress.

We desire to express our appreciation to the many individuals, officials, and organizations who afforded the Commission the benefit of their experience, research and suggestions.

Respectfully submitted,

C. Hardaway Marks, Chairman

Shirley T. Holland, Vice-Chairman.

Leroy S. Bendheim

Edwin B. Brooks, Jr.

Ralph T. Catterall

C. W. Cleaton

Charles K. Hutchens

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