

ECONOMICS, MORALITY AND THE REAL-ESTATE LOAN

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I. INTRODUCTION

In the area of consumer protection, most of the exploratory discussion and preliminary efforts aimed at legislative drafting, including the current project of the National Conference of Commissioners on Uniform State Laws, have concentrated on the need for protecting the purchaser of personal goods and services from being deceived in the process of credit extension and collection. Such deception usually results either from misunderstanding or sheer ignorance on the part of the consumer, or is caused by dishonest or unethical behavior on the part of the credit supplier. It is generally recognized that the primary impact of protective legislation for the consumer should be directed to those areas where regulation is actually needed. Concentration on specific weaknesses tends concomitantly to dismiss from further consideration those areas where no problem exists. Consumer-credit legislation, therefore, often excludes from its coverage transactions involving sophisticated corporate borrowers, large amounts of money, and credit secured by investment property such as real estate or marketable securities. It is the purpose of this article to point out some of the economic, moral, and legal issues involved in any examination of the real-estate loan in the context of proposed consumer-credit legislation.

II. ECONOMICS, MORALITY, AND THE LAW

Economics, morality, and the law are so tightly interlaced in any consideration of credit cost and disclosure questions as to be nearly indistinguishable. Yet if a study is to be objective, the significance of each factor must be weighed independently.

A number of contemporary economists and financiers find it surprising that the idea of price control for goods and services persists in a capitalistic society, since such measures ordinarily are justified only in times of national emergency. Arbitrary limits on credit rates constitute a form of price control comparable to ceilings on the prices of commodities, and, in the "money market," interfere just as effectively with the free working of the law of supply and demand. One of the basic tenets of a free-enterprise economy is that buyers

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and sellers are expected to compete in open markets for goods and services, including those of a financial nature. Indeed, apart from usury laws and some consumer-credit legislation, interest rates are determined for the most part by market conditions.

Interest rates, including real-estate loan rates, represent the price paid by the borrower for the use of the lender's money. Rates in the money market are not established by any conspiracy among financial institutions or other lenders; when the nation as a whole decides to spend more money on goods and services than can be financed out of the current flow of funds, interest rates go up. Although this economic principle is well understood in the financial community, it is unfortunately not fully accepted by some legislators and a large segment of the public. The arguments for easy money and low interest rates are about the same today as they always have been, and tend to hold the financial community responsible for events over which it has little control.

It is true that under some circumstances price ceilings cause little trouble. For example, a ceiling of one dollar per pound placed on butter would cause little concern today among butter vendors, because the current price is approximately eighty cents per pound. If demand increased, however, or the supply dwindled, the price ceiling would quickly become important. Rate ceilings placed on mortgage lending by interest-rate limitations and usury laws have had significant effects in at least ten eastern states.¹ Several of these statutes have remained on the books without change since the early days of the Republic when the economy was largely agricultural, and appear to be as anachronistic today as the date the legislation bears.² The result is an economic paradox, since the ceilings which were intended to help and protect the borrower succeed only in diminishing his local sources of money; lenders turn elsewhere, primarily to the developing southwestern and western states, where the rates deliberately have been set at more realistic levels.

Observers point out that morality and fairness must be considered in determining the appropriate amount of interest to be paid.³ It is also true, however, that a maximum-interest-rate law cannot be deemed to be a declaration of any valid moral law. If the collection of interest

¹ Those states are Delaware, Maryland, New Jersey, New York, North Carolina, Pennsylvania, South Carolina, Tennessee, Vermont, and Virginia.

² For a discussion of general usury statutes as an anachronism, see Note, 65 *Yale L.J.* 105 (1955).

³ "[E]xaction of usury is odious, illegal and immoral," said the Georgia Supreme Court in *First Fed. Sav. & Loan Ass'n v. Norwood Realty Co.*, 212 Ga. 524, 527, 93 S.E.2d 763, 766 (1956). It might be inferred from this declaration of the court that an interest rate of 8% (which is legal, hence moral, in Georgia) is immoral in neighboring South Carolina (where it is illegal).

on money lent is moral at all, it does not cease to be moral at 6, 7, or 8 per cent. Indeed, it would be hard to reconcile any such theory with the conclusion that the 21 per cent maximum interest rate permitted in Rhode Island⁴ is moral, while any excess over the legal 6 per cent rate in the nearby state of New York is immoral.⁵

That arbitrary rate ceilings have little to do with morality is demonstrated by their across-the-board applicability and their general failure to make any exception based upon ability or willingness to pay. A man who borrows not from need, but from an incentive to accumulate more money has the same rate ceiling applied to his loan as the "poor" man who borrows to pay his hospital bills. Any alleged morality of rate-fixing is also questionable in the context of the large versus the small loan. In Illinois, for example, small loans may bear annual interest of 36 per cent,⁶ whereas large loans generally are limited to 7 per cent.⁷ The person unable to offer security for a larger loan ordinarily has a greater financial problem than the person who is able, yet for this needier individual a 36 per cent rate is legal, hence moral, while for the larger borrower 8 per cent is illegal, hence immoral.

In some states the identity of the lender determines the "moral issue." A loan from a credit union at eight or ten per cent would be countenanced, while a similar loan from a mortgage banker or insurance company would not. An interest-rate ceiling applied to a business corporation contracting voluntarily to repay borrowed money at a rate in excess of the legal limit also makes little sense as far as morality is concerned; fortunately this has been recognized by statute in twenty-two states where corporations have been excepted from application of the usury laws.⁸ Although immorality may be associated with excessive rates, it fails to follow that a rate ceiling applicable to all parties at all times is a manifestation of economic morality.

It obviously is impossible for the law to establish a price for credit that is conscionable in every situation, since all transactions and all consumers have fundamental differences. This has been recognized in one of the special reports to the National Conference of Commissioners on Uniform State Laws, which concluded that the "government cannot establish a price that is 'fair' to each and every consumer."⁹ Thus it appears that the only practical approach toward re-

⁴ R.I. Gen. Laws Ann. § 6-26-2 (1956), as amended by R.I. Laws 1966, H.B. 1892, § 1.

⁵ N.Y. Gen. Bus. Law § 370 (McKinney 1957).

⁶ Ill. Ann. Stat. ch. 74, § 30 (Smith-Hurd 1966).

⁷ Ill. Ann. Stat. ch. 74, § 4 (Smith-Hurd 1966).

⁸ See Annot., 63 A.L.R.2d 924 (1959).

⁹ Report of Special Committee on Retail Installment Sales, Consumer Credit, Small Loans and Usury 30 (1965) [hereinafter cited as Special Committee Report].

solving issues of economic morality would be for the law to provide that credit rates must be "fair" or "conscionable," leaving it to the courts, acting in their traditional role, to decide whether a rate in any given litigated case satisfies the standard. Provision might be made, however, for a "conscionable rate floor"—a realistic percentage figure established by the state within which all interest shall be deemed "fair." This would aid the courts and reduce the amount of litigation.

Morality, however, does become a significant factor when brought into a consideration of a borrower's knowledge of the price he is paying for the use of credit. In addition to condemning a dishonest statement or explanation of such charges, many would find immoral the practice of quoting a cost-of-credit rate in terms of discount, rather than interest, when the lender is aware or has good reason to believe that the borrower either does not know the difference or equates a five per cent discount rate with a five per cent interest rate. There are many complex methods of computing cost-of-credit rates, in addition to incomprehensible disclosure terms, often used by some credit suppliers to confuse or to deliberately misinform the unsophisticated. To the extent that they are misleading, these practices must be considered to be immoral. Complete disclosure of the costs of credit to the borrower, stated in terms of indisputable clarity, certainly is an area in which government standards and regulation are not only justifiable but highly desirable. The current efforts at both the federal and state level to enact "truth-in-lending" legislation thus appear to be well founded in morality and in need, and for this reason should be endorsed in those areas where needed.

III. THE REAL-ESTATE LOAN

Should a loan secured by real estate be included in those types of credit transactions covered by consumer-oriented protective legislation, or is this an area of lending where current abuses are largely nonexistent? The following statement appears in the Special Report to the National Conference of Commissioners on Uniform State Laws:

[The nature of the security taken by the credit supplier] can also be used to exclude certain transactions. For example, real estate first mortgage loans have not been a target for consumer-oriented legislation. Long term real estate financing is cheaper because the risk and service charge factors are relatively less. Moreover, information about money costs is widespread in this segment of financing and competition is keen. Thus it may be that some credit transactions secured by real estate can be excluded from the coverage of our draft legislation. However, the real estate mortgage is being used,

at least to some extent as a means of financing ordinary consumer purchases. And it may be necessary for our proposed legislation to cover some real estate transactions. The Special Committee plans to look into the area of real estate transactions for consumer credit abuses.¹⁰

This is a fair statement, although it is submitted that abuses in the area of real-estate financing, and particularly in residential financing, have been relatively nonexistent. This is due to several factors, including the type of financing and the types of lenders generally involved in such credit transactions.

Defined broadly, consumer credit includes all forms of credit extended to individual persons for nonbusiness purposes, such as the purchase of consumer goods and services and for personal debt repayment. Secured loans to enable consumers to build or acquire homes, however, traditionally have been excluded from consideration in this context.¹¹ Such loans typically are for large sums, extend for a long term (such as twenty or twenty-five years), and are secured by immobile property having a long life. Another reason for the separate and unique treatment of real-estate loans has been the huge volume and significance of the business.

Approximately sixty-three per cent of American families own their own homes.¹² Investment in real estate represents more than half of the total wealth of the country. Housing is greatly affected with the public interest, but in a context somewhat different from the interest in preventing abuses in consumer-credit practices. Home-ownership is traditionally promoted by the government as a factor contributing to the political, social, moral, and ideological stability of the citizenry, and as a powerful economic goad to the accumulation of savings and capital. The purchase of a residence, typically with the aid of a mortgage, actually has more of the hallmarks of an investment than of an expenditure for consumption.¹³

¹⁰ *Id.* at 17.

¹¹ A noted commentator in the field has observed:

The characteristics of real property, such as its physical durability and its relative stability in value, are such that real property, when offered and taken as security, materially affects the nature of the credit arrangement to which it relates. As a result, credit arrangements secured by real property, the interaction giving rise to such arrangements, and the system of legal prescriptions which have evolved to regulate such arrangements are sufficiently different from other consumer credit arrangements to require separate review and analysis.

Curran, *Trends in Consumer Credit Legislation* 14 (1965).

¹² United States Savings and Loan League, *Fact Book* 42 (1966).

¹³ Today, a family looks upon a home as an investment rather than as a family possession to be held for generations. Because of the great mobility of the American people, the home is no longer passed down to children and grandchildren. While it still is the center of family life and still has deep emotional

The buyer of a home, like other investors, is typically an individual who knows what he is doing. He has planned for a long time to make the investment, ordinarily the largest one of his life. He has saved the necessary down-payment toward this goal; he is not an impulse buyer. There appears to be little question that real-estate credit contributes to the making of an investment on the part of the buyer, rather than constituting an expenditure for consumption.

The abuses noted in the field of consumer-goods credit have been notably absent in real-estate financing, largely because (1) the real-estate lender looks primarily to the security for repayment, rather than just the personal assets of the borrower; and (2) the credit cost of a real-estate loan traditionally has been stated in terms of simple interest, and all incidental costs have been made fully known to the borrower. Specialists in home real-estate financing, such as savings and loan associations and savings banks, for example, have for years performed voluntarily in the same manner that the "truth-in-lending" proposals would require for all lenders. In addition, the risks in real-estate lending often are not as great as those inherent in most consumer-goods financing; credit rates are determined with this factor in mind, and the market has generally proved to be a fair regulator. In states having realistic usury limits or where mortgage lenders are exempted from the usury laws, mortgage interest rates are not notably higher than in states having a low, applicable ceiling; indeed, in some instances such rates have been lower.¹⁴

It is true, of course, that real-estate credit can also be used under certain circumstances for the purchase of consumer goods. It should

and social roots, the owner has come to consider his home also as an investment, as a means of building equity and as a form of savings.

Ibid. An editorial in *House and Home*, Oct. 1966, p. 79, contains the following example:

A little arithmetic can prove to a potential buyer that over a 25-year period a house will cost *nothing* while his automobiles will cost him \$22,656. Assume the buyer takes out a 25-year, \$20,000 mortgage on a \$25,000 house. At 7% he will pay \$42,408 on the mortgage in 25 years, but income tax deductions of \$22,408 in interest will give him an effective rebate, in the 30% bracket, of \$6,722. So his house will actually cost him \$35,686 in mortgage payments plus his \$5,000 downpayment—or a total of \$40,686. But using the most conservative estimates of increasing value, the house will be worth at least \$40,000 after 25 years—and that figure does not include an annual 1.2% inflationary factor in the value of money. In short, he will be able to get back every bit of money he has put into his house purchase. So if he sells the house, it will have cost him nothing. Let's also assume that the homebuyer buys eight cars and keeps each for three years—and that each car is worth approximately \$4,000 and is financed at 12%. At the end of the 25-year period, he will have paid about \$23,000 for his cars and will wind up with only one car valued at about \$1,600.

¹⁴ In Rhode Island, for example, the usury rate is fixed at 21%, R.I. Gen. Laws Ann. § 6-26-2 (1956), as amended by R.I. Laws 1966, H.B. 1892, § 1, and the current home mortgage rate on existing homes is 6½%, according to the Federal Savings League of New England. In New York, the usury rate is set at 6%, N.Y. Gen. Bus. Law § 370

be borne in mind, however, that the use to which the credit is put does not change the primary characteristic of the loan as being real-estate secured. The "purpose test" is generally considered to have little merit in determining which transactions should be subject to consumer-credit-type legislation.¹⁵ Indeed, the high cost of consumer credit was one of the considerations behind the introduction more than two decades ago of the "open-end" mortgage, a prime example of the beneficial impact that marketplace regulation can have. Under the open-end mortgage the homeowner arranges in advance the maximum amount of his mortgage and is thereafter allowed to borrow from time to time on his real-estate loan up to either the original loan amount or to some other stated figure based on property value.¹⁶ Such a provision is made a part of the recorded mortgage contract and means that the additional advances can be obtained without the expense of title search, new appraisal, and other costs that ordinarily are attached to the refinancing of a real-estate loan. By the judicious use of these real-estate mortgage instruments, families can realize a substantial saving in credit costs.

The family that buys a \$4,000 automobile and finances it over the next three years at a 6 or 7 per cent mortgage credit rate may save hundreds of dollars after it repays this advance on its mortgage. On such a purchase, for example, if \$4,000 were borrowed at a 5 per cent add-on rate payable over three years, the cost of the loan would total \$600. The same amount borrowed at the 6 per cent mortgage rate (computed by the declining-balance method), and repaid in the same time, would cost only \$380—or over 36 per cent less. Of course, such families must discipline themselves to prepay the additional part of the real-estate loan within the three-year period if the fullest savings possible in interest cost is to be realized.

Abuses in the use of the open-end advance are virtually unknown. The credit rate has customarily been extended and expressed as simple annual interest, without additional fees and charges, thus making the transaction more comprehensible to the borrowing family.¹⁷ Since true annual interest charges can range from 18 to 42 per cent at small loan companies, 12 to 34 per cent on car loans arranged through

(McKinney 1957), and the current home rate is the same. Federal Home Loan Bank Board, *Interest Rates and Other Characteristics of Conventional First Mortgage Loans Originated on Single-Family Homes*, Sept. 1966.

¹⁵ Special Committee Report 14. "[I]n the area of loan credit the purpose test seems least satisfactory as it is impossible for lenders to police the use their borrowers make of the funds loaned." *Ibid.*

¹⁶ See Hoagland & Stone, *Real Estate Finance* 40-41 (3d ed. 1965).

¹⁷ On signature loans and other short-term credit loans, the borrower is immediately confused by such terms as discount, add-on, or so-much-per-month on the unpaid balance.

auto dealers or finance companies, and 18 to 20 per cent or more on installment purchases through retail outlets, a family has a marked advantage in being able to treat its real-estate mortgage as a savings account toward the purchase of consumer goods.

The fact that the great majority of real-estate loans are made by regulated financial institutions is another reason for the almost total lack of abuses in this field. Savings and loan associations, commercial banks, and savings banks extend 62.6 per cent of all real-estate loans,¹⁸ and are closely regulated and supervised by the state and federal governments. Similar control is exercised over credit unions and insurance companies and government-backed real-estate lending programs such as the Federal Housing Administration and the Veterans Administration. Indeed, all federal savings associations are required "to provide for the sound and economical financing of homes."¹⁹ Such institutions also must supply the borrower with comprehensive closing statements of costs. Thus, additional state-imposed record-keeping and reporting requirements would be burdensome and duplicative.

Real-estate lending should not be subject to further regulation under consumer-credit laws, since, in effect, this area has already been discriminated against by the operation of the nation's many archaic usury laws. An objective appraisal of the economic scene reveals a preponderance of legislative and tax policy which favors the borrower, and very little which favors the real-estate lender. In housing, small business, agriculture, and a dozen other fields, government is deeply involved in the facilitation of borrowing by firms and individuals. Comparable encouragement to the private savers of capital—the potential lenders—to accumulate and make available the funds needed for such programs are somewhat rare. The unrealistic usury laws generally applicable to real-estate lending are examples of this governmental approach that has led to unfortunate and unexpected results. Far from helping the borrower, as intended, such limits have succeeded only in impeding both borrower and lender, and have served to hamper private mortgage lending by restricting the flow of needed funds for prospective homeowners. This paradoxical result serves as a reminder that the marketplace regulator best serves the interests of all concerned. The obvious remedy, of course, is to eliminate the archaic usury limits, but public misunderstanding of the issues is a powerful deterrent.

IV. CONCLUSION

It is beyond question that there is a need for consumer-credit regulation, and that this is justified by economic, moral, and legal

¹⁸ 52 Fed. Reserve Bull. 1506-07 (1966).

¹⁹ Banks and Banking, 12 C.F.R. § 544.1 (1963).

considerations. It is submitted, however, that the most viable approach is to provide didactic standards and procedures for the advertising and disclosure of interest and other credit costs, assuring that every borrower will be advised of these costs on a uniform basis in terms which he can easily understand. This is not to say, however, that the government should do his thinking or make the choice of alternatives for him. Choice, following knowledge, should be left to the citizen, who, after all, has a right to make an uneconomic contract. The danger of overprotection was put succinctly in a recent editorial in a Chicago newspaper:

We see evil in a viewpoint that regards the public as "people who have neither taste, judgment, nor hope, but only a swollen and diseased desire for the accumulation of things that is constantly irritated and enflamed by forces of the conspiracy." We prefer to regard the public as human in its desire for better things, yes, but also as independent-minded, discerning, quick to spot and reject fraud and, thanks to the competitive system, utterly free to do so. As to the viewpoint that the public is, indeed, a mass of guinea pigs meekly being herded to and fro, this has an unvarying corollary: That the herd needs constant tending, constant protection from the unspeakable folly of its own miserable judgment. In a word, the critics of the competitive system stand ready as Big Brother to usurp the decision-making function at every juncture. If there is, indeed, an "unholy conspiracy against the American public," perhaps here is a more logical place to look for it.²⁰

Assuming that comprehensive disclosure and a comparison of rates are available to a discerning borrower, the marketplace is then the best regulator of credit costs; competition will eliminate those who supply credit at unconscionable rates. In those few remaining cases where a particular consumer feels that the cost of credit is "unfair," the matter should be decided by the courts or administrative agencies, although consumer-credit laws might very well provide for a "conscionable rate floor."

The real-estate lending area, as it exists, is outside of the area where corrective consumer-credit measures are needed. Real-estate credit is being supplied, not only at reasonable rates, but with a full disclosure to the borrower of the cost of such credit in easily understandable terms. State collection and foreclosure laws are rapidly being updated, with a preponderance of attention being given to fair-

²⁰ Chicago Daily News, Nov. 22, 1965, p. 8, col. 2.

ness and to protection of the borrower's interests. While elimination of archaic usury limits unquestionably is needed, the characteristics and volume of real-estate credit dictate that it be treated uniquely and separately from the treatment contemplated for consumer credit under current proposals to develop a uniform law. Problems such as those resulting from the failure, under Article 9 of the Uniform Commercial Code, to adequately distinguish real-estate loans from commercial credit, would then be avoided.²¹

It is recognized, of course, that some states will choose to enact consumer-credit statutes applicable to all nonbusiness-purpose credit, including real-estate loans. In such cases, real-estate credit probably would not suffer from being included under any cost disclosure provision, for most such credit suppliers already comply with the contemplated requirements. Should rate ceilings be adopted as part of this statutory treatment, however, it is submitted that real-estate credit should be excepted, or at the very least, if it is to be treated as consumer credit, be subjected to the same realistic ceilings that may be applied to other forms of consumer credit. In the few states clinging to the obsolete six per cent usury law, any relaxation of the present usury ceiling would be a welcome aid to the cause of homeownership, and hence to the economy in general.

²¹ See Pfeiler, *Uniform Commercial Code—Adverse Effect on Real Estate Mortgages*, 29 *Leg. Bull.* 201 (1963); Shanker, *An Integrated Financing System for the Purchase Money Collateral: A Proposed Solution to the Fixture Problem Under Section 9-313 of the Uniform Commercial Code*, 73 *Yale L.J.* 788 (1964).