The Mortgage Banking Act: A New Way Around California's Usury Laws

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THE MORTGAGE BANKING ACT: A NEW WAY AROUND CALIFORNIA'S USURY LAWS?

Much of the financing for large construction projects in California has traditionally been provided by lending institutions which are subject to California's 10 percent usury law.¹ With the enactment of the mortgage banking act,² effective January 1, 1974, some of the problems engendered by the usury provisions were partially alleviated: one effect of the act was to place mortgage bankers in the category of industrial loan companies, thereby exempting them from interest limitations. This circuitous action is necessary since both the 10 percent limit on interest and the exemptions therefrom are contained in the California Constitution³ and, thus, can only be amended by a vote of the people.⁴

Notwithstanding their classification in the Financial Code, mortgage bankers and industrial loan companies have little in common. Mortgage bankers serve either as independent sources of mortgage funds or as correspondents for such financial institutions as life insurance companies and real estate investment trusts in the placing of mortgage investments. The amounts involved are normally quite substantial: to qualify under the mortgage banking act loans must be at least $100,000.⁵ Industrial loan companies, on the other hand, deal primarily in small and moderate-sized loans to individuals. Despite the dissimilarities, mortgage bankers can fit within the definition of an industrial loan company as found in the Financial Code.⁶

To gain an understanding of the mortgage banking act, the necessity for its passage, and some of the resulting problems, certain background knowledge is essential. First, the statutory framework of usury in California will be examined. Next, a description of the mortgage market—the backdrop of the legislation under discussion—will be provided to facilitate understanding of the context in which mortgage bankers operate. A somewhat detailed examination of both industrial loan companies and mortgage bankers, necessary background to a dis-

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1. CAL. CONST. art. XX, § 22 (reference throughout is to the section 22 concerning usury); CAL. CIV. CODE, §§ 1916-1 to -5 (West Supp. 1974).
3. CAL. CONST. art. XX, § 22.
4. Id. art. XVIII, § 4.
6. Id. § 18003 (West 1968).
cussion of the mortgage banking act itself and its operations, will be undertaken.

Since mortgage bankers frequently serve as correspondents or agents of other institutions in placing mortgage loans, a major goal of the act is to free the other institutions of usury limitations by allowing the use of mortgage bankers as a conduit in order to facilitate the flow into California of mortgage money which would otherwise be inhibited by the state's usury provisions. Thus, a problem of key importance involves the constitutionality of a provision of the mortgage banking act allowing the free transfer of mortgage banking loans. After a consideration of this problem, a suggestion for needed reform in the usury laws is offered.

California Usury Laws

Although interest rates had been regulated in some areas, there was no general usury law in California until 1918, when the initiative usury law was adopted. The initiative set a maximum interest rate of 12 percent per annum, made usury a misdemeanor and provided for penalties.

Due to the initiative nature of the usury law the legislature was unable to amend it. Thus in 1934, when the lawmakers felt a change was desirable, a constitutional amendment was submitted to the voters. The measure was adopted and became article XX, section 22 of the California Constitution. That section and the initiative usury law comprise the basic law of usury in California.

The 1934 amendment set the legal rate of interest at 7 percent and provided a maximum rate of 10 percent. The key part of the amendment exempted virtually all commercial lenders from its provisions. The legislature was empowered to regulate and control these

7. Id. § 19130 (West Supp. 1974).
8. E.g., Cal. Stat. 1909, ch. 634, at 969 (personal property brokers); Cal. Stat. 1861, ch. 192, at 184 (pawnbrokers). For an example of the application of usury principles in early California law, see Fowler v. Smith, 2 Cal. 39, rehearing granted, 2 Cal. 568 (1852).
11. Id. § 1916-3.
12. Id.
15. CAL. CONST. art. XX, § 22.
16. Building and loan associations, industrial loan companies, credit unions, pawnbrokers, personal property brokers, banks and nonprofit agricultural cooperatives are exempt Id.
institutions, including interest rates they could charge, despite their exemption from the general usury law.\textsuperscript{17}

Because the amendment was held not to repeal the entire initiative usury law\textsuperscript{18} but only those provisions in direct conflict with it,\textsuperscript{19} the net effect was to exempt the named financial institutions from the operations of the initiative usury law and to reduce the maximum interest rate contained therein from 12 percent to 10 percent.

**The Mortgage Market**

Before considering in detail the operation of the mortgage banking act, some consideration must be given to the background and general nature of the activities being regulated. Therefore the nature and scope of the mortgage market in general, and in California in particular, will be briefly described.

The mortgage market is composed of borrowers and lenders: borrowers with insufficient funds to accomplish their objectives in purchasing and developing real estate, and lenders with surplus capital. Any sums advanced by lenders must be of sufficient size to be of use to borrowers.\textsuperscript{20} At the same time the advancing party must possess the necessary funds and must be assured a rate of return commensurate with other investment possibilities.\textsuperscript{21}

The main sources of funds for mortgages\textsuperscript{22} are commercial banks, mutual savings banks, savings and loan associations, life insurance companies and other financial corporations established to make loans on real estate.\textsuperscript{23} Individual investors are not a large factor.\textsuperscript{24}

\begin{itemize}
  \item \textsuperscript{17} Id.
  \item \textsuperscript{18} CAL. CIV. CODE §§ 1916-1 to -5 (West Supp. 1974).
  \item \textsuperscript{19} Penziner v. West American Finance Co., 10 Cal. 2d 160, 171-76, 74 P.2d 252, 257-60 (1937).
  \item \textsuperscript{20} J. PUGH & W. HIPPALA, CALIFORNIA REAL ESTATE FINANCE 1 (1st ed. 1966) [hereinafter cited as PUGH].
  \item \textsuperscript{21} Development of real property is a major industry in the United States. In 1972 the value of construction contracts where work was actually performed was $91,213,000,000. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 680 (1973) [hereinafter cited as CENSUS ABSTRACT]. In California all building construction totalled $6,980,800,000 in 1971. CALIF. DEP'T OF FINANCE, CALIFORNIA STATISTICAL ABSTRACT 99 (1972) [hereinafter cited as CALIF. ABSTRACT] (valuation of building permits issued). Most of this activity is dependent on the availability of proper financing: "[w]e are concerned with the lifeblood of the real estate industry when studying real estate finance . . . . [I]t is real estate finance which really . . . determines . . . what will or will not be done." PUGH, supra note 20, at 1.
  \item \textsuperscript{22} As used herein, the term "mortgages" includes deeds of trust and any other security interest in real property.
  \item \textsuperscript{23} W. BRYANT, MORTGAGE LENDING 58 (2d ed. 1962) [hereinafter cited as BRYANT]; PUGH, supra note 20, at 2. "Other financial corporations" are mainly mortgage bankers, mortgage companies and real estate investment trusts.
  \item \textsuperscript{24} Individuals and others (including mortgage companies) held $69 billion of a
Ranked in overall position nationally, savings and loan associations are the major holders of mortgage debt.\(^{25}\) Commercial banks rank second,\(^{26}\) followed by life insurance companies.\(^{27}\)

Since the mortgage banking act is concerned only with mortgages over $100,000 made to corporations or partnerships, a more accurate reflection of the relevant sources of mortgage money can be obtained by excluding from consideration farm loans and loans on one- to four-family residences, both of which categories, because of their size, would normally be outside the scope of the mortgage banking act. Absent these types of loans, life insurance companies are the primary holders of mortgage debt,\(^{28}\) followed by banks,\(^{29}\) savings and loan associations,\(^{30}\) and mutual savings banks.\(^{31}\) Overall figures for California are similar.\(^{32}\)

Generally speaking, the laws of supply and demand operate in the mortgage market. When money is plentiful and demand is low, the cost of mortgage money will be low. When money is scarce and the demand is high, the cost of money will also be high.

That cost—the interest rate—has varied considerably over the past several years depending both on the type of loan involved and the time period. In 1960 prime commercial paper brought 3.85 percent; in August 1974 it had risen to 11.43 percent.\(^{33}\) Within the last three years the prime rate has varied from a low of 4.75 percent during the early part of 1973 to a high of 12.25 percent in mid-1974.\(^{34}\) One finds a similar picture in the mortgage market, with home mortgage yields total of $565.4 billion worth of mortgage debt outstanding in the United States in 1972.\(^{60}\) FED. RES. BULL. No. 1, at A49 (1974).

25. $200 billion in 1972. \(\text{id.}\) at A51.
26. Nearly $100 billion. \(\text{id.}\) at A50.
27. Almost $77 billion. \(\text{id.}\)
28. Over $49 billion.
29. $38 billion.
30. $38 billion.
31. $25 billion. These figures are rough estimates obtained by subtracting 1972 preliminary figures for one- to four-family homes from final 1972 figures for nonfarm holdings. \textit{Compare Census Abstract, supra} note 21, at 452, \textit{with} 60 FED. RES. BULL. No. 1, at A49-A53. The figures for savings and loan associations are somewhat distorted since they include some farm loans. \textit{Cf. id.} at A49 n.5.
32. Savings and loan associations hold more than $28 billion in mortgage loans, banks about $9.5 billion and life insurance companies over $10 billion. \textit{Calif. Abstract, supra} note 21, at 132 (1970 figures); \textit{Institute of Life Insurance, Life Insurance Fact Book} 81 (1973). Although there are no statistics, it can be safely assumed that California follows a pattern similar to the national one when only large loans are considered, with life insurance companies playing a larger role.
34. 60 FED. RES. BULL. No. 6, at A28 (1974); \textit{id.} No. 8, at A28 (1974).
rising from 7.12 percent in 1968 to 9.25 percent in June, 1974.\textsuperscript{35} Other sectors of the money market have shown similar trends.\textsuperscript{36}

As interest rates rise they begin to run into state-imposed ceilings. In California that ceiling is set at 10 percent. Although most financial institutions are exempt from the 10 percent limitation,\textsuperscript{37} several major sources of mortgage funds are not. Notable among these are life insurance companies, real estate investment trusts, pension funds, and mortgage companies.

Historically, the western United States has lacked capital and has had to import it from the eastern financial centers,\textsuperscript{38} a situation which has resulted in somewhat higher interest rates in the western than in the eastern part of the country.\textsuperscript{39} This lack of capital, and the inflexible usury laws made it apparent that the resulting unprofitability could substantially diminish investment in California mortgages by the large nonexempt institutions such as life insurance companies.\textsuperscript{40} It was these factors which led to the legislation enabling mortgage bankers to incorporate as industrial loan companies and consequently to acquire an exemption from the interest ceiling. As will be seen, this legislation allows life insurance companies and other nonexempt institutions to channel mortgage investments through mortgage bankers, thereby avoiding the 10 percent constitutional interest limit.\textsuperscript{41}

**Industrial Loan Companies and Mortgage Bankers: Birds of a Feather?**

Considering the nature of industrial loan companies and mortgage bankers, one must question whether it is logically feasible and legally possible to include mortgage bankers within the class of industrial loan companies. In order to answer these questions it is necessary to look at the background and characteristics of both types of institutions.

**Industrial Loan Companies Nationally**

Industrial loan companies were originally formed as a means of avoiding the usury laws.\textsuperscript{42} In 1910 Arthur J. Morris, an attorney in 35. *Id.* No. 6, at A53 (1974); *id.* No. 8, at A45 (1974). Figures are for primary market conventional loans, HUD series on new homes.
37. *See note 16 supra.*
38. *Pugh, supra* note 20, at 33.
39. *Id.*
41. *See text accompanying notes 95-100 infra.*
Norfolk, Virginia, was looking for a way to make loans on salaries and wages. Virginia’s usury laws precluded an adequate rate of return on such loans. Morris’s new plan involved setting up a banking institution to make loans. Interest was discounted in advance, the investigation fee permitted under Virginia law was charged, and the borrower was required to purchase, on a weekly basis, non-interest-bearing investment certificates sufficient to pay off the principal at the end of the term.

For example, a person might have borrowed $500 for one year. Since the maximum rate of interest in Virginia was 6 percent, $30 was deducted for interest, $10 for the 2 percent “investigation” fee, and $460 was advanced to the borrower. The borrower was then obligated to purchase investment certificates at a rate of $10 per week for fifty weeks. At the end of fifty weeks the certificates would be used to pay off the loan. Delinquencies on the certificates resulted in “fines” of 5 percent per week. The net result of this scheme of interest deducted in advance with weekly installment repayment is a true annual interest rate of 17.7 percent.43

Even with such a high effective rate Morris plan banks still had to choose their borrowers with great care, and normally refused to loan less than $100.44 Originally, only loans for periods of one year were involved.45

The Morris plan spread rapidly. By 1933 the scheme was being used by 108 banks in thirty-two states.46 Although state laws occasionally allowed loans as large as $5,000 the average loan was only slightly more than $200.47

Today there are comprehensive industrial loan laws in at least twenty-one states.48 Some retain the original concept of industrial loan

43. Benfield, Money, Mortgages and Migraine—The Usury Headache, 19 CASE W. RES. L. REV. 819, 841 n.109 (1968). Since equal periodic payments reduce the average outstanding balance to one-half the principal, the interest rate will be double the stated amount, here 16% instead of 8%. The additional 1.7% results from the discounting of interest in advance.


45. Id.

46. Id. at 64.

47. Id.

companies: interest discounted in advance, investigation fees, repayment by use of investment certificates, and late fees.\textsuperscript{40} Other states have so changed the concept as to treat industrial loan companies almost the same as commercial banks.\textsuperscript{50} In some jurisdictions they are allowed to accept savings deposits.\textsuperscript{61} Many states restrict the size of loans that may be made,\textsuperscript{62} or the length of the loan.\textsuperscript{53} Some states have either repealed all industrial loan legislation,\textsuperscript{54} or have provided either that no new companies may be incorporated\textsuperscript{55} or that new companies cannot issue investment certificates.\textsuperscript{56} Despite the trend toward restricting or abolishing the concept, at least one state has recently adopted a new industrial loan law.\textsuperscript{57} Notwithstanding this diversity, legislation regulating industrial loans generally retains its original small loan orientation.

\textbf{Industrial Loan Companies in California}

California adopted its first industrial loan act in 1917.\textsuperscript{58} An industrial loan company was defined as "any corporation which in the regular course of its business loans money and issues its own choses in action under the provisions of this act."\textsuperscript{59} The original California act was very similar to what might be called the "traditional" industrial loan act: interest on loans made could be at the rate of 6 percent per annum and deducted in advance,\textsuperscript{60} an investigation fee was authorized,\textsuperscript{61} and there

\begin{itemize}
\item \textsuperscript{54} N.Y. Laws 1972, ch. 39, § 162 (effective Feb. 29, 1972).
\item \textsuperscript{57} Iowa Code Ann. §§ 536A.1-28 (Supp. 1974) (added 1965).
\item \textsuperscript{58} Cal. Stat. 1917, ch. 522, §§ 1-12, at 658-62.
\item \textsuperscript{59} Id. § 1, at 658.
\item \textsuperscript{60} Id. § 4, at 659.
\item \textsuperscript{61} One dollar for every fifty dollars or fraction thereof, not to exceed five dollars. Id.
were provisions for the issuance of "certificates of investment" in connection with loans, to be pledged as security for the loans.\textsuperscript{62} The companies were restricted to making loans of one year or less.\textsuperscript{63}

In 1941 the act was amended,\textsuperscript{64} and the basic definition of an industrial loan company was changed to encompass "any corporation which in the regular course of its business loans money and issues its own installment investment certificates with loans under the provisions of [the industrial loan] act."\textsuperscript{65} This revision required the issuance of certificates of investment on non-real estate loans under $300\textsuperscript{66} and authorized the companies to issue investment certificates not in connection with any loan.\textsuperscript{67} The interest provisions were also modified: the 6 percent rate was retained and could still be deducted in advance,\textsuperscript{68} and the "investigation fee" was raised.\textsuperscript{69} At the same time, a maximum fee schedule was imposed: all other authorized fees, in addition to any late charges, could not exceed 2.5 percent per month up to $100, 2 percent per month to $300, and 10 percent per annum on all amounts in excess of $300. In general, the 1941 act provided for a more detailed regulation of the companies than had the 1917 act.

In 1951 California adopted a Financial Code\textsuperscript{70} which incorporated the industrial loan law. Several significant changes were made. The definition of an industrial loan company was changed to conform to the original 1917 definition: "any corporation which in the regular course of business loans money and issues its own choses in action . . . ."\textsuperscript{71} The penalty for charging interest in excess of that permitted by law was severe: forfeiture of all principal, interest and charges.\textsuperscript{72} The issuance of an investment certificate became optional with each loan,\textsuperscript{73} and loans were now limited to two years rather than one, with a longer period allowed for certain real estate loans.\textsuperscript{74}

Industrial loan companies are currently regulated under sections 18000 to 19131 of the Financial Code and title 5, sections 1100 to

\textsuperscript{62} \textit{Id.}
\textsuperscript{63} \textit{Id.}\ § 5.
\textsuperscript{64} Cal. Stat. 1941, ch. 1187, at 2945.
\textsuperscript{65} \textit{Id.}\ § 1.
\textsuperscript{66} \textit{Id.}\ § 4, at 2946.
\textsuperscript{67} \textit{Id.}
\textsuperscript{68} \textit{Id.}
\textsuperscript{69} \textit{Id.} at 2947.
\textsuperscript{70} Cal. Stat. 1951, ch. 364, at 829.
\textsuperscript{71} CAL. FIN. CODE § 18003 (West 1968). The change was made by Cal. Stat. 1951, ch. 421, at 1398, which was approved by the governor six days after the code.
\textsuperscript{72} CAL. FIN. CODE § 18650 (West 1968).
\textsuperscript{73} \textit{Id.}\ § 18663.
\textsuperscript{74} Cal. Stat. 1951, ch. 364, § 18669, at 1125.
1281 of the California Administrative Code. They are still closely supervised, highly regulated, and consumer oriented, and deal primarily with small to medium-sized loans.

Mortgage Banking

It is clear that the mortgage banking act, in placing mortgage bankers in the industrial loan category, is motivated solely by a desire to exempt mortgage bankers from the usury laws without the necessity of a vote of the people. This, of course, raises questions as to whether mortgage banking companies are of such a nature, and engage in such activities, as to be compatible with their classification as industrial loan companies.

Mortgage bankers deal primarily with the financing of real estate. Two procedures are available to a mortgage banker in pursuing this objective. First, it may take mortgages on its own account, out of its own funds, with the intention of holding them to maturity, or at least for the indefinite future.

This type of mortgage company uses the funds which it has accumulated through the sale of stock to make loans which it takes into its own portfolio with the idea that such loans will provide good revenue. In these cases the company is usually free of the lending limitations placed against institutional lenders such as banks, life insurance companies, and savings and loan associations. They establish their own lending policies and servicing procedures.

Construction loans are often made on the mortgage banker's own account, since other institutions frequently do not want to be involved in the necessary supervision.

Alternatively, mortgage companies may serve as correspondents; loans in this category are made either with the mortgage banker's own funds with the intention of assigning them (possibly to an already committed assignee) or with funds advanced by another institution such as a life insurance company. Since life insurance companies and other institutions are frequently located far from the real estate to be financed it is often desirable to utilize another company to facilitate the mortgaging process. These institutions find it most feasible and economical to have a local company make the inspections and pursue the details of the transaction. The correspondent, especially if it is a mortgage banker, will frequently advance sums to the borrower as needed, later transferring the loan to the intended principal.

75. The exemption is in the constitution, article XX, section 22, and any amendment thereto must be approved by the electorate. Cal. Const. art. XVIII, § 4.

76. Pugh, supra note 20, at 395.

77. Bryant, supra note 23, at 62; Pugh, supra note 20, at 280, 395.

78. See generally Bryant, supra note 23; Pugh, supra note 20, at 73-74.

79. Bryant, supra note 23, at 58.
banker in this case acts as a mere conduit for money, but assumes the additional responsibility for collecting payments and performing necessary bookkeeping and accounting functions. The mortgage banker thus becomes the agent of the principal lender.  

In short, although mortgage bankers may engage in financing on their own account, their primary function is to serve as mortgage loan correspondents of such financial institutions as life insurance companies, mutual savings banks, pensions funds and real estate investment trusts. Their activities involve large sums of money, frequently do not involve consumers and are generally long term. Industrial loan companies on the other hand, are primarily oriented to relatively small, short term, installment consumer loans. Thus, a comparison of the two institutions reveals that mortgage bankers and industrial loan companies have little in common, a basic incompatibility which the new mortgage banking act recognizes by creating the new category of "mortgage banker" under the industrial loan law, exempting that category from many provisions of the industrial loan law, and placing some restrictions on the formation and operation of mortgage banking companies.

The Mortgage Banking Act

Section 1 of the new mortgage banking act adds the definition of mortgage banker to the Financial Code:

"Mortgage banker" means any industrial loan company incorporated under this division which, by the terms of its authority to engage in the industrial loan business, is not permitted to issue or sell investment certificates and the business of which is limited to that set forth in Chapter 10 (commencing with Section 19100) of this division.

A mortgage banker is limited to the making and servicing of mortgage banking loans. Both terms are defined.

A mortgage banking loan is a loan made to a corporation or partnership secured directly or collaterally solely by a lien on real property, except furniture and fixtures which have a direct bearing on the economic value of the real property which secures such loan, in the principal amount of one hundred thousand dollars or more, and any extensions, modifications or forbearances thereof or additional advances thereunder.

"[S]ervicing" is the collection of payment of interest and principal

80. BRYANT, supra note 23, at 71-72; PUGH, supra note 20, at 393-96.
81. BRYANT, supra note 23, at 71.
82. CAL. FIN. CODE §§ 18000-19131 (West 1968 & Supp. 1974). Industrial loan companies are exempt from the general usury laws under article XX, section 22 (usury) of the California Constitution.
84. Id. § 19102.
and the performance of bookkeeping and accounting functions incidental thereto.\textsuperscript{85}

The act forbids the transfer of any loan within the first ninety days after execution. Thereafter there are no restrictions on sale, assignment or transfer of the loan. The act specifically permits the formation of assignment agreements before the end of the ninety day period, or even before the loan is made.\textsuperscript{86}

Section 18669.2 of the Financial Code, added by the mortgage banking act, provided that mortgage bankers are exempt from forty-nine other sections of the code applicable to other industrial loan companies. In considering these exemptions, it should be kept in mind that industrial loan companies are consumer oriented and may accept thrift accounts, factors which call for close regulation and which are not present in the mortgage banking business. The cumulative effect of these exemptions is to give mortgage bankers the great flexibility that is needed to carry on their business.\textsuperscript{87}

The most important exemption involves maximum charges on loans. The intention of the legislature was apparently to place an 18 percent ceiling on the interest rate that mortgage bankers could charge. As originally introduced the mortgage banking act\textsuperscript{88} exempted mortgage bankers from all interest limitations, but the bill was amended to remove the exemption from the section providing for a maximum inter-

\textsuperscript{85} Id. \textsuperscript{86} Id. § 19130. 
\textsuperscript{87} Several of the more significant exemptions deserve some mention. There need be no determination that the public convenience and advantage would be promoted by the establishment of the company. Cal. Fin. Code § 18200.3(a) (West Supp. 1974). This exemption will allow free entry into the system, facilitate the formation of mortgage banking companies and eliminate much of the basis for exercise of the corporation commissioner's discretion to refuse a license. Mortgage bankers are not restricted to one class of stock. Cal. Fin. Code § 18209 (West 1968). This provision allows the companies the greater flexibility in corporate finance afforded by the issuance of preferred or other classes of stock. Industrial loan companies may not collect any charges if a loan is not made. Cal. Fin. Code § 18654 (West 1968). Presumably this exemption would allow commitment fees and other charges to be exacted regardless of whether the loan is ever made, a more common and more justifiable procedure when dealing with large sums of money committed to higher risk ventures in advance of any actual transfer of funds. With one exception, industrial loan companies are forbidden to require any incidental purchases in connection with a loan. Cal. Fin. Code § 18675 (West Supp. 1974). Mortgage bankers are exempted, thus allowing greater flexibility in putting together loan deals, especially if a purchase leaseback is involved. Unlike industrial loan companies (Cal. Fin. Code § 18677 (West 1968)) a mortgage banking company may make loans to its own officers and directors. This provision, like others, is important for deposit or thrift institutions for the protection of depositors or certificate holders, a factor not present in the mortgage banking field. Other restrictions mortgage bankers are free of include those on investments (Cal. Fin. Code § 18613 (West Supp. 1974)) and on dealings with out-of-state residents (Cal. Fin. Code § 18413 (West 1968)).

\textsuperscript{88} S.B. 321 (1973).
est rate of 18 percent. Nonetheless, despite this action there is no limit on interest charges: since mortgage bankers may only make loans of $100,000 or more, they fall within another section of the Financial Code which exempts from the 18 percent maximum all loans by industrial loan companies in excess of $10,000.

Despite the numerous provisions from which mortgage banking companies are exempt, there remain several key provisions of the industrial loan law to which they are subject. Chief among these is section 18003, defining industrial loan companies. Any change in this section would cast doubts on the constitutionality of exempting mortgage bankers from the 10 percent usury limit, since that would change the basic definition of the act referred to in article XX, section 22 of the constitution.

Another problem arises from the definition of business allowable to mortgage bankers. Previously, their operations brought them within the definition of a real estate broker under section 10131 of the Business and Professions Code. Many mortgage companies engage in such activities as brokering real estate and selling insurance. Thus existing mortgage bankers may have to decide whether they wish to give up any collateral business they may have for the advantages offered by incorporation under the industrial loan law. Several other provisions of the industrial loan act might also prove troublesome to mortgage bankers.

90. Id. § 19102.
91. Id. § 18649.
92. The code defined a real estate broker as a person who: "(d) Solicits borrowers or lenders for or negotiates loans or collects payments or performs services for borrowers or lenders or note owners in connection with loans secured directly or collaterally by liens on real property or on a business opportunity." CAL. BUS. & PROF. CODE § 10131 (West Supp. 1974).
93. See text accompanying notes 83-84 supra. Although formation of a subsidiary may appear to be an alternative, section 18626 of the Financial Code casts some doubt on the legality of any such procedure. It provides that "[a] holding company or any other device may not be used for the purpose of evading or avoiding any of the provisions of this division." CAL. FIN. CODE § 18626 (West 1968).
94. Although no showing of public convenience need be made, any prospective mortgage banking company must still obtain authorization from the commissioner of corporations. CAL. FIN. CODE § 18200 (West 1968). Specifically, the applicant must show that its capital structure is adequate, and that its proposed officers and directors have the necessary "experience, ability and standing to afford reasonable promise of successful operation." CAL. FIN. CODE §§ 18200.3(e), (d) (West Supp. 1974). Another section allows the commissioner of corporations to require reasonable reserves for loans made. The commissioner may also prescribe procedures for writing off delinquent loans. CAL. FIN. CODE § 18616 (West 1968). Industrial loan companies normally are...
Constitutionality of Financial Code Section 19130

In times of tight money as interest rates approach or even surpass California's usury ceiling, such large projects as shopping centers, office buildings, hotels and large-scale subdivisions have in the past been endangered. Under section 19130 of the Financial Code, however, it would seem to be a simple matter for life insurance companies, advisers to real estate investment trusts or even individuals to incorporate a mortgage banking company to make real estate loans, hold them for ninety days, and then assign the loans to the principal company, retaining only servicing functions. There is, however, a serious obstacle to this procedure.

The California Constitution is quite specific: "[No] person, association, copartnership or corporation shall by charging any fee, bonus, commission, discount or other compensation receive from a borrower more than 10 percent per annum . . . ." The problem is whether, on assignment of loan with interest greater than 10 percent, the non-exempt assignee will be considered to have "received" more than 10 percent for a loan or forbearance on a loan. There are no California cases dealing with assignments by an exempt lender to a nonexempt party, but a Florida case, Coral Gables First National Bank v. Constructors of Florida Inc., illustrates the possible dangers. Although that case dealt with an exemption from the penalty provisions of a usury law rather than the interest limitations, it does show that at least one state will not allow an exempt institution to use its status to shield the nonexempt party.

95. "No mortgage banking loan shall be assigned or otherwise transferred within 90 days after the date of execution. Thereafter, a mortgage banking loan may be assigned to a third party, whether or not licensed under this division, so long as the servicing of the loan is always performed by a mortgage banker, which may or may not be the mortgage banker making the loan. The rights of a mortgage banker, under this chapter, shall also accrue to the assignee or transferee of a mortgage banking loan.

None of the foregoing shall prohibit a mortgage banker from agreeing, prior to making a loan to assign or otherwise transfer the loan subject to the foregoing limitations." CAL. FIN. CODE § 19130 (West Supp. 1974).

96. CAL. CONST. art. XX, § 22 (emphasis added).
98. See id. Coral Gables First National Bank v. Constructors of Florida Inc. involved loans in excess of $400,000. Coral Gables National Bank had a lending limit of $200,000 per loan and arranged a participation with Pan American Bank of Miami so that the full loan could be made. The loan was usurious under Florida law, which
Examples of where the problem of participations under section 19130 might arise in California include the following situations:

1. A life insurance company (Lifeco) establishes a wholly-owned subsidiary mortgage banking company (Morco). Morco keeps all loans and pays only dividends to Lifeco.

2. Lifeco establishes Morco as a wholly-owned subsidiary. Morco assigns all loans to Lifeco.

3. Morco is an independent company. It assigns some of its mortgage loans, retaining others for its own portfolio.

4. Morco is an independent company but assigns all of its loans. It prearranges all loans and will not loan without a prior commitment from a prospective assignee.

In order for the new mortgage banking legislation to be completely successful none of the four examples should involve any risk of violation of the usury laws. Yet only in example 1 is it clear that there is no violation. In examples 2, 3, and 4 the assignees of the loans will be receiving interest in excess of 10 percent and, thus, would come within the literal meaning of article XX, section 22. Since both the 10 percent limit and the exemptions are constitutional provisions no simple act of the legislature such as the mortgage banking act can override them. Furthermore, in examples 2 and 4 it seems clear that the mortgage banker is being used merely as a funnel or conduit to avoid the usury provision of the constitution. As the California Supreme Court has stated, "The courts have been alert to pierce the veil of any plan designed to evade the usury law . . . ." Nonetheless there exist sound reasons why section 19130 should be held constitutional.

In considering the constitutional exemptions from the usury law three factors involved seem to stand out. First, the exemptions were granted only to financial institutions. Although each is different, they all form part of the financial community and are constantly involved in the lending and collecting of money. For none of them is lending
a part-time or extraordinary occurrence. Second, each of the institutions is competitive in its class, and to a certain extent with each of the others. It is to be expected that market forces among and within the categories are likely to keep interest rates near their natural level. Third, the legislature has traditionally exercised some measure of control over each of the named institutions. Any abuses not corrected by competition are subject to correction by the legislative process.

The nature of mortgage banking loans qualifies mortgage bankers for exemption under each consideration, especially when considering the competitive aspect. Given the large amounts involved ($100,000 or more) and the nature of the mortgagors (corporations or partnerships) it is likely that normal market forces will operate and the necessary borrower-rapacious lender syndrome will be avoided.

The traditional rationale for usury laws is to protect the borrower. If, however, money rates go so high that necessary foreign capital will not enter the state more than protection is needed: the borrower needs the money to finance whatever project was planned. What is involved in the mortgage banking law is not a private scheme to avoid the usury laws but rather a legislative plan to stimulate commercial and large-scale residential development in California. In such a case every presumption of validity should be given the legislative acts.

In this connection some important public policy considerations should be noted. The new law facilitates mortgage lending. It makes California more attractive to foreign capital and is a step toward assuring the availability of funds to continue the development necessary for an expanding economy.

Despite these considerations it is by no means certain that the California courts will rule section 19130 constitutional. Furthermore, it is far from desirable to try to wed such diverse partners as industrial loan companies and mortgage bankers. What is needed instead is a general revision of California's usury scheme.

The Usury Problem

Fixed interest limitations are inherently unreasonable. They are not easily changed, either upward or downward, as interest rates fluctuate in the marketplace. This is especially true in California where the limits are enshrined in the constitution and can be changed only through a statewide election.

The California law is so rife with exceptions that it can be said that "if a lawyer can't find a way to get around the usury law, then

he's not worth his fee."¹⁰¹ The law has become a trap for the unwary, the unwlawyered and the uneducated.¹⁰² In spite of the loopholes, exceptions, and general unwillingness of borrowers to injure their credit ratings by pleading usury, lenders have been caught by the trap, sometimes with significant amounts of money involved.¹⁰³

Alternative Solutions

The UCCC

Several jurisdictions have radically different approaches to the usury problem. The Uniform Consumer Credit Code (UCCC),¹⁰⁴ for example, makes substantial changes in the law of usury.

The UCCC classifies loans into categories: consumer loans, regulated loans, supervised loans, consumer related loans, and other loans. "Consumer" loans are those made to persons other than organizations, primarily for personal, family, household or agricultural purposes, payable in installments or with a finance charge, and less than $25,000 or secured by an interest in land (excluding certain loans secured by land, primarily first security interests in homes).¹⁰⁵ "Regulated" and "supervised" loans are subcategories of consumer loans: a regulated loan is a consumer loan with a finance charge in excess of 10 percent; a supervised loan, one with a finance charge in excess of 18 percent.¹⁰⁶

On consumer loans other than supervised loans an 18 percent finance charge may be contracted for and received,¹⁰⁷ certain additional

¹⁰¹ Miller, supra note 40.
¹⁰⁵ Id. Consumer Credit Code §§ 3.104-.105.
¹⁰⁶ Id. § 3.501.
¹⁰⁷ Id. § 3.201.
expenses may be charged to the borrower\textsuperscript{108} and a delinquency charge is permitted,\textsuperscript{109} as is a deferral charge.\textsuperscript{110}

Certain additional restrictions are placed on regulated and supervised lenders as a prerequisite to charging rates in excess of either 10 percent or 18 percent.\textsuperscript{111} Supervised loans are subject to maximum finance charges: 36 percent on balances less than $300, 21 percent from $300 to $1000, and 14 percent on principal balances greater than $1000. As an alternative the supervised lender may charge 18 percent on the entire unpaid principal balance.\textsuperscript{112}

"Consumer related" loans are defined as loans not consumer loans, under $25,000, either made to a person other than an organization, or secured primarily by a security interest in a one- or two-family dwelling occupied by a relative of the debtor.\textsuperscript{113} The loan is subject to the same interest provisions as consumer loans.\textsuperscript{114} On all other loans—\textit{i.e.}, not consumer or consumer related as defined in the code—there is no limit to the interest rate that may be charged.\textsuperscript{115}

The comment to section 3.605 of the code provides an interesting rationale for exempting these loans from interest limitations:

In the belief that there is little place for usury limitations in sophisticated business transactions, this section follows those states which exempt loans to corporations from their usury laws and extends the exemption to other organizations as well. Placing arbitrary ceilings on the amount of interest which can be charged in larger business transactions may prevent persons engaged in high risk business ventures from obtaining needed capital loans. It is impossible to measure how much is too much interest with respect to large business transactions. If the limit is set so high as to provide adequately for speculative business ventures the limit becomes virtually meaningless for most transactions. If it is set at a level close to the top of the range for most business transactions it will preclude loans for extraordinary ventures.\textsuperscript{116}

Response to the UCCC's usury provisions has been far from uniform. State approaches to the subject remain diverse.

\textit{Alternative State Provisions}

In 1969 Georgia exempted all loans over $100,000 from interest limitations.\textsuperscript{117} The preamble to that legislation expressed thoughts

\textsuperscript{108} Id. § 3.202.  
\textsuperscript{109} Id. § 3.203.  
\textsuperscript{110} Id. § 3.204.  
\textsuperscript{111} Id. §§ 3.501-.514.  
\textsuperscript{112} Id. § 3.508.  
\textsuperscript{113} Id. § 3.602.  
\textsuperscript{114} Id. § 3.604.  
\textsuperscript{115} Id. § 3.605.  
\textsuperscript{116} Id. § 3.605, Comment.  
similar to those in the UCCC comment. The legislature took note of the substantial increases in interest rates which were causing difficulty for Georgians attempting to secure loans. Since interest rates were expected to continue to fluctuate, a solution was necessary. The legislature expressed the thought that borrowers of amounts greater than $100,000 should be able to determine the rates they were able to pay for themselves. It was hoped that the new exemption would attract investment capital and thus promote industrial growth.118

The North Carolina statute represents an extremely complex approach to the usury issue. Rates are divided into contract rates and installment rates. Variables include the length of the loan, size, security interest involved, and the repayment period.119

Alaska and New York have more innovative and flexible approaches to the usury problem. Both statutes provide for termination of the scheme on a fixed date.

While Alaska has an ostensible maximum interest rate of 8 percent,120 all loans fall into one of two exceptions to the rate. In all non-real estate loans, and loans involving one- to four-family dwellings, an amount up to 4 percent above the annual rate charged member banks for advances by the Twelfth Federal Reserve District may be charged.121 In other real estate loans the difference may be 4.5 percent.122 These provisions cover only loans dated between April 29, 1973 and April 15, 1975.123

New York in 1968 revised its usury laws to allow the state banking board to adjust the permissible interest rate according to changing economic conditions "in such manner as to insure the availability of credit at reasonable rates to the people of the state while affording a competitive return to persons extending such credit."124 In spite of the

118. Id. § 57-119, Editorial Note.
119. Installment rates vary according to the length of the loan, the principal amount of the loan, the security interest involved and the repayment period (e.g., monthly, quarterly), and operate as an exception to the contract rates which apply to all other loans. The maximum rates on "installment loans" vary from 10% to 15% and do not apply to any loans over $300,000 or to any loan over $50,000 secured by real property. N.C. GEN. STAT. § 24-1.2 (Supp. 1973). In the contract category (i.e., all loans not regulated in the installment category) any amount may be charged for loans greater than $300,000, and 12% on loans between $100,000 and $300,000. Below $100,000 the basic rate is 9% with two exceptions: a business property loan between $50,000 and $100,000 may bear 10% interest; a loan of less than $50,000 secured by a first mortgage or a first deed of trust on real property is limited to 8%. Id.
120. ALASKA STAT. § 45.45.010(b) (Supp. 1973).
121. Id. § 45.45.010(b)(1).
122. Id. § 45.45.010(b)(2).
123. Similar provisions were applicable for periods prior to 1973. See ALASKA STAT. § 45.45.010, Comments (Supp. 1973).
language the New York legislature evidently did not completely trust either the banking board or market conditions: the rate had to be set between 5 percent and 7.5 percent, and the law expired in 1971. In a series of amendments the legislature gradually loosened somewhat, allowing the rate to be set as high as 8 percent or, under special enumerated circumstances, 8.5 percent. The expiration date is now in 1975.125

The California UCCC

A California version of the Uniform Consumer Credit Code has been introduced into the legislature126 with some significant variations from both the uniform version127 and present California provisions on usury. The proposed California version retains the existing framework of article XX, section 22 of the California Constitution and the initiative usury law128 yet provides for uniform regulation of all the categories of exempt lenders.

The California version eliminates the Uniform Code’s distinction between supervised and regulated lenders129 and defines supervised lenders as those making loans with finance charges greater than 10 percent per year. Supervised lenders consequently must also be exempt lenders. Section 1301(q) includes most of the exempt lenders as “supervised financial organization[s]”; any others must be licensed under section 3503 in order to make supervised loans.

The basic “consumer,” “consumer related,” and “all other” loan distinctions are retained. “All other” loans are subject to no limit on finance charges other than that imposed by the initiative usury law and article XX, section 22 of the constitution.130 The other two categories are subject to maximum charges on a sliding scale: 30 percent on the balance under $200, 24 percent from $200 to $500, 18 percent from $500 to $1500, and 12 percent on the unpaid principal balance over $1500; as an alternative the lender may charge 18 percent on the entire unpaid balance of the principal.

The bill has much to recommend it in the usury field.131 It reduces the confusion caused by the myriad of provisions presently existing for exempt lenders.132 It is logical, realistic and clear. Unfor-

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125. Id. § 14-a (McKinney Supp. 1973).
126. S.B. 3 (1973); S.B. 3 (1972).
127. See text accompanying notes 104-15 supra (uniform version).
128. See ADVISORY COMMISSION ON UCCC, supra note 94, at 5.
129. Id.
132. E.g., CAL. FIN. CODE §§ 99-3606 (banks); 5000-11708 (savings and loan associations); 14000-16004 (credit unions); 18000-19131 (industrial loan companies);
tunately, however, it does not address itself to the problems confronting the nonexempt lender.

Conclusion and an Alternative

The mortgage banking act adds new flexibility to California real estate finance practices by sidestepping the usury laws. Although the classification of mortgage banking companies as industrial loan companies is logically unsound, it has the practical effect of freeing both mortgage bankers and the financial institutions which utilize their services from unwarranted restrictions on their lending activities. The act, however, merely alleviates the symptoms in one area. It is not the needed comprehensive revision of California's constitutional and statutory usury scheme. What is needed is a usury law that protects the consumer from extortionate or unreasonable interest charges; provides a reasonable, competitive rate of return to the lender; is flexible in the face of changing conditions; is easily comprehensible; takes into account the need for different interest rates for different types of transactions; and recognizes the necessity of varying regulations for the diverse members of the lending community.

As the California version of the UCCC provides for close supervision and regulation of lenders when interest rates exceed 10 percent, and as it would be neither feasible nor desirable to supervise private lenders, an alternative plan, perhaps more acceptable to the voters, could involve a variant of the New York or Alaska models, subjecting those lenders not licensed or supervised under the proposed California Consumer Code to interest limitations.

Article XX, section 22 could be revised to exempt from interest limitations supervised financial organizations, supervised lenders, and possibly all loans over a certain amount.\(^{133}\) All other lenders would remain subject to a revised limit. This limit could be set administratively, as in New York, or externally, as in Alaska. The Alaskan solution appears to be superior, especially considering the need for voter approval. It is responsive to changes in the economic picture, and the Federal Reserve Bank is not subject to the same political pressures that a state agency or board might be.\(^{134}\)

\(^{21000-21209}\) (pawnbrokers); \(^{22000-22653}\) (personal property brokers) (West 1968 & Supp. 1974).

133. The trend in recent state legislation has been towards abolishing interest restrictions on large loans. \(\text{E.g., GA. CODE ANN. \S 57-119 (1971)} \) ($100,000 or more); \(\text{N.D. CENT. CODE ANN. \S 47-14-09 (Supp. 1973)} \) (business loans over $25,000); \(\text{OHIO REV. CODE ANN. \S 1343.01 (Supp. 1973)} \) ($100,000); \(\text{ORE. REV. STAT. \S 82.125 (1973)} \) (amounts over $50,000); \(\text{PA. STAT. ANN. tit. 41 \S 3 (Supp. 1974)} \) ($50,000); \(\text{REV. CODE WASH. ANN. \S 19.52.080 (Supp. 1973)} \) ($100,000 or more if for real estate development).

134. \text{See generally Cooper,}\ A Study of Usury Laws in the United States to Consider
By adopting a plan including an externally-set limit California would achieve a model usury law. It would allow higher rates to the supervised, institutional lenders who make the majority of loans. Close supervision and regulation would tend to minimize extortionate rates and loan sharking. Setting an exemption limit somewhere between $100,000 and $300,000 would allow those persons with a significant amount of bargaining power to make their own deals unhampered by unneeded and unwanted "protection." Adopting a realistic, externally-set, responsive rate for small and medium-sized noninstitutional loans would provide ample protection for the average businessman or developer and assure an ample supply of capital for their needs by allowing an adequate competitive return to the lender.

Even under this scheme the potential borrower with a high-risk enterprise might still be shut out of the market. Although abolition of all general interest limitations might appear to be desirable given that plight, the responsive externally-set rate appears to be an appropriate compromise.

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