DEPARTMENT OF BUSINESS OVERSIGHT
Ensuring a Fair and Secure Financial Services Marketplace for all Californians

INITIAL STATEMENT OF REASONS FOR PROPOSED REGULATORY ACTION UNDER THE CALIFORNIA FINANCE LENDERS LAW AND THE CALIFORNIA RESIDENTIAL MORTGAGE LENDING ACT PRO 03/13

Statement of Specific Purpose (Government Code Section 11346.2, Subdivision (b)(1))

The Department of Business Oversight ("Department") licenses and regulates finance lenders and brokers under the California Finance Lenders Law (Financial Code Section 22000 et seq., the "CFLL") and mortgage lenders and servicers under the California Residential Mortgage Lending Act (Financial Code Section 50000 et seq., the "CRMLA"). Under the CFLL and the CRMLA, it is unlawful for a finance lender, broker, mortgage lender, or servicer to conduct business without first being licensed by the Department, unless exempt from licensure requirements.

The CFLL provides that the licensing law does not apply to any person doing business under any law of the United States relating to banks and savings and loan associations.[1] In various Commissioner's Opinions, the Commissioner[2] has interpreted the language "doing business under any law of the United States" to be broad enough to encompass subsidiaries of federally chartered banks and federal savings associations, where the entities are nondepository lenders organized under state law.[3] Similarly, the CRMLA exempts from the licensure requirement any bank doing business under the authority of, or in accordance with, a license, certificate or charter issued by the United States, and a federally chartered savings and loan association or federal savings bank. The Commissioner has interpreted this language as including a subsidiary of a federal depository institution.[4]

[1] Financial Code section 22050(a).

[2] Operative July 1, 2013, the former Department of Corporations merged with the former Department of Financial Institutions, and formed the Department of Business Oversight, headed by the Commissioner of Business Oversight. In accordance with Financial Code section 321, the Commissioner of Business Oversight succeeded to all acts of the Commissioner of Corporations.

[3] See Commissioner's Opinion No. 6590 (October 22, 1996); Commissioner's Opinion No. 6595 (November 5, 1996); and Commissioner's Opinion No. 6738 (August 5, 1999).

[4] See Commissioner's Opinion No. 6531 (October 11, 1995).

Through this rulemaking action, the Department is proposing to withdraw the prior Commissioner's Opinions and instead adopt regulations under both the CFLL and the CRMLA providing that non-depository subsidiaries, affiliates, and agents of depository institutions do not fall within the licensure exemptions for a bank or savings association under the CFLL and the CRMLA, except as specified. [5]

Past Commissioner's Opinions[6]

From 1988 to 1999, the Commissioner issued six Commissioner's Opinions to subsidiaries of federal depository institutions and holding companies, confirming that the subsidiaries may rely upon the statutory exemptions for persons doing business under the laws of the United States relating to depository institutions, and not obtain licensure under the CFLL and CRMLA. These interpretive opinions provide exemptions to operating subsidiaries of national banks,[7] a wholly-owned subsidiary of a federal savings bank,[8] operating subsidiaries of a federally chartered savings association,[9] and an operating subsidiary of a bank holding company.[10]

The opinions generally concluded that the statutory exemption for "any person doing business under any law of any state or the United States relating to banks [and] savings and loan associations" was broad enough to encompass subsidiaries subject to limited federal oversight. These opinions reasoned that the subsidiaries were exempt from licensure under the assumption that the cumulative effect of federal prudential regulatory efforts (i.e. by the Office of the Comptroller of the Currency, the former Office of Thrift Supervision, the Federal Reserve Board, and the Federal Deposit Insurance Corporation) over nonbank operating subsidiaries was adequate to oversee and regulate entities which otherwise would have been required to be licensed by the Department.

While none of the interpretive opinions were based on claims of preemption by the federally-regulated entity,[11] the opinions were based on a presumption of federal oversight and

---

[5] Subdivision (a) of Financial Code section 22050, and subdivision (c)(1) and (2) of Financial Code section 50002.

[6] The Commissioner of Business Oversight, formerly the Commissioner of Corporations, is authorized under both the California Finance Lenders Law (Financial Code section 22150) and the California Residential Mortgage Lending Act (Financial Code section 50312) to issue interpretive opinions (specific rulings). Interpretive opinions are legal opinions issued by the Commissioner on the breadth and interpretation of various laws administered by the Department. Distinguishable from a regulation, an interpretive opinion is not a rule of general application because it only applies to the particular entity and set of facts surrounding the opinion. Nevertheless, such opinions set forth the Commissioner's view on the applicability of the law to particular facts.

[7] See Commissioner's Opinion No. OP 6590 CFLL, 1996 Cal. Sec. LEXIS 6, October 22, 1996.

[8] See Commissioner's Opinion No. 95/1 RMLA, 1995 Cal. Sec. LEXIS 3, October 11, 1995.

[9] See Commissioner's Opinions No. OP 6595 CFLL, 1996 Cal. Sec. LEXIS 9, November 5, 1996; and Commissioner's Opinion No. OP 6738 CFLL, 1999 Cal. Sec. LEXIS 1, August 5, 1999.

[10] See Commissioner's Opinion, File No. OP 5792 CM, 1988 Cal. Sec. LEXIS 11, December 1, 1988. See also Commissioner's Opinion, File No. OP 5862, 1989 Cal. Sec. LEXIS 3, February 24, 1989.

[11] Subdivision (c) of article III, section 3.5 of the California Constitution specifically prohibits any administrative agency (such as the Department) from declaring a statute unenforceable, or refusing to enforce a statute on the basis

adequate consumer protection that no longer appears warranted and may have been misguided, given the marketplace events of the last decade and the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203, the "Dodd-Frank Act") reversal of state preemption.

Accuracy of Past Interpretations

In proposing this rulemaking action, the Department has considered whether the plain meaning of the exemptions in Financial Code section 22050(a) (the CFLL) or Financial Code Section 50002(c)(1) (the CRMLA) necessitate a particular interpretation, or alternatively whether the legislative history of the exemptions provide guidance on the intended meaning of the exemption. With regard to the plain meaning, the Department notes that the lending laws of many other states have nearly identical exemptions for "persons doing business under the laws of the United States relating to banks […]", and yet the interpretation of the same language varies among states. While one state indicates that the plain language provides an exemption to operating subsidiaries of federally-chartered depository institutions,[12] other states with similar language interpret their laws as not providing an exemption for operating subsidiaries, unless a more specific exemption is present.[13] Further, if the availability of the exemptions was clear from the plain language of the statutes, the Department would not have been requested to issue six Commissioner's Opinions in 11 years to clarify the meaning of the exemptions. Consequently, the Department concludes the plain meaning of the language as applicable to subsidiaries is not clear from the language alone.

In looking to the legislative history of the statutory exemptions, the Department notes that the language can be traced to predecessor laws dating back to the early years of the 20th century, and the legislative histories of the exemptions are not readily available. In Commissioner's Opinion No. 5792 dated December 12, 1988, while interpreting the meaning of the same language in predecessor lending laws, the Department indicated, "We have been unable to find legislative history establishing guidelines with respect to the parameters of this broad exemption, nor have we found pertinent case law to guide us in interpreting the above quoted phrases as used in [Financial Code sections 24050 and 26050]." As a consequence of the lack of legislative history, the Department proceeded in that Commissioner's Opinion by examining the cumulative effect of federal laws and rules as well as the authority of federal agencies over the operating subsidiary to determine whether the exemption was available.

In this rulemaking action, the Department revisits the question of the intended meaning of the exemptions for persons doing business under the laws of the United States relating to depository institutions, and questions whether examining the cumulative effect of federal laws and rules, and the authority of federal agencies, is the proper paradigm for determining the

---

that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

[12] Kentucky.

[13] For example, Michigan, Virginia, Washington, and Ohio.

applicability of the exemptions to subsidiaries. More fundamentally, the Department questions whether the assumption underlying the past opinions, that subsidiaries were subject to supervision and oversight comparable to that of banks and state-licensed lenders, was accurate. The Department's experience in administering the CFLL and the CRMLA through the economic downturn of the first part of the 21st century has provided convincing evidence that the assumptions underlying the past opinions were misguided. Subsidiaries of federal depository institutions had not been subject to supervision and oversight comparable to that of federal depository institutions. Further, as the subsidiaries were not depository institutions themselves, the federal laws "relating to" depository institutions were not designed to protect borrowers, but instead were designed to protect the safety and soundness of the depository institutions. Thus, interpreting these laws as providing the equivalent regulatory oversight as state licensing laws was misguided, and the Department concludes not likely to be what was intended by the Legislature when the statutory exemptions for depository institutions were enacted.

Borrower Protection

In revisiting the exemptions for depository institutions, the Department seeks to achieve several objectives that will benefit consumers. The Department seeks to promote the uniform oversight of nondepository consumer lending in California. The Department seeks to ensure that regulatory requirements and consumer protections under the CFLL and the CRMLA are uniformly applicable to consumer finance and mortgage lenders and brokers. In addition, the Department seeks to ensure that California borrowers have a state regulator that can assist them with consumer complaints and requests for assistance, without regard to the organizational structure of the nondepository lending institution. Finally, the Department seeks to ensure that the state regulator has authority to exercise visitorial powers over nondepository lending institutions doing business in this state, for the protection of consumers against unlawful, unfair or deceptive lending practices.

Since the financial crisis that began in 2007, the Department has assisted thousands of borrowers who have needed assistance with their loans. Due to the nature of the crisis, the loans were generally mortgages. The Department's lack of supervisory authority over subsidiaries of depository institutions continuously proved crippling to the Department's ability to assist many borrowers. It further hindered the Department's and state's ability to gather adequate information on the extent of the mortgage crisis in California, thereby frustrating attempts to structure solutions to assist consumers. Finally, with respect to the ability to structure solutions to assist distressed borrowers, the lack of visitorial authority and the lack of ability to hold subsidiaries accountable for compliance with the lending laws of this state prevented the Department from providing effective assistance for many borrowers. Through this rulemaking action, the Department proposes to ensure that nondepository subsidiary lenders doing business in this state are subject to the same licensing and regulatory requirements as lenders that are not owned by depository institutions.

Implementation of the Dodd-Frank Act

The Department's ability to reconsider the interpretations of the federal depository institution exemptions under the CFLL and the CRMLA has been hampered over the years by the federal government's aggressive preemption of states in their efforts to regulate nondepository subsidiaries of federal banks and other depository institutions. In 1996, the Office of Thrift Supervision issued regulations which preempted state regulatory efforts over real estate lending activities of federal savings associations and their subsidiaries.[14] Subsequently in February 2004, the Office of the Comptroller of the Currency ("OCC") followed the Office of Thrift Supervision's lead and "…officially preempted national banks and their subsidiaries from state…" lending laws.[15] As a consequence, many national banks began to transition their nonbank subsidiaries from state-licensed to OCC-regulated lending operations.[16] With the enactment of the Dodd-Frank Act, Congress affirmatively removed the preemptive powers of the OCC over states' ability to regulate and enforce regulatory laws with regard to nonbank subsidiaries, affiliates, and agents of banks and savings associations.

The Dodd-Frank Act

Congress passed the Dodd-Frank Act in a large part to address widely perceived causes of the financial crisis that befell the United States between 2007 to 2009—namely the downturn in the housing and financial markets and perceived abuses in the mortgage lending practices of national banks and nonbank mortgage lenders.[17] The Dodd-Frank Act included language to scale back federal preemption as it impacts a state's enforcement of its consumer protection laws, and further expressly provided that states were not preempted from regulating state-chartered subsidiaries of national banks.

More specifically, the Dodd-Frank Act contained a savings clause expressly providing that it does not preempt, annul, or affect the applicability of any state law to any subsidiary or affiliate of a national bank (provided that subsidiary or affiliate is not also a national bank). Consequently, the Dodd-Frank Act expressly made inapplicable many years of actions by federal agencies to preempt state oversight of subsidiaries and affiliates of national banks. The Department's proposal implements the part of the Dodd-Frank Act that eliminated federal

[14] The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services," Arthur E. Wilmarth, Jr. (36 *Iowa J. Corp. L.* 893, 910, Summer, 2011).

[15] "The Impact of Federal Preemption of State Anti-Predatory Lending Laws on the Foreclosure Crisis," Research Report, Center for Community Capital, Univ. N. Carolina at Chapel Hill, Ding, et al., August 27, 2010, at p. 2. See http://www.ccc.unc.edu/documents/Preemption_final_August%2027.pdf.

[16] Financial Crisis Inquiry Commission Report, *Final Report of the National Commission on the Causes of the Financial* and *Economic Crisis in the United States* "Part III: The Boom and Bust: Chapter 7: The Mortgage Machine" at p. 112.

[17] Wilmarth, *supra* note 14 at 896.

preemption over state-incorporated nondepository subsidiaries, affiliates, and agents of banks and savings associations.[18]

Proposed Regulations

Subsidiaries Subject to Licensure

Existing rules set forth requirements for the licensing and regulation of finance lenders, brokers, residential mortgage lenders, mortgage servicers, and mortgage loan originators. To implement Section 1045 of the Dodd-Frank Act and expressly withdraw the past Commissioner's Opinions regarding the breadth of the depository financial institution exemptions under the CRMLA and the CFLL, the proposed language provides that for purposes of defining an exempt entity not subject to licensure requirements under the CFLL and the CRMLA, a nondepository subsidiary, affiliate, or agent as specified is not exempt from licensure unless it is a subsidiary, affiliate, or agent that is chartered as a national bank or federal savings association. In other words, a nondepository subsidiary, affiliate, or agent of a federal savings association is required to be licensed under the CFLL or the CRMLA unless it is a subsidiary, affiliate, or agent that is chartered as a national bank or federal savings association. The reasons for these proposed requirements in the CFLL and the CRMLA are set forth throughout this *Statement of Specific Purpose*, and in particular the section on *Borrower Protection.*

Commercial Lender Exemption

However, for purposes of the CFLL, the proposed language provides that a nondepository subsidiary of a national bank or a federal savings association that does not engage in the business of making consumer loans in this state is exempt from licensure. A similar provision was not added to the CRMLA regulations as that law does not govern commercial lending. The reason for permitting nondepository subsidiaries making commercial loans to rely on the depository institution exemption is because the lending transactions do not raise the equivalent borrower protection concerns that motivated this regulatory action and the withdrawal of past Commissioner's Opinions. Further, as highlighted when the Commissioner sought input on this proposal from interested parties,[19] a commercial lender's status as a subsidiary of a federally-regulated depository institution ensures that the primary borrower protections of the commercial lending provisions of the CFLL are satisfied. More specifically, under the CFLL, the licensure process ensures that the applicants undergo background checks and other scrutiny, and that applicants have the financial resources to deliver on commitments made in the loan process. In the case of nondepository subsidiaries, the need for these state

[18] To wit, the 2010 Senate Committee Report on the Dodd-Frank Act dated April 30, 2010, specifically stated:

> Section 1045 clarifies that State law applies to State-chartered nondepository institution subsidiaries, affiliates, and agents of national banks, other than entities that are themselves chartered as national banks. Such entities are generally chartered by the States and therefore, should be subject to State Law. *S. Rep. No. 111-176*, at 126 (2010).

[19] See Government Code section 11346(b).

protections is not present, because their status as subsidiaries of federal depository institutions ensures that these protections are already addressed.

While through this rulemaking action the Department no longer subscribes to the reasoning contained in past Commissioner's Opinions regarding the adequacy of the cumulative effect of federal laws and rules, and the authority of federal agencies, for establishing that subsidiaries making loans to consumers are doing so under the laws of the United States relating to depository institutions, the same is not so for subsidiaries making commercial loans. The regulatory protections of the CFLL governing commercial lending are in large part unnecessary as applicable to subsidiaries of federal banks and savings associations, given the regulatory protections under federal law. In the Commissioner's view the oversight by the OCC, as the primary regulator of banks chartered under the National Bank Act (12 USC 1 et seq.) and federal savings associations chartered under the Home Owners Loan Act of 1933 (12 USC 1461 et seq.), is sufficient to conclude that the nondepository subsidiaries of these financial institutions engaged in the business of making commercial loans are doing business under the laws of the United States related to banks and savings associations. Importantly, prior to the consolidation of the three predecessor lending laws into the CFLL in 1994, the only Commissioner's Opinions issued concluding the exemption for depository institutions was applicable to subsidiaries were issued under the Commercial Finance Lenders Law,[20] and the Commissioner's view is that such an interpretation effectuates the legislative intent of the exemption, as applicable to commercial lending.

Consequently, this proposed regulatory action proposes to enact a provision providing that a nondepository subsidiary of a national bank or a federal savings association that does not engage in the business of making consumer loans in this state is exempt from licensure. This provision is intended to provide clarity to commercial lenders that are subsidiaries of federally-chartered institutions, and to relieve these lenders of regulatory burdens that are unnecessary for the protection of borrowers.

Conclusion

In sum, this proposed regulatory action provides that subsidiaries of depository institutions are subject to licensure under the CFLL and CRMLA, unless the subsidiaries are engaged in the business of making commercial loans, as provided.

This proposed regulatory action does not mandate the use of specific technologies or equipment.

Major Regulations (Government Code Section 11346.2, Subdivision (b)(2))

This rulemaking action is not a major regulation.

[20] See Commissioner's Opinion No. 8792 (December 1, 1988) and Commissioner's Opinion No. 5862 (February 24, 1989).

Studies Relied Upon (Government Code Section 11346.2, Subdivision (b)(3))

The Department did not rely upon any technical, theoretical, or empirical study or report in proposing this rulemaking action, other than the documents set forth in this statement of reasons.

Potential for Adverse Economic Impact on Business and Individuals (Government Code Section 11346.3, Subdivision (a))

The Commissioner has determined that the proposed regulatory action will not have an adverse economic impact or potential for an adverse economic impact on business, including the ability of California businesses to compete with businesses in other states, or individuals. While the proposed rulemaking action will require some lenders not currently licensed by the Department to obtain licenses, the anticipated number of impacted businesses is relatively minor. The Department bases this conclusion on the National Bank and Federal Savings Institution Operating Subsidiary List maintained on the Office of the Comptroller of the Currency's website at http://www.helpwithmybank.gov/national-banks/operating-subsidiaries/national-banks-subsidiaries-a-m.html#a. Only 65 subsidiaries are listed. The Department currently licenses seven mortgage lenders on the list, and many other subsidiaries do not appear to be engaged in lending. Based on this information, the Department estimates that potentially 30 businesses may be engaged in lending, and therefore may be impacted by this proposed rulemaking.

The Department has over 2600 licensed lenders under the CFLL, and close to 400 licensed lenders under the CRMLA. The Commissioner has determined that a regulatory action that impacts only 30 additional businesses will not have an adverse economic impact on business, including the ability of California businesses to compete with businesses in other states. To the contrary, this rulemaking action will level the field for lenders already licensed in California, by ensuring that the regulatory requirements for operating subsidiaries are equivalent to those for licensees.

Economic Impact Assessment (Government Code Section 11346.3, Subdivision (b))

The Creation or Elimination of Jobs within the State

The Commissioner has determined that this regulatory proposal will not have a significant impact on the creation or elimination of jobs in the State of California. This proposed rulemaking action will only impact a limited number of lenders, and these lenders are expected to continue to engage in business in this state under the conditions of the proposed rulemaking action.

The Creation of New Businesses or the Elimination of Existing Businesses within the State

The Commissioner has determined that this regulatory proposal will not have a significant impact on the creation of new businesses or the elimination of existing businesses in the State of California because the pool of lenders impacted by this rulemaking is relatively

small, in comparison to the number of licensees making loans, and the Commissioner anticipates that the lenders impacted will comply with the regulatory requirements and continue in business. New lenders that may be subsidiaries of depository institutions will be subject to the same licensure requirement as other new lenders that are not subsidiaries of depository institutions, and consequently the Commissioner does not anticipate that this regulatory action will impact the creation of new businesses.

The Expansion of Businesses Currently Doing Business within the State

The Commissioner has determined that this regulatory proposal will have no impact on the expansion businesses currently doing business in California. This proposed rulemaking action has no impact on the expansion of a lender currently doing business in this state, as licensure is required regardless of the extent of lending business done in this state.

The Benefits of the Regulations to the Health and Welfare of California Residents, Worker Safety and the State's Environment

The Commissioner has determined that this regulatory proposal may benefit the health and welfare of California residents for the reasons set forth above. In particular, through this proposed rulemaking action the Department seeks to achieve several objectives that will benefit consumers, including promoting the uniform oversight of nondepository consumer lending in California, ensuring that regulatory requirements and consumer protections under the CFLL and the CRMLA are uniformly applicable to consumer finance and mortgage lenders and brokers, ensuring that California borrowers have a state regulator that can assist them with consumer complaints and requests for assistance, without regard to the organizational structure of the nondepository lending institution, and ensuring that the state regulator has authority to exercise visitorial powers over nondepository lending institutions doing business in this state, for the protection of consumers against unlawful, unfair or deceptive lending practices.

Reasonable Alternatives (Government Code Section 11346.2, Subdivision (b)(4))

(A) The Department is not aware of any reasonable alternative that would achieve the same purpose but be less burdensome and equally effective.
(B) This proposed regulatory action does not impact small business, and consequently the Department has no reasonable alternative to lessen the adverse impact on small business.

Evidence Relied Upon (Government Code Section 11346.2, Subdivision (b)(5))

The Department has surveyed other states and has concluded that the majority of other states impose state licensure requirements on subsidiaries of federal depository institutions. The Department has concluded that state licensure is a routine requirement for nondepository lender subsidiaries of national banks and savings associations, and this action by California will not have a significant adverse economic impact on business.