Report to the Legislative Council

The Regulation and Licensing of Loan Brokers and the Regulation and Registration of Originators and Principal Managers Under IC 23-2-5 As Amended by P.L. 230-2007 (HEA 1717)

Indiana Secretary of State, Securities Division

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Report to the Legislative Council on the Regulation and Licensing of Loan Brokers and the Regulation and Registration of Originators and Principal Managers

The Indiana Secretary of State, Securities Division submits this report as required by Section 29 of P.L. 230-2007 (HEA 1717). Through this report the Securities Commissioner discusses the licensing of loan brokers and the registration of originators by examining the regulatory landscape and in particular the effects of P.L. 230-2007 (HEA 1717) on licensing and registrations. Specifically, this report addresses budget and staffing, additional actions needed to implement the Loan Broker Act, statistical data, challenges encountered in implementing the Loan Broker Act, and recommendations by the Securities Commissioner regarding implementation of the Loan Broker Act.

Budget and Staffing Needs in Order to Implement the Amended Loan Broker Act

The Indiana Secretary of State, Securities Division ("Securities Division") currently regulates securities, loan brokers, franchises, collection agencies, and continuing care facilities. The major focus of the office is on securities and loan brokers. In fact, the area of loan brokers is the area with the highest concentration of individual focus. As can be seen from the enforcement actions taken by this office in recent years, the area of loan broker enforcement has been an increasing focus of the Securities Division. (See Chart below comparing the administrative enforcement actions taken by the Securities Division against loan brokers with respect to all enforcement actions filed by the Securities Division.)

Loan Broker Administrative Enforcement Actions Since 2000
(Does not include Criminal Prosecutions)

Year	Loan Broker Actions	Total Actions
2000	8	72
2001	9	72
2002	40	77
2003	58	94
2004	46	76
2005	47	98
2006	51	105
2007 (through 10/19)	85	138

Current Staff

Currently the Securities Division employs several staff members that deal directly with loan brokers. Two (2) full-time investigators are assigned solely to investigate loan brokers and related industries. Five (5) other full-time investigators also have cases concerning loan brokers.

In addition to the investigators, six (6) attorneys on the Securities Division staff handle either administrative or criminal enforcement of loan broker cases. The Securities Division also employs a loan broker licensing staff, including a Loan Broker Examiner and a processor, who work directly with the licensing of loan brokers and the registration of individuals.

New Staff

In October 2007, the Securities Division created two (2) additional full-time staff positions for Loan Broker Field Examiners that are responsible for prospectively examining loan brokers for compliance with the Loan Broker Act. With the new addition of two (2) Loan Broker Field Examiners, the Securities Division will attempt to prospectively address violations of the Loan Broker Act and add a proactive component to the existing regulatory scheme, which is a complaint driven model. The sole responsibility of the Loan Broker Field Examiner will be to conduct examinations of loan brokers statewide and report any problems or violations for disciplinary action.

Staff Summary

Two (2) full-time investigators devoted to loan brokers
Five (5) investigators partially devoted to loan brokers
Six (6) attorneys with loan broker cases
One (1) Loan Broker Examiner for licensing issues
One (1) Loan Broker processing staff
Two (2) Loan Broker Field Examiners

Budgeting

The Securities Commissioner believes that current budget and staffing levels are appropriate for the regulation of loan brokers. As stated previously, the Securities Division has begun a new program for the prospective examination of loan brokers, which adds two (2) staff members solely devoted to loan broker regulation and enforcement. Also, the changes to the Loan Broker Act through Public Law 230-2007 (HEA 1717) have only been in effect for four (4) months. As this was a significant piece of legislation that has a large impact through criminal background checks and registration exams, the effect of the legislation on licensing over time should be examined before significant staffing and budgeting changes are made. The legislature has taken an important step with the increased protections for Indiana residents, and the legislation needs time to work. The Securities Division also proposes to adopt the national licensing system of loan brokers created by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators in January of 2009. It is difficult to predict what effect the adoption of the national licensing system will have on loan broker licensing numbers.

Additional Actions Needed to Implement the Amended Loan Broker Act

The Securities Commissioner anticipates that additional actions must be taken to fully implement the desired outcome of P.L. 230-2007 (HEA 1717). These additional actions will take place

primarily through two (2) avenues: by changes to the Loan Broker Act and by changes to the Loan Broker Regulations.

Statutory Changes

The Securities Commissioner is proposing legislation through the Interim Study Committee on Mortgage Lending Practices and Home Loan Foreclosures to amend the Loan Broker Act for the 2008 legislative session. This proposed legislation includes the following:

1. **Amend the criminal background check standards to allow for federal criminal background checks conducted by the Federal Bureau of Investigation ("FBI").** The Amended Loan Broker Act provides for criminal background checks, but the FBI rejected the language of the amendment because it did not meet its criteria for conducting federal criminal background checks. The Securities Commissioner is proposing an amendment that will meet the FBI's requirements.

2. **Amend the powers and duties of the Securities Commissioner to allow for the adoption of a national licensing system.** The Securities Division proposes the use of the national licensing system developed by the Conference of State Bank Supervisors and American Association of Residential Mortgage Regulators. The Securities Commissioner is proposing an amendment allowing for the adoption of that system and the ability to take any action necessary to implement that system beginning January 1, 2009.

3. **Amend the prohibited acts section to create additional violations.** The Securities Commissioner is proposing an amendment to create a violation for receiving funds in a mortgage transaction when a person receiving funds knew during a mortgage transaction or should have known that the transaction was fraudulent. A second violation would be created for a person to file a mortgage loan document with any county recording office that the person knew or should have known to contain a material false representation or omission.

4. **Amend the prohibited acts section to create a violation for suitability.** The Securities Commissioner is proposing an amendment to create a prohibited act for any person in connection with a contract for the services of a loan broker to recommend any loan without first making a determination that the loan is suitable for the borrower or potential borrower based on income, expenses, assets & liabilities, and credit history.

5. **Amend the Loan Broker Act to create a violation based on privacy interests of the borrower or potential borrower.** Currently the Loan Broker Act does not contain any protections for potential borrowers who entrust the loan broker with their most sensitive financial and personal information. The amendment would create a violation for a loan broker to release confidential borrower information, to engage in reckless activity allowing the release of confidential borrower information, or to engage in negligent activity allowing the release of confidential borrower information. The amendment

would also require loan brokers to dispose of confidential borrower information in such a manner that the information is kept confidential.

6. **Amend the exemptions to clarify the exemption for correspondents of United States Department of Housing and Urban Development Loans while also providing for an additional fee for notification of originators of exempt companies**. The current exemption for HUD brokers under Ind. Code § 23-2-5-19(a)(8)(E) is confusing in that it requires loan brokers claiming the exemption to close 25 HUD insured loans in Indiana during the calendar year. The confusing issue is that the statute allows for a claim of an exemption even if the person does not have any basis for claiming that the person will prospectively close 25 HUD insured loans. The statute would amend the exemption to state that a person is exempt if the person acted as a correspondent of loans insured by HUD if the person had closed at least 25 loans insured by HUD in the **previous** calendar year.

Rulemaking

In September, the Securities Division filed a Notice of Intent to Adopt a Rule with changes to the Indiana Loan Broker Regulations. The following additions or amendments were included in that Notice of Intent:

1. **Add a definition of branch office**. The Securities Division has previously required through rulemaking that loan brokers submit notice of all material facts. The location of a branch office is a material fact. The Securities Division, however, has not defined what constitutes a branch office, and this proposed rule will clarify that issue.

2. **Amend inconsistencies**. Public Law 230-2007 (HEA 1717) contains provisions that conflict with the current Loan Broker Regulations. The proposed rule will amend the current regulations to ensure consistency with the Loan Broker Act.

3. **Include privacy interests**. Because the issue is a serious concern, the Securities Commissioner has included in the Notice of Intent a proposal to include the privacy considerations mentioned in the statutory changes above that will allow the Securities Division to take action to protect borrower information prior to any legislation becoming effective.

Statistical data regarding Numbers of Licenses and Registrations Issued under Amended Loan Broker Act

As of October 19, 2007, the Securities Division shows one thousand two hundred seventy-one (1,271) active licenses for loan brokers; three thousand four hundred eight (3,408) active registrations to individuals, which includes all originators, principal managers, and ultimate equitable owners; and one thousand ninety-one (1,091) active notices of exemption.

Since July 1, 2007, the Securities Division has issued eight (8) licenses to loan brokers under the Amended Loan Broker Act with a total of eleven (11) ultimate equitable owners. In that same

time period, the Securities Division has issued eight (8) certificates of registration to principal managers and twenty (20) certificates of registration to originators, who are not principal managers. The Securities Division has also received thirty-six (36) Notices of Exemption during that time span.

The Securities Division has worked with vendor the Performance Assessment Network to create a registration examination for principal managers and originators. That examination became available on October 1, 2007. Up until that time, the Securities Division issued Temporary Certificates of Registration to all applicants who met every requirement for registration as a principal manager or originator except for passage of the exam, and these Temporary Certificates of Registration are set to expire on October 31, 2007. If the applicant does not take and pass the examination by that date, the registration will be terminated, and the applicant must reapply for registration. Since the Loan Broker Performance Assessment became available on October 1, 2007, six (6) individuals have passed the principal manager exam while four (4) have failed. An additional fourteen (14) individuals have logged into the system but have not yet completed the exam. Two (2) individuals have taken the exam multiple times and have passed on the second attempt. For the originator exam, fifteen (15) have passed while four (4) have failed. An additional four (4) individuals are intending to complete the exam.

Challenges Encountered or Anticipated in Implementing the Amended Loan Broker Act

Whenever the legislature enacts significant changes to a statute, especially changes that are designed to address problems in the industry, the industry may object to those changes. It is important to state that the Indiana Association of Mortgage Brokers has supported House Bill 1717 throughout the entire process of drafting and implementation. The Indiana Association of Mortgage Brokers has taken great efforts to educate its membership and loan brokers at large on the changes that came about through P.L. 230-2007 (HEA 1717) and the benefits those amendments will bring to the industry. Others in the industry, however, have objected to any amendments to the Loan Broker Act. The complaints fall within three (3) areas:

Increased Fees

The most common criticism that the Securities Division has received concerns the registration fees. Prior to the amendments to the Loan Broker Act, fees for loan brokers were two hundred dollars ($200) for a two (2) year registration period. The original Loan Broker Act did not require any fees for originators or any other individual. The Amended Loan Broker Act requires a four hundred dollar ($400) filing fee for a two (2) year registration of a loan broker. In addition to the fee for the loan broker, the Loan Broker Act contains a two hundred dollar ($200) fee for every ultimate equitable owner (one who owns 10% or more of the equity of the loan broker), a two hundred dollar ($200) fee for every principal manager (one who supervises the loan broker employees at every branch), and a one hundred dollar ($100) fee for every originator. Even the smallest loan broker, where the owner is the only employee, must pay eight hundred dollars ($800) to become licensed (paying fees of four hundred dollars ($400) for the loan broker, two hundred dollars ($200) as an ultimate equitable owner, and two hundred dollars ($200) to be a principal manager). Prior to the amendment, the total fee would have been two

hundred dollars ($200). Since the fees for these loan brokers have increased, the Securities Division has received complaints.

Criminal Background Check

The complaints received by the Securities Division concerning criminal background checks mostly concern the process of obtaining a criminal background check. The FBI rejected the language of P.L. 230-2007 (HEA 1717) and will not perform a national criminal background check at this time. To fulfill the statutory requirement for a background check over the previous ten (10) years, the Securities Division requires that the applicant obtain a background check for every state in which he or she has lived or worked over the prior ten (10) years. This has created an issue in that some states refuse to release criminal background information. The inability to obtain criminal background information from all states will be solved through the updated language that will meet the FBI's requirements to run national criminal background checks.

Increased complexity of the Application

In creating new applications to comport with the Amended Loan Broker Act, the Securities Division adapted a paper version of the application being used for the national licensing system. These applications are much more complex and are more difficult to complete. The Securities Division has experienced a large percentage of applications that must be sent back for deficiencies. Since the proposed adoption of the national licensing system will not occur until January 2009, complaints based on the complexity of the application are likely to continue. The Securities Division will continue to offer seminars throughout 2008 on how to properly complete the applications. The Securities Division Staff also responds to all requests for appointments for help in completing the application.

Recommendations by the Commissioner

The Indiana Loan Broker Act was enacted in 1985 to empower the Securities Division to stop a particular type of fraud from being committed by securities brokers. At that time the securities brokers engaging in this fraud would solicit businesses that needed financing, and the brokers would promise to provide financing by means of a business loan, charge a large commission, and get out of the deal without ever providing that financing while keeping the up-front fee charged. The Loan Broker Act targeted these transactions by requiring persons performing such activities to become registered with the Securities Division, and explicitly prohibited fraud and up-front fees.

With respect to the mortgage industry, until the mid-1990's, the industry was concentrated almost exclusively in banks and savings & loans, which had in-house loan officers to originate loans. These entities also funded and serviced their own loans almost exclusively. Since that time, the industry practices of mortgage transactions has shifted dramatically. The restructuring of the savings & loan industry in the 1980's, as well as the considerable financial benefits of home ownership, led to the emergence of mortgage lenders. These mortgage lenders outsourced the loan officer origination function to third parties, which energized the independent loan broker industry. Increased securitization of mortgage loans created an even greater demand for

mortgage notes and generated an emphasis on volume. The market emphasis of volume over accuracy promotes the creation of new products such as adjustable rate mortgages and stated income loans as well as opportunities for fraud.

The Securities Division has applied the same model of protecting investors of securities transactions to protecting consumers in loan broker transactions under the reasoning that a person's home is the largest investment he or she will make in a lifetime. This model emphasizes the protection of investors over the solvency of the industry and seeks to address the informational imbalance between the loan broker and the consumer that is inherent in every transaction. All individuals working with clients on the loan transaction must take education classes so that they understand the federal and state requirements for the loan so they can give the proper disclosures to the borrower prior to completion of the transaction. Through Public Law 230-2007 (HEA 1717) the Securities Commissioner has imposed a greater level of professionalism on those working in the loan broker industry, similar to the securities industry, by requiring criminal background checks and a registration examination. Also, similar to the securities model, the Securities Commissioner has increased the number of reasons why a license or registration can be revoked, denied, or suspended.

To further the efforts of the Securities Division in implementing the Amended Loan Broker Act, I ask the Legislative Council to support the legislative proposals outlined within this report. This report has addressed the budget and staffing needs of implementation of the Amended Act and the challenges encountered with implementation of the Act. I ask the Council to keep in mind that the changes initiated by P.L. 230-2007 (HEA 1717), in particular the new examination program which has recently been implemented and the criminal background checks, should be given time to bear fruit. Therefore, I ask the Council to support the provisions of the Amended Loan Broker Act that took effect on July 1, 2007, and to support the legislative proposals offered at this time in order to pursue the important goals of a clean industry and the protection of Indiana consumers.