

# REENGINEERING NONBANK SUPERVISION

## Chapter Two: Overview of Nonbank Supervision

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## About This Paper

This paper, *Reengineering Nonbank Supervision*, serves two primary purposes. First, it is a stakeholder awareness document covering state supervision of the nonbank marketplace, and second, it is a change document, or roadmap, to assist state supervisors in identifying the current state of supervision and making informed changes to state supervisory processes. The paper is comprised of several standalone chapters that together will cover the industry supervised by state nonbank financial regulators, the existing system of supervision for nonbanks and the challenges and opportunities for state supervisors in “reengineering” that system.

The first chapter, Introduction to the Nonbank Industry, provided a broad overview of the industry participants that are the primary focus of state nonbank supervisors. In this second chapter, CSBS covers the existing authorities and supervisory processes granted to nonbank regulators in supervising the industry.

These chapters will be available on the CSBS website [here](#) as they are published.

State financial regulators are the primary regulators of nonbanks operating within the United States. Together, they have forged a series of initiatives, collectively known as [CSBS Vision 2020](#), to modernize nonbank licensing and supervision. This white paper will contribute research and engage discussion on possible actions that might be taken.

## Acknowledgements

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The Conference of State Bank Supervisors (CSBS) is the nationwide organization of banking and financial regulators from all 50 states, the District of Columbia and the U.S. territories. State regulators supervise state-chartered banks and are the primary authority governing nonbank financial services providers, including mortgage providers, money services businesses, consumer finance companies, payday lenders, check cashers and debt collection firms. Created in 1902, CSBS has for more than a century given state regulators a national forum to coordinate supervision and develop policy, provide training to state banking and financial regulators and represent its members before Congress and federal financial regulatory agencies.

## CHAPTER TWO

# Overview of Nonbank Supervision

This overview begins with a brief discussion of supervision policy in the nonbank space, followed by a discussion of the various agencies charged with supervision and responsibility for oversight, both at the federal and state levels. Next, we explain the fundamentals and processes of state supervision of nonbanks and close with a discussion of existing supervisory tools and state resources. As we deliver future chapters, (e.g., mortgage) we will address the specifics of state supervision within that industry sector. The white paper will conclude by addressing the future of state supervision.

When we refer to nonbanks or the nonbank industry, we are referring to financial institutions responsible for delivering products and services either directly to consumers or related to consumers' use of those products and services and are supervised or regulated by state nonbank financial regulators. In this overview we address the system of supervision rather than how each sector is supervised (i.e., mortgage loans and money transmission are different products and services requiring different approaches and tools and often completely different regulator skillsets.).

Further, we have simplified what can be a complex discussion of supervision. There are 50 states, plus

### 10 KEY POINTS

- 1 – State regulators are considered the primary or prudential regulator of nonbanks. State attorneys general, CFPB and law enforcement perform crucial roles in consumer protection.
- 2 – Supervision is oversight via licensing, examination, enforcement and handling of consumer complaints.
- 3 – NMLS converts the licensing process from weeks to days, and NMLS call reports provide a wealth of detailed information states utilize to assess risk at both the industry and individual company level.
- 4 – The consumer protection role of the state system is to ensure that business practices do not result in consumer harm through negligence, non-compliance or intentional acts intended to enrich the nonbank to the consumer's harm.
- 5 – Examinations allow states to monitor the services and products offered to consumers and to determine whether a company is operating in a safe and sound manner.
- 6 – Enforcement actions are an integral part of the consumer protection process.
- 7 – The nonbank is responsible for maintaining a sound financial condition so that it is able to meet statutory and regulatory obligations; comply with laws, rules and directives of their supervisors; and ensure that consumers are treated appropriately and protected from harm.
- 8 – Through self-assessment and self-reporting, management builds trust with the regulators, and that trust will carry the institution through the examination and beyond.
- 9 – Nonbanks with a poor "culture of compliance" are likely to have issues related to compliance and consumer protection. Compliance staff should be empowered with enough authority and autonomy to implement an effective compliance program.
- 10 – Information sharing among the states is effective and beneficial in licensing, examination, investigation and enforcement.

the District of Columbia, U.S. Virgin Islands, Puerto Rico, Guam and American Samoa; each can have multiple agencies with supervisory authority. Rather than discuss the authorities and processes of each individual state and each individual agency, we address the system in general. There are significant similarities between states and standard “multistate” processes allowing us to provide an accurate description as if the system were a whole. However, each state and agency operate under independent (sovereign) authority, and nothing in this overview should be relied upon for legal purposes.

## Overview of Nonbank Regulatory Policy

In general, policy or policy views precede everything. Policy means the principles by which certain courses of action are taken. In the supervision of nonbanks, certain policy views led to the creation of laws, followed by the promulgation of regulation that is implemented by a regulatory agency. This implementation itself is considered “policy,” or the way in which the agency acts or operates to enforce the law and regulation.

As an example, an elected body of government (e.g., state legislature or Congress) holds a policy view that certain nonbanks should be licensed and/or supervised in order to conduct business with the public. That view is transformed into a statute or law requiring companies to hold a license and do other things to conform to expected norms. It is then passed to an assigned regulatory agency to craft and publish rules or regulation, as well as guidance and interpretation, that will tell the nonbanks how the license is to be obtained and in what ways they must conduct or not conduct business. The agency itself does this under other state laws (e.g., administrative law) dictating how agencies must conduct this formal process. Through these laws and rules, the regulators institute expectations or norms of conduct for the industry and then subsequently monitor, examine or investigate the industry for compliance with those expectations. Over time, policy views may change to meet more modern needs; however, policy is anchored in law and may require a change of the law in order to be modernized.

Fifty plus state policy views may seem onerous to an industry now operating beyond individual state borders; however, state policy is rooted in the economic needs of the local community and the protection of the residents and businesses within that community. While there may be differences from one state to the next, there are more similarities. After all, lending is lending, and money transmission is money transmission.

One of the most overlooked features of the state system is the ability for large or small companies, as well as consumers, to reach their legislator and regulator directly. In turn, state government is responsive to the needs of the community. At times this may result in a state being ahead of federal government in facilitating change. Other times the state may hold fast to certain consumer protections or local ways of doing business. The key is that governance in one corner of the country may address a need that is expressed differently in another corner.

State nonbank regulators recognize that the operating needs of companies offering services beyond state borders may conflict with a state focused system and have acted responsibly and timely to modernize rules, interpretations and processes wherever possible. Examples of this responsiveness can

be seen in model laws, multistate information sharing agreements, uniform policy development, coordinated supervision and reliance on other states to fulfill regulatory responsibilities. Through CSBS and its sister regulator associations, commissioners and their agencies work actively to create a seamless, uniform and responsive system of supervision while preserving the best of localized governance and upholding consumer protection standards.

## State Police Powers

A principle of the U.S. federalist system is the preservation of state police powers to ensure the health, safety, and general public welfare of state citizens. While police powers are most often thought of in terms of health and safety, this tenet applies to economic growth and consumer protection as well.

When the constitution was written, there were very few corporations. In colonial times, Charters of Incorporation were issued by the king, a power which he delegated to colonial legislatures. After independence and the drafting of the U.S. Constitution,<sup>1</sup> states remained the exclusive domain for corporate charters. By 1815, the states chartered over 200 banks, firmly establishing state police power over financial intermediaries.<sup>2</sup> While financial services and regulation has evolved over the past 200 years, state authority to ensure state citizens are safe from predatory or unsafe practices has been a crucial tenet of the federalist financial regulatory system.

## Regulating a Market without Deposit Insurance

To fully understand nonbank supervision, we explain the difference between banks and nonbanks. This difference is better understood in the term “non-depository.” In this paper, we have opted for the term nonbank, not because it is more descriptive, but because in wide usage, it seems to be less confusing. Either way, nonbank or non-depository, we are describing the industry not for what it is, but for what it is not.

The fundamental difference between banks and nonbanks is the treatment of customer funds. Banks take deposits (“depository”). This is often taken for granted, but there is a long history behind banks holding other people’s money.<sup>3</sup> In fact, the Bank Holding Company Act defines a bank as “(A) An insured

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<sup>1</sup> The Constitutional Convention of 1787 included a vote on the power “to grant charters of incorporation in cases where the public good may require them, and the authority of a single State may be incompetent.” James Madison, *Journal of the Federal Convention*, Saturday 18, August 1787. Madison enlarged the scope of this consideration to include situations “where the interest of the U.S. might require & the legislative provisions of individual States may be incompetent.” Madison, *supra*, Friday 14, September 1787. In an eight to three vote, the delegates voted against a federal corporate chartering power. In addition to believing it unnecessary, the framers thought the federal power would be too divisive due to mercantile monopolies in the South and banks in the North.

<sup>2</sup> See Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 AM. U.L. REV. 81, 93 (October 1995).

<sup>3</sup> See, e.g. Jones, William, Sir, *An essay on the laws of bailments* (1781). Available at <http://lawlibrary.wm.edu/wythepedia/library/JonesEssayOnTheLawOfBailments1796.pdf>. “A deposit, in the civil law, is a contract, by which a thing is committed to the custody of one, to be kept without reward, upon condition that the same thing shall be returned when he that deposits the thing shall demand it.”

bank as defined in section 3(h) of the Federal Deposit Insurance Act, or (B) An institution . . . which both— (i) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and (ii) is engaged in the business of making commercial loans.”<sup>4</sup>

Banks are allowed to use deposits for their own purposes – with some constraints – so long as they have enough money to return to customers when demanded.<sup>5</sup> To ensure banks have the funds necessary to pay when a customer demands the return of their deposits, banks are required to hold a certain percentage of customer funds readily available for withdrawal. Banks have other tools in the event customer withdrawals exceed cash on hand, which is ultimately backed up by federal deposit insurance (a government “backstop”). This entire system is known as fractional reserve banking, and our banking laws and practices are predicated on banks using customer funds for their own purposes and returning funds upon demand. In situations where those funds become unavailable through mismanagement or theft, the government is there to step in and make depositors whole.<sup>6</sup>

With nonbanks, there are no deposits. Funding for operations comes from elsewhere. For companies that lend, funding comes from a combination of paid in capital and credit. For business models that take other people’s money – money services businesses (MSBs) – the nonbank is required to treat the funds as instructed. This could mean transfer the funds from A to B, hold the funds until they are spent, exchange the funds for something else or a combination of these.

Since nonbanks have neither deposits nor a government backstop, it is crucial that states exercise their police power to prevent the kinds of business practices that lead to a loss of customer funds or otherwise harm local economies. For nonbank lenders, states create and enforce lending standards designed to keep credit markets transparent and fair. For money services businesses, states design requirements around the lack of a backstop. Instead of a fractional reserve, there is a 100% reserve requirement, and in the event of failure, customer funds must be 100% available to customers because there is no deposit insurance to turn to.

## Supervision in General

It is important to discuss the terms “supervision,” “supervisor,” “regulation” and “regulator” because those terms are used frequently in oversight of the industry. For those on the outside, the use of these terms, often interchangeably, might seem puzzling. Before discussing this further, let’s state a simple point: Whether we use supervision or regulation, or supervisor or regulator, or supervisory or regulatory, or regulatory supervisor, we are always close to the mark and likely understood. But regulators/supervisors are typically very precise and detailed people, so let’s nuance this a bit further.

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<sup>4</sup> 12 U.S.C. 1841(c).

<sup>5</sup> The modern, United States definition of deposit is found in the Federal Deposit Insurance Act. Deposit means “the unpaid balance of money . . . received or held by a bank . . . for which it has given . . . to [an account, certificate, check, draft, letter of credit, or traveler’s check] on which the bank . . . is primarily liable.” 12 U.S.C. 1813(l).

<sup>6</sup> To the limits of the federal insurance: up to \$250,000 per depositor.

Supervision is a broad term that can mean different things to different people. In the context of this paper, supervision refers to a regulator's oversight of nonbank industries through licensing, examination, investigation, enforcement and handling of consumer complaints.

The term regulation refers to the written rules that define acceptable behavior and conduct for financial institutions. The term supervision, in contrast, refers to the enforcement of these rules. [Source: St. Louis Federal Reserve Bank website]. State and federal regulators hold both authorities and responsibilities.

Think about it this way: Regulation tells a company or person what they must do, can do or must not do. Supervision is the process of making sure the company or person abides by the regulation. A regulator (meaning an agency, the head of the agency, or an employee of a regulatory agency) writes the rules or regulations for the industry to follow AND supervises how the industry follows them. So, when referring to those who write regulations and supervise financial institutions, the terms regulator and supervisor can be exchanged without any loss in understanding.

The term nonbank supervision has been used in many places in lieu of nonbank regulation. We do this to be specific when our discussion is focused more on how the states review companies than the rule writing process that governs those companies. However, we use both terms and again, either works in almost any situation.

## **State Supervision of Nonbanks**

When states supervise nonbanks, they do so first from the legal authority provided in state law and second from the regulations or rules crafted to interpret those laws into practical application. For example, a state's law may simply state that a company is required to hold a license issued by a state bank commissioner before conducting any business with consumers. Such a statement is clear, but intentionally lacks the specifics of how that licensing is to take place. From there, the state agency is responsible for determining how a license request is applied for, reviewed, issued and renewed, and when necessary, taken away. If during the process of supervising the industry, the agency determines that a company is operating without a license, the regulator relies on the simple statement in law to cite a violation, often using the regulation to detail the specifics of the violation and bring an enforcement action against the unlicensed company and ordering it to cease conducting unauthorized business.

State law begins as a bill (an idea addressing a need) and is passed into law by approval of the state legislature and signature of the governor. Some laws give specific agencies the authority to enforce a statute, a written expression of the law. In nonbank supervision, state regulators are responsible for assuring institutions comply or adhere to state law or rule. State laws may also incorporate elements or requirements of federal regulations, which make violations of these regulations an automatic violation of state law. And some federal laws (e.g., Title X of the Dodd-Frank Act) authorize state regulators to pursue matters with authority like that held by the authorized federal agency.

In nonbank supervision, the bank commissioner, or other financial regulator, is typically granted the following authorities:

- ✓ **Regulation or Rule Writing:** The interpretation of the law into practical application that defines acceptable behavior, conduct, requirements, etc. for financial institutions. The rule writing process follows very specific and transparent steps laid out in the state’s administrative law.
- ✓ **Provide Regulatory Interpretation:** State regulators have the responsibility to interpret the statutes and regulations falling under their jurisdiction. While these interpretations may be challenged, legal history has shown great deference to regulatory interpretations made by authorized agencies. Interpretations are typically made in the form of interpretive or opinion letters (enforceable similar to regulations) and guidance (intended to assist regulators and the companies they supervise in proper practices and adherence to regulations).
- ✓ **Licensing and/or Registration:** Most nonbanks covered by state law have a licensing and/or registration requirement. A license is a grant of privilege by the commissioner (or the commissioner’s agency) to conduct specific activity under the law. For example, a mortgage originator license allows a mortgage company to originate mortgage loans with consumers. Registration, in contrast, is a lesser undertaking than granting a license, and is essentially the capture or recording of information about an entity or person. For example, MSBs must be registered (identified) with the federal Financial Crimes Enforcement Network (FinCEN); however, that registration does not authorize or allow the MSB to conduct business with consumers. State law may require the issuance of a license, the recording or “registration” of information, or both.

Most often in the nonbank space, state regulators issue a license, which involves a process of submission of an application, with substantive background and financial information, review of the application and a decision by the commissioner or designee to approve and grant a license. The license will typically contain an expiration date by which the entity or person must reapply for or renew the license if they wish to continue in business.

- ✓ **Examination:** An examination of a nonbank entity is the review of books, records and other information to determine the entity’s financial condition or health, its adherence to safe and sound practices, and its compliance with law and regulation. Examinations are performed by financial examiners.
- ✓ **Investigation:** An investigation contains many of the same elements and authorities as an examination, but it is typically a review for the purposes of identifying violations for a possible enforcement action. Investigative authority may also utilize subpoenas or other law enforcement tools not available under examination authority. Frequently, an examination may be converted to an investigation when findings make it clear that laws have been violated. Upon conversion, the investigation becomes an endeavor to build evidence for the state’s case. The state agency may employ examiners, investigators or attorneys to conduct its investigations. The handling of consumer complaints is typically viewed as a subset of investigation authority, or often, simply an isolated investigation.
- ✓ **Enforcement:** An agency’s enforcement authority is limited to the powers granted to it by statute. Agencies cannot pursue matters that are outside the scope of the statute in an administrative proceeding, nor can they impose new procedures or penalties that the statute does not provide. They may, however, be able to pursue additional remedies by going outside of purely administrative procedures, such as by filing a civil lawsuit in a court of general jurisdiction. An agency can only do this, of course, if authorized to do so by statute

## WHAT HAPPENS WHEN A COMPANY OPERATES WITHOUT A LICENSE?

(<https://www.justia.com>). Although state nonbank regulators most often pursue enforcement through administrative authority, it is not uncommon for an agency to work in concert with the state attorney general or state prosecutor, local law enforcement (police or prosecutor), or federal law enforcement (e.g., Federal Bureau of Investigation (FBI), Inspector General, IRS or U.S. Department of Justice) in civil or criminal investigations and prosecutions. Alternatively, the state nonbank regulator may conduct its own investigation and subsequently make a referral to another agency for prosecution or further investigation.

In most situations, state regulators are considered the primary or prudential regulator of nonbanks. While the Consumer Financial Protection Bureau (CFPB) holds primary federal jurisdiction over nonbanks, the CFPB does not have licensing authority and at this writing has not exercised prudential authority over nonbanks. Licensing, or “gatekeeping” authority is fundamental to state supervision, and it is the foundation that allows nonbanks to conduct business in any state. In most cases, absent this license, a nonbank cannot conduct any business activity with consumers. The removal or suspension of a license by a state regulator causes immediate cessation of legally performed business in that state. This action does not absolutely ensure a cessation of business, but any such business will be in violation of state law and subject to further enforcement penalties including fines and possible criminal sentencing. [See side bar]

### Federal Supervision of Nonbanks

Federal supervision of nonbanks works in very much the same way as state authority, originating in federal law and interpreted through federal rule, crafted by the authorized agency. Federal regulators, with some exceptions, hold the same authority as state regulators to write rules, provide interpretations, examine, investigate, enforce and handle consumer complaints. However, there are differences between state and federal supervision.

While federal regulators are considered the primary determiner of federal law and regulation, they hold no authority to enforce state law or regulation (this is not to say that a federal agency could not make a

Unlicensed activity is one of the most serious offenses a nonbank may commit. As explained in the text, licensing involves a credentialing process by the state regulator designed to assure that the nonbank entity and its representatives have the capabilities and possess the character and fitness to command the confidence of the public they intend to serve. In other words, the “gatekeeping” function of licensing provides reasonable assurance that consumers will be protected through appropriate actions, professionalism and financial security.

Thus, holding the appropriate licensure before solicitation of any business is a fundamental responsibility of the nonbank. When a nonbank violates this responsibility, it and the public should expect an appropriate response from the regulator. Frequently this response will include an investigation into any alleged activity (including subpoena), an order to cease and desist, accompanied by restitution of any amounts already transacted, an appropriate penalty and investigation costs. The nonbank should also expect the investigating regulator to inform other regulators who have jurisdiction over the offender. The nonbank or offending individuals will typically have the opportunity to enter a settlement with the regulator(s), or request an administrative hearing to contest the action.

finding of unsafe or unsound operations if the agency detects apparent violations of state law or regulation). There are further important nuances between federal agency and state agency authority, approach and process. Some examples of these follow:

- The CFPB and FinCEN hold the authority to register, but not license entities. For example, FinCEN is responsible for the registration of MSBs with the Department of Treasury. This registration captures limited information about the MSB, but there is no application or approval process involved.
- Although FinCEN has examination authority over MSBs, it currently delegates this authority to the IRS, and the Federal Trade Commission (FTC) has authority to investigate, but not examine.
- Both the CFPB and the FTC maintain complaint databases, but for most complaints neither agency directly investigates individual complaint matters, and FinCEN holds no authority to handle consumer complaints.

## The Regulators

### State Agencies

There are over 100 state agencies with some jurisdiction over nonbanks. These agencies include banking departments, consumer finance departments, consumer protection departments, licensing departments, securities departments, secretaries of state, attorneys general and others. Some of these agencies may have jurisdiction over a single company type or share jurisdiction with another agency over specific nonbanks. The majority of nonbank jurisdiction falls under banking departments, or “umbrella” agencies containing banking and nonbanking departments under a single commissioner.

The state system of supervision can be a complex landscape for those not intimately engaged with this network of agencies, jurisdictions and supervisory authorities. State bank and nonbank agencies may have similar or vastly different naming conventions and responsibilities. At the simplest end of the spectrum are the banking departments (standalone agencies) or banking divisions (subsidiary to higher level agency) that are granted authority to supervise nonbanks in addition to their primary supervisory responsibility over banks. But not every banking department holds authority to supervise all, or in some states any, nonbanks. The following table provides examples of banking departments/divisions and their authority to supervise nonbanks.

Authority	TX Dep of Banking	CT Dep of Banking	WA Div of Banking	MA Div of Banking
Banks	X	X	X	X
MSBs	X	X		X
Mortgage		X		X
Consumer Finance		X		X
Debt Collectors		X		X

*[Note: This table is an example of possible jurisdictions at the time of this writing and does not include all possible jurisdictional coverage by the example regulators.]*

Notice two of the agencies above are departments, and two are divisions. All have bank supervision authority, but only two also supervise all the nonbanks listed. In Texas, supervision of mortgage falls

under the Texas Department of Savings and Mortgage Lending (a separate agency from banking with a different commissioner), and in Washington an “umbrella” agency known as the Department of Financial Institutions contains both the Division of Banks and a nonbank division known as the Division of Consumer Services with authority for MSBs, mortgage, consumer finance and other nonbanks.

## Federal Agencies

At the federal level, authority to supervise nonbanks has been largely consolidated into the CFPB’s oversight responsibilities. While there are other agencies with “pieces” of nonbank supervision at the federal level, the CFPB is considered the primary federal agency with jurisdiction and responsibility for nonbanks. However, before turning to the CFPB, it is relevant to identify some of these other agencies.

Note that the Federal Trade Commission (FTC), included under federal law enforcement below, could also be included in this section due to their authority to write regulation. Also, FinCEN is very closely aligned with law enforcement, but is included here due to their “regulator like” authorities and responsibilities.

### Financial Crimes Enforcement Network

The mission of FinCEN is to safeguard the financial system from illicit use, combat money laundering, and promote national security through the strategic use of financial authorities and the collection, analysis, and dissemination of financial intelligence. [see [FinCEN.gov](http://FinCEN.gov)]

Title 31 U.S.C. 310 establishes FinCEN as a bureau within the Treasury Department and describes FinCEN's duties and powers to include:

- Maintaining a government-wide data access service with a range of financial transactions information
- Analyzing and disseminating information in support of law enforcement investigatory professionals at the Federal, State, Local, and International levels
- Determining emerging trends and methods in money laundering and other financial crimes
- Serving as the financial intelligence unit of the United States
- Carrying out other delegated regulatory responsibilities

Certain authorities are delegated to FinCEN pursuant to TREASURY ORDER 180-01. This order describes FinCEN's responsibilities to implement, administer, and enforce compliance with the authorities contained in what is commonly known as the "Bank Secrecy Act." [See sidebar]

## BANK SECRECY ACT

The Currency and Foreign Transactions Reporting Act of 1970, commonly referred to as the "Bank Secrecy Act" or "BSA," requires U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering. The act requires financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding \$10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion or other criminal activities. The BSA is sometimes referred to as an "anti-money laundering" law ("AML") or jointly as "BSA/AML." Several AML acts, including provisions in Title III of the USA PATRIOT Act of 2001, have been enacted up to the present to amend the BSA. (See 31 USC 5311-5330 and 31 CFR Chapter X [formerly 31 CFR Part 103] ).

While state regulators view FinCEN as more of an arm to federal law enforcement than a regulatory body, FinCEN does have authority to promulgate regulations and set forth requirements such as registration for nonbanks. For the nonbank marketplace, this authority extends to MSBs, mortgage companies, consumer finance companies and others. Additionally, FinCEN holds the authority to examine and investigate certain nonbanks; however, at this time, the agency has primarily designated this responsibility to the IRS.

Regardless of supervisory authority, the state system of supervision has a longstanding, close working relationship with FinCEN and frequently shares information and collaborates on policy related to BSA and anti-money laundering issues. Further, the Money Remittances Improvement Act of 2014, 31 U.S. Code § 5318, authorizes the Treasury Department, and therefore FinCEN, to rely on state examination of remittance providers.

#### Federal Housing Finance Agency

The Federal Housing Finance Agency (FHFA) is focused on housing finance, primarily related to the mortgage secondary marketplace. The agency's stated mission is to ensure that the regulated entities operate in a safe and sound manner so that they serve as a reliable source of liquidity and funding for housing finance and community investment.

The FHFA is responsible for the effective supervision, regulation, and housing mission oversight of Fannie Mae, Freddie Mac, the 11 Federal Home Loan Banks (FHLBanks) and the Office of Finance together the "regulated entities." FHFA's mission is to ensure these regulated entities operate in a safe and sound manner so that they serve as a reliable source of liquidity and funding for housing finance and community investment. Since 2008, FHFA has also served as conservator of Fannie Mae and Freddie Mac. FHFA conducts annual on-site examinations and ongoing supervision of each regulated entity to identify existing and emerging risks, evaluate the overall effectiveness of each entity's risk management systems and controls, and assess compliance with laws and regulations. [See FHFA.gov]

So, while FHFA does not supervise the nonbank mortgage institutions supervised by the state system, the agency oversees the institutions that make a large part of the nonbank marketplace possible. State regulators have shared limited amounts of information with FHFA in the past, but currently have no formal supervisory sharing agreements in place.<sup>7</sup>

#### Federal Reserve System

The Dodd-Frank Act assigned the Federal Reserve the authority and responsibility to supervise and regulate certain nonbank financial companies that the FSOC has determined should be subject to Board supervision and prudential standards pursuant to section 113 of that act. These firms—whose failure could pose a threat to U.S. financial stability—are subject to comprehensive, consolidated supervision and regulation by the Federal Reserve. This provision of the Dodd-Frank Act addresses an important regulatory gap that existed before the 2007–09 financial crisis. Because the material distress or failure of a nonbank financial institution supervised by the Federal Reserve can have an outsized effect on the financial sector and the real economy, the Dodd-Frank Act requires the Federal Reserve to reduce the probability of such events through prudential standards for nonbank financial institutions designated by

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<sup>7</sup> FHFA does have a business-to-business data format subscription service with NMLS that gives the agency access to licensing information.

the FSOC. To date, FSOC has made no such designations.[See [https://www.federalreserve.gov/aboutthefed/files/pf\\_5.pdf](https://www.federalreserve.gov/aboutthefed/files/pf_5.pdf)]

#### U.S. Department of Housing and Urban Development

U.S. Department of Housing and Urban Development (HUD) is a large federal agency with a wide array of responsibilities. HUD's Office of Housing plays a vital role for the nation's homebuyers, homeowners, renters, and communities through its nationally administered programs. It includes FHA, the largest mortgage insurer in the world.

Prior to the Dodd-Frank Act and the creation of the CFPB, state regulators worked closely with HUD in enforcing both the Real Estate Settlement Procedures Act (RESPA) and the Secure and Fair Enforcement for Mortgage Licensing Act of 2008<sup>8</sup> (the SAFE Act). Responsibility for both laws was transferred to the CFPB and today, state regulators primarily engage HUD on issues related to FHA lending programs. [See <https://www.hud.gov/>]

#### Government National Mortgage Association, or Ginnie Mae

Ginnie Mae is a self-financing, wholly owned U.S. government corporation within HUD. Ginnie Mae is the primary financing mechanism for all government-insured or government-guaranteed mortgage loans. These loans are insured or guaranteed by the FHA, the HUD, Office of Public and Indian Housing, the U.S. Department of Veterans Affairs' Home Loan Program for Veterans, the U.S. Department of Agriculture's Rural Development Housing, and Community Facilities Programs and Rural Development Guaranteed Rural Rental Housing Program. While Ginnie Mae is not considered a regulator, it does have supervisory authority over lenders and servicers participating in these federal lending programs.

A recent rise in the market share of Ginnie Mae lending by nonbanks (currently at approximately 90% of the market) has created a growing relationship with the state system through CSBS.

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<sup>8</sup> See 12 U.S.C. Sec. 5101–5116, Title V of the Housing and Economic Recovery Act of 2008 (Pub. L. 110–289, 122 Stat. 2654, 12 U.S.C. 5101 et seq.) as amended by Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) (Pub. L. No. 111–203, 124 Stat. 1376).

## TITLE “X” (TEN)

The Dodd-Frank Wall Street Reform and Consumer Financial Protection Act of 2010 (Dodd-Frank Act) was signed into law on July 21, 2010. Among other important changes to regulation and supervision of the financial marketplace, Title X of the Dodd-Frank Act established the Bureau to regulate the offering and provision of consumer financial products or services under 18 of the existing federal consumer financial laws. Section 1042 of the Dodd-Frank Act, 12 U.S.C. 5552, governs the enforcement powers of the states under the Dodd-Frank Act. Under section 1042(a), a state attorney general or regulator (state official) may bring an action to enforce Title X of the Dodd-Frank Act and regulations issued thereunder. Prior to initiating any such action, the state official is required to provide notice of the action to the Bureau and the prudential regulator, if any, pursuant to section 1042(b) of the Dodd-Frank Act. Section 1042(b) further authorizes the Bureau to intervene in the state official’s action as a party, remove the action to a federal district court, and appeal any order or judgment.

has not invoked to date

- Reviewing nonbanks for financial condition or safe and sound practices
- Finding violations in individual consumer complaints and resolving complained about matters.

### Consumer Financial Protection Bureau

The CFPB was created under Title X of the Dodd-Frank Act to provide a single point of accountability for enforcing federal consumer financial laws and protecting consumers in the financial marketplace. Previously, that responsibility was divided among several federal agencies, including the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision, which was merged with the OCC in 2011, the FTC, HUD and others. Today, the bulk of consumer protection supervision for banks and nonbanks lies primarily with the CFPB. [see <https://www.consumerfinance.gov/>]

The CFPB identifies its work as including:

- Rooting out unfair, deceptive, or abusive acts or practices by writing rules, supervising companies, and enforcing the law
- Enforcing laws that outlaw discrimination in consumer finance
- Taking consumer complaints
- Enhancing financial education
- Researching the consumer experience of using financial products
- Monitoring financial markets for new risks to consumers

More specifically, the CFPB plays much of the same role with nonbanks at the federal level that the state regulators do at the state level. As a supervisor, the CFPB promulgates and interprets rules, conducts examinations, investigations and enforcement actions for compliance with certain consumer financial laws, and accepts consumer complaints.

Substantive differences from state regulators exist as follows:

- While state regulators may review and enforce for federal consumer finance law under Title X, the CFPB cannot do so for state law
- The CFPB does not license nonbanks, although the agency has authority under Title X to establish systems of registration for certain nonbanks; an authority the agency

Congress mandated that the CFPB coordinate and consult with state regulators in Title X of the Dodd-Frank Act.

- **Section 1015 Coordination:** requires the CFPB to coordinate with state regulators “as appropriate, to promote consistent regulatory treatment of consumer financial and investment products and services.”
- **Section 1024(b)(3) Supervision of Nondepository Covered Persons:** “To minimize regulatory burden, the Bureau shall coordinate its supervisory activities with the supervisory activities conducted by prudential regulators and the State bank regulatory authorities, including establishing their respective schedules for examining persons described in subsection (a)(1) and requirements regarding reports to be submitted by such persons.”
- **Section 1024(b)(7)(D) Registration, Recordkeeping and Other Requirements for Certain Persons – Consultation with State Agencies:** “In developing and implementing requirements under this paragraph, the Bureau shall consult with State agencies regarding requirements or systems (including coordinated or combined systems for registration), where appropriate.”

The CFPB agency head is called the director, a position appointed by the U.S. President and confirmed by the U.S. Senate. A Deputy Director sits immediately below the Director and is also an appointed and confirmed position. The CFPB is divided into the Office of the Director and six divisions. Each of these two main areas have multiple sub-offices that perform the work of the agency. The Division of Supervision and Enforcement and the Office of Consumer Response (complaints) work most closely with the state system. [see Coordinated Supervision]

### Attorneys General as Supervisors or Regulators?

Typically, the state attorney general and staff do not perform supervisory or regulatory functions. Their role is to enforce laws, either on behalf of a regulatory agency, or where a law has no identified agency enforcement office. For example, a state may have a law addressing Unfair and Deceptive Acts or Practices (UDAP), but no specific regulatory agency is provided with authority to enforce the statute because it applies very broadly across all industries and individuals operating in the state. Therefore, the state attorney general will hold the enforcement authority.

However, in a small number of states, the attorney general is granted authority by the legislature to “be” the regulator or supervisor for a specific industry. Examples of these are the South Carolina Attorney General, who holds authority over money transmitters, and the Colorado Attorney General, who holds authority over payday lenders and certain mortgage originators. In these limited situations, the attorney general is the regulator equivalent of a bank or nonbank agency, and state regulators enter into information sharing and coordination arrangements with that specific attorney general.

In addition to these special attorney general offices, state nonbank supervisors have a long history of working closely with attorneys general, typically their offices of consumer protection. Through these relationships the regulators and attorneys general share information and investigation resources and bring coordinated enforcement actions against nonbanks under both regulator and attorney general jurisdiction. Since the 1990s there have been several joint national enforcement cases resulting in billions of dollars of restitution to consumers.

## State Jurisdictional Coverage

As stated earlier, jurisdictional coverage (who the states have authority over) can be complicated and not all states have the same jurisdiction. In general, jurisdictional coverage for the primary areas of nonbank supervision can be seen in the table below:

Area of Jurisdiction	Number of States*	Number of Agencies
Mortgage Origination	54	61
Mortgage Servicing	53	53
MSB	52	52
Consumer Finance	54	54
Payday Lending	33	33
Debt Collection	34	38

*\*Maximum number of states is 54 when including D.C., Guam, Puerto Rico and U.S. Virgin Islands.*

## Non-Regulator Influence on Compliance and Supervision

While the state system of supervision is the primary regulator(s) of nonbanks, other spheres of influence have significant impact on both industry compliance with laws and rules, and enforcement of that compliance.

### Law Enforcement

Law enforcement related to nonbanks exists at three levels: local, state and federal. State regulators may work closely with any of these three levels on a case by case basis. Further, law enforcement cases (criminal or civil) have an impact both directly and indirectly on industry compliance. For example, the FBI or the HUD Inspector General (IG) may investigate a case against an individual or company (e.g., mortgage originator) for DOJ criminal prosecution. This case will not only have a direct impact on the prosecuted, but an indirect impact or deterrent on the industry as knowledge of the case becomes public. Further, state regulators may take note of investigated matters, either through support to the law enforcement agency directly or through public knowledge of the case and add the investigated matter to a list of review items.

A description of some of the law enforcement agencies and how they may work with state regulators follows:

#### Local Law Enforcement

At the city and county level, police departments and sheriff offices may have white collar crime units responsible for investigating financial crimes. These crimes will most often be prosecuted at the county level. Especially in larger cities, it is not uncommon for state regulators to be enlisted to assist in investigative review and analysis, or to testify as expert witnesses in trial.

#### State Law Enforcement

At the state level there are police agencies and prosecutors with jurisdiction to investigate and prosecute financial crimes across the entire state. An example of police agencies at the state level is the

Georgia Bureau of Investigation (GBI). Prosecutors are typically the state prosecutor or the criminal division of the attorney general.

It was not uncommon during the financial crisis for nonbank examiners or investigators to work directly with state law enforcement. The Georgia Department of Banking and Finance was known particularly during this period to be working closely with the GBI and others on mortgage fraud cases. In the 10 years from 2005 – 2014, the department made 158 mortgage fraud referrals to law enforcement and other regulatory agencies totaling more than \$217 million.

#### Federal Law Enforcement

Several law enforcement agencies at the federal level either work with or impact the work of state nonbank regulators. Some of these federal agencies include:

#### Federal Trade Commission

The FTC protects consumers by addressing unfair, deceptive or fraudulent practices in the marketplace. The FTC investigates, sues companies and people that violate the law, develops rules, and educates consumers and businesses about their rights and responsibilities. The FTC also collects complaints about hundreds of issues from data security and deceptive advertising to identity theft and Do Not Call violations and makes them available to law enforcement agencies and regulators worldwide for follow-up.

The FTC's investigative authority is found in the FTC Act and extends to all nonbanks but not banks and other depositories. The basic consumer protection statute enforced by the Commission is Section 5(a) of the FTC Act, which provides that "unfair or deceptive acts or practices in or affecting commerce...are...declared unlawful." "Unfair" practices are defined as those that "cause [] or [are] likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition." In addition, the Commission enforces a variety of specific consumer protection statutes (e.g., the Equal Credit Opportunity Act, Truth-in-Lending Act, Fair Credit Reporting Act, and others).

The Commission enforces the substantive requirements of consumer protection law through both administrative and judicial processes. While collaboration between state regulators and the FTC has been somewhat infrequent in recent years, information sharing, and enforcement cooperation does occur and was more pronounced during times of rampant predatory lending. (Federal Trade Commission, n.d.)

#### Federal Bureau of Investigation

The FBI is responsible for investigating white-collar crime and cybercrime at the federal level. Reportedly coined in 1939, the term white-collar crime is now synonymous with the full range of frauds committed by business and government professionals. These crimes are characterized by deceit, concealment, or violation of trust and are not dependent on the application or threat of physical force or violence. The motivation behind these crimes is financial—to obtain or avoid losing money, property, or services or to secure a personal or business advantage.

These are not victimless crimes. A single scam can destroy a company, devastate families by wiping out their life savings or cost investors billions of dollars (or even all three). Today's fraud schemes are more sophisticated than ever, and the FBI generally focuses on complex investigations.

FBI special agents work closely with partner law enforcement and regulatory agencies such as the Securities and Exchange Commission, the Internal Revenue Service, the U.S. Postal Inspection Service, the Commodity Futures Trading Commission, FinCEN, state bank and nonbank regulators, and others, targeting sophisticated, multi-layered fraud cases that harm the economy. Throughout the 1990s and 2000s, state nonbank regulators frequently assisted the FBI in solving mortgage fraud and other financial crimes cases. (Federal Bureau of Investigation, n.d.)

Other federal law enforcement agencies that work with the state system of supervision are:

- HUD Office of Inspector General: One of the original 12 Inspectors General authorized under the Inspector General Act of 1978, the HUD OIG is focused on law enforcement issues related to HUD, including mortgage lending.
- U.S. Postal Inspector: Postal Inspectors enforce more than 200 federal laws in investigations of crimes that may adversely affect or fraudulently use the U.S. mail, the postal system or postal employees.
- The Office of the Special Inspector General for the Troubled Asset Relief Program: This is a federal law enforcement agency and an independent audit watchdog that targets financial institution crime and other fraud, waste, and abuse related to TARP.
- Department of Justice: The Attorney General, who is the head of the DOJ, is the chief law enforcement officer of the federal government.
- FHFA Office of Inspector General: This office promotes economy, efficiency, and effectiveness and protects FHFA and the entities it regulates against fraud, waste and abuse, contributing to the liquidity and stability of the nation's housing finance system.
- U.S. Secret Service: Created to investigate and prevent counterfeiting. Today the agency's investigative mission has evolved from enforcing counterfeiting laws to safeguarding the payment and financial systems of the United States from a wide range of financial and computer-based crimes.

## Civil Suits

The judiciary significantly influences the nonbank market and its regulation. In fact, the courts have played a central role in expanding nonbank access to funding from banks. For half a century, the Glass-Steagall Act prohibited commercial banks from engaging in investment bank practices, such as issuing securities. As investment banks began to fund nonbank mortgage activity and add private label securities to the secondary market, commercial banks responded through bank holding companies.

Through the 1980s, the Federal Reserve began approving bank holding companies' applications for acquisitions of securities firms and otherwise engaging in securitization activities. The Federal Reserve reasoned that as long as bank holding company subsidiaries are not "engaged principally" in securities

## WHO IS THE LENDER?

For years, civil suits have waged over which entity is the “true lender” in a consumer transaction. This is important because consumer protections provided in state law and the ability of states to enforce those protections hinge on who the courts determine was the actual lender. For example: Banks are exempt from state usury restrictions while nonbanks are subject to the restrictions unless they hold an exempt license. But not all states offer a license exemption, and so a company wishing to make loans at rates above the rate of usury may enter a relationship with a willing bank to act as a lending front for the nonbank. This type of arrangement is often referred to as “rent a bank” or “rent a charter.”

Consumers are afforded certain protections from nonbanks that might make the loan transaction illegal and unenforceable if the consumer can prove that the “true lender” is the nonbank rather than the bank. Such tests matter for nonbank supervisors too. A determination that the nonbank is the true lender triggers the state authority and ability to examine and/or take action for identified violations of law.

underwriting and dealing, such activities were permissible. After a civil suit was brought by the banks to expand securities abilities, the Second Circuit blessed the Federal Reserve’s decision<sup>9</sup>.

Throughout the 1980s, changes to the Federal Reserve’s Regulation Y (12 CFR Part 225 - Bank Holding Companies and Change in Bank Control) and subsequent civil suits continued to be decided in favor of securitization by banks. As a result, more players and more money flowed into the private label secondary mortgage market, a primary outlet for nonbank mortgage originators. These legal decisions opened the door to Wall Street funding beyond investment banks. After Glass-Steagall was repealed altogether by the Gramm-Leach Bliley Act in 1999, the floodgates opened for the private label market. To this day, excluding the secondary market, banks are the primary source of funds for nonbank lenders.

In more recent memory, a consumer’s lawsuit against a debt collector upended the relationship between nonbank debt collectors and the banks from which they buy debt. Madden v. Midland. Similarly, a consumer’s defeat in federal district court established a “true lender” test that will impact the amount of interest that can be charged by banks that sell loans to nonbanks. [see sidebar] Sawyer v. Bill Me Later. Most recently, a Florida court decided that virtual currency is subject to money transmission laws. None of these scenarios involved regulators, but nonetheless they influence both supervision and compliance.

### Media, Awareness Campaigns & Consumer Advocacy

Media campaigns are a tool of any resourceful group seeking to influence public opinion, policy and legislation in the broad arena of consumer financial services. On the industry side, trade groups and lobbyists have long played a role in crafting legislation and public messaging for their respective industries or clients. Local, state and national chapters of a variety of industry

groups are in active dialogue with legislators at all levels of government and often actively participate in drafting legislation. They also function as a media resource when questions arise around the business

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<sup>9</sup> The Board determined that a bank holding company subsidiary is not engaged principally in securities underwriting if no more than 5% to 10% of their total revenues was derived from securities activities over two-years, and the activities in connection with each type of bank-ineligible security did not constitute more than five to ten percent of the market for the particular security. Securities Industry Assoc. v. Board of Governors of Federal Reserve System, 839 F.2d 47, citing 73 Fed. Reserve Bull. at 482, (2d Circuit 1983).

conditions, companies and market practices of their member institutions. The Mortgage Bankers Association is an example of a trade association with a multi-faceted agenda that encompasses professional education, media savvy as well as active advocacy at all levels of government on behalf of its mortgage industry members.

Other stakeholders such as legal aid attorneys, consumer organizations and advocacy groups have historically turned to the media to publicize issues concerning seemingly arcane business practices or products while engaging in awareness and advocacy campaigns to achieve their goals. Long before issues surrounding predatory mortgage lending and payday lending gained frequent attention in the media, numerous consumer advocacy organizations had for years been working to introduce pro-consumer legislation and raise awareness of market practices involving these issues and products.

One example is the campaign around high-interest mortgage lending in the late 1980s and early 1990s, specifically involving the Fleet Financial Group subsidiary, Fleet Finance. Media stories, lawsuits and advocacy campaigns arose against Fleet describing practices of racial targeting for high-interest mortgages, equity stripping, repeated refinancing, imposition of excessive fees, and aggressive debt collection and foreclosure practices. This led to the introduction of the phrase “predatory lending” by journalists and advocates as shorthand to describe this collection of lending practices. These cases and stories were part of an active campaign by legal services and bankruptcy attorneys around the country, but especially in Georgia, as well as advocacy groups such as the Neighborhood Assistance Corporation of America, based in Boston, now well-known for their yellow “Stop the Loan Sharks” t-shirts that demonstration participants wear when conducting advocacy campaigns.<sup>10</sup>

These early campaigns not only raised awareness of such mortgage lending practices on a wide scale but also led to the 1994 passage of the Federal Home Ownership and Equity Protection Act of 1994 (HOEPA) that defined “high-cost loans” and sought to curb the abusive practices highlighted in the campaigns and cases against Fleet Finance. As an amendment to the Truth-in-Lending Act, this brought a new element to state-level examinations that piggyback on Federal laws and had the effect of “deputizing” state examiners on the front lines of enforcing anti-predatory lending laws.

## State & Federal Legislatures & Executive Branch

States have authority over financial services companies thanks to the police powers granted to states. Congress also has authority over financial services practices because of the authority to regulate interstate commerce. The result is a mix of law that is implemented through regulation and supervision. In banking, state and federal safety and soundness laws are often broad in order to permit regulators to

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<sup>10</sup> Canellos, Peter S., *Boston Globe*, October 5, 1992. “4 Class-Action Suits Hit Fleet’s Ga. Unit.”  
Vejnoska, Jill, *The Atlanta Journal and Constitution*, October 11, 1992. “The Loan Trap – lenders prey on unwary”.  
Hudson, Mike, *The Washington Monthly*, June 1992. “Stealing Home: How the government and big banks help second-mortgage companies prey on the poor”.  
Hudson, Mike, *Mother Jones*, July/August 1994. “Robbin the Hood: How Wall Street takes from the poor and gives to the rich.”

police the line between economic growth and risky practices. For example, while federal law requires banks to hold risk-based capital, the composition of risk-based assets is left to regulators, and ultimately, the Basel Capital Accords.

Conversely, state non-bank financial services laws are often prescriptive, such as minimum financial condition requirements, fees caps and required disclosure language. Since there is no federal backstop, state laws strike a clear line on what is permitted, making nonbank regulatory standards more black and white but less flexible in implementation.

## Preemption of State Law

Historically, preemption of state law has typically been seen as a means of raising low standards imposed by states. The first such case in Constitutional Law was *Gibbons v. Ogden*, where federal law preempted state-granted monopolies. In environmental law, states have historically been preempted where they fail to meet or enforce higher standards promulgated by Congress. Because of this historical context, states are often viewed as having lower standards than that of the federal government.

There is one area where the historical narrative reverses: financial services. Through the National Banking Act, Congress has delegated preemptory authority to the OCC. Rather than increasing consumer protection standards, the OCC has consistently worked to lower standards, primarily in the consumer protection space. State regulators have witnessed that OCC preemption determinations hurt consumers through the preemption of anti-predatory lending laws, adjustable rate mortgage restrictions, and state oversight of national bank operating subsidiaries. This consistent effort by the OCC to preempt state consumer protection laws created the legal foundation for the mortgage crisis and prevented states from having the opportunity to respond to lending practices that hurt consumers. Congress recognized this in the Dodd-Frank Act, repealing the OCC's preemption of state supervision of national bank operating subsidiaries, requiring the CFPB to determine whether OCC preemption determinations are tenable, and lowering the agency deference available to the OCC on preemption challenges.

## Financial Stability Oversight Council

The Financial Stability Oversight Council (FSOC) was established by the Dodd-Frank Act and is charged with three primary purposes:

1. To identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace.
2. To promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the U.S. government will shield them from losses in the event of failure.
3. To respond to emerging threats to the stability of the U.S. financial system.

FSOC has a clear statutory mandate that created for the first-time collective accountability for identifying risks and responding to emerging threats to financial stability. It is a collaborative body chaired by the Secretary of the Treasury that brings together the expertise of the federal financial regulators, an independent insurance expert appointed by the president and state regulators.

FSOC has important authorities to constrain excessive risk in the financial system. For instance, the council has the authority to designate a nonbank financial firm for tough new supervision to help minimize the risk of such a firm from threatening the stability of the financial system. However, at this time, it does not appear that any state supervised nonbanks, even the very largest nonbanks, rise to the systemically important level that would pose great risk to the financial system and warrant such a designation.

# State Supervision of the Nonbank Industry

## State Statutes and Rules

There are literally hundreds of state laws or rules that govern both the nonbank marketplace and supervision of the many industries that constitute the marketplace. While some of these laws and rules date back to the 1800s, the vast majority have been established since the 1980s as nonbanks became more and more prolific.

While many of these laws and rules are nearly the same from state to state, founded on the same consumer protection concerns regardless of state borders, many are also quite different. And some states have laws or types of laws with no counterpart in other states. For example, payday lending laws exist in only 33 states. Some of the states that do not have payday lending laws allow it, while some of the states that do not have laws prohibit, disallow or effectively prohibit payday lending. For example, in New York there is no law specific to payday; however, New York banking law (N.Y. Banking Law 340 et seq.) prohibits accepting a post-dated check. Massachusetts does not have a law addressing payday lending, but since payday loans will almost always exceed the state's lending or usury rate, payday loans are effectively banned. At the same time, Hawaii also does not have a law addressing payday lending, but in that state making payday loans is legal.

In other areas, laws may read exactly or very close to the same but are interpreted differently by the enforcing agency or state courts. This was the case with nonbank mortgage laws prior to 2008 and is the case with money transmitter laws today.

This type of inconsistency in state laws, rules and interpretations exists across all nonbank industry types and is not unique to the financial services industry. Historically it has been a point of frustration for industry and a source of criticism against the states. These differences or inconsistencies in state laws have been referred to as a patchwork quilt. But what to some may seem a weakness in the state system can at the same time be viewed as a strength.

## Current Approach: Pros and Cons

"Federalism is rooted in the belief that issues that are not national in scope or significant are most appropriately addressed by the level of government closest to the people."<sup>11</sup> As a result, our federalist system relies upon states as the "laboratories of democracy." As described by Justice Brandeis:

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<sup>11</sup> Executive Order 13132 (August 4, 1999).

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*It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.*

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The resulting differences between states underscore differences in markets, risk tolerances and willingness to try new things.

Differences between states have led to a plethora of financial innovations that are widely used today. From the checking account to virtual currency, the states are able to experiment with new requirements to see what works. States can do this because of their local presence – it takes years for issues to trickle up to the U.S. Congress, whereas state regulators and legislators have local knowledge of policies and their impacts on the state.

The local knowledge of the effect of financial services is one of the great strengths of state supervision. Consumer harm and market irregularities are difficult to recognize from Washington, D.C., but are obvious when you see them close, at the local level.

The benefits of a state authority quickly erode when:

- Differences between states are in form, not substance, and
- Differences between states are destructive to competition.

When two states have substantively similar requirements that are implemented differently, it is only natural to find the differences akin to busy work and not policy objectives. This is felt in financial services when businesses seek to operate across state lines, only to find a series of similar requirements that offer no greater consumer protection or market access, and this can result in claims that the patchwork quilt is burdensome and restrictive.

One of the greatest threats to state supervision of nonbanks is currently in the money transmission space. State requirements are generally similar: control persons must be investigated, companies must have surety bonds, meet minimum net worth requirements, hold customer funds in high quality liquid assets, and all these requirements are reviewed during exams. Despite the shared nature of these requirements, the implementation varies significantly. As a result, differences between states are rooted in implementation, not policy experiments.

But despite the patchwork nature of the quilt, it still provides an effective cover of supervision and consumer protection. And where the patches are stitched together by systems such as the Nationwide Multistate Licensing System (NMLS), the State Examination System (SES), and protocols for information sharing, coordinated examinations and enforcement actions, the quilt is very strong. There are tradeoffs

in the state system, that while not perfect, balance against each other and argue for this system, with all its imperfections, rather than available alternatives.

For example:

- While consumers may not have access to every product and every service provider, they are protected by state laws that are designed by legislators to be particular to their constituents' interests. A state addressing a problem or creating an opportunity, where another state is not, is likely doing so because the problem has been identified in one place but not necessarily another. These laws are folded into a system of regulation and supervision where consumers have direct access to their regulators, and individual complaints and concerns are investigated and resolved.
- Nonbank companies also have direct access to their legislators and regulator. Through this access they can request consideration and participate in the creation of regulations they will ultimately be subject to. While they may not be able to conduct business in the same manner in every state, they have the opportunity to have influence on the system that governs them. This is especially true for the tens of thousands of smaller companies operating in regionalized pockets of the country, but larger companies as well have the same access and ability to influence local government. While this may be a less convenient system for national level companies, under the state system smaller companies are not foreclosed from having a voice.

## Uniformity and Standardization

Uniformity and standardization do not mean all things must be the same in every state. States must retain their ability to respond to the needs of their community: ensuring that consumers are protected while at the same time fostering an environment conducive to commerce. Through systems such as the NMLS (see Nationwide Multistate Licensing System) and interstate agreements (see Multistate Supervision) the states achieve consistency in approach while preserving the unique fundamentals of the state system. Instead of eliminating the differences between states, commissioners work hard to harmonize those differences.

Below we discuss the fundamentals of supervision: licensing, reporting requirements, compliance and consumer protection, examinations, investigations and enforcement actions. When these fundamentals employ standardized approaches for addressing nuances in state law, that standardization creates harmonization and uniformity in the state system of supervision. For example:

- **Licensing:** States may require different bond or net worth amounts but utilize the same online application form through the NMLS. Thus, a company can apply for licenses in Nebraska, Kansas and Oklahoma on a single application form and assure the regulators in each of these states that it will maintain the appropriate bond and net worth amounts.
- **Reporting requirements:** Licensed companies report through the NMLS standardized information agreed to by the regulators that is captured simultaneously at the state and national level.

- **Compliance and consumer protection:** States have very similar, and in many cases the same requirements for disclosures to consumers and treatment of consumers. In mortgage transactions for example, complying with federal requirements typically satisfies compliance with most of the states' requirements.
- **Examinations, investigations and enforcement actions:** State examiners and investigators attend national level training schools with other state regulators where they learn the same examination processes and procedures and investigative techniques that foster uniform approaches to how a company is reviewed. These trainings make it possible for examiners to participate in multistate exams or investigations where they are looking for the same things and sharing their findings with each other. While enforcement must be handled pursuant to each state's independent legal authority, the actual documents are often drafted from standard templates that facilitate national level settlements. Often, a small group of enforcement attorneys from selected states will resolve a matter on behalf of all states. Such efficiency is made possible through uniformity in process and approach.

### Gatekeeping/Credentialing

One of the primary roles of the state nonbank regulator is as a gatekeeper, entrusted to protect the public from those who should not be allowed to conduct business with the state's consumers. They do this through review of applications and granting approval to conduct specific types of business in legally acceptable ways.

#### Chartering vs. Licensing vs. Registration

In state regulatory supervision, there are basically three types of gates: charters, licenses and registrations. Each of these are discussed more fully below:

Charter – Legally speaking, a charter is a grant of authority from an authority. State and federal financial regulators charter banks, credit unions, savings and loans, trust companies and other types of depository institutions. A bank charter allows a corporation to commence operation in the business of banking. With the exception of trust companies and very specific charters issued by the Comptroller of the Currency under the National Bank Act, nonbanks are not chartered.

License – According to Black's Law Dictionary, a license is permission, accorded by a competent authority, conferring the right to do some act which without such authorization would be illegal. In written words there may be very little difference between a charter and a license. But in regulatory practice, the differences are significant. A bank charter may allow a bank to conduct a multitude of business lines, whereas a license typically allows the nonbank to conduct a single type of business. Conceivably, a nonbank could conduct many, but not all the business lines a bank is authorized to conduct, but the nonbank would need several different licenses to do so.

Registration – Basically the recording or listing of information in a register. State laws may have a license AND registration requirement, likely a holdover term from the days when a paper license was issued, and the information was entered into an official register. Today, state agencies issue licenses electronically and the information is automatically captured into a system that performs as a register. However, registration alone is also an active part of allowing individuals or companies to conduct business. For example, the federal SAFE Act requires depositories to register their mortgage loan

originators in the NMLS and in fact, the NMLS is known in federal law as the Nationwide Mortgage Licensing System and “Registry”. Another example is FinCEN’s requirement under the BSA for all MSBs to register with the agency through the BSA E-Filing System.

In general, these three “gates” into a regulated environment can be thought of in terms of a hierarchy from charter down to licensing and then registration. With most charters, more information is required, and the scrutiny is greater than for licensing. But once granted a charter (at least a deposit charter), the business owner can do far more than can be done with a license. Likewise, applying for a license is a much greater undertaking than simply registering a business. This is because a license confers authority while a registration simply records the existence of an entity or person involved in a business line.

In nonbank supervision gatekeeping is conducted through the review of an application and the issuance of a license. Each state agency maintains a dedicated licensing staff responsible for this function. A decade ago, this was a labor-intensive process of paper submission, research and review, determination to approve, capture and recording of information, and issuing a license (printing and mailing certified documents). Each year at license renewal time, or when a company changed ownership, location, or added covered personnel, much of the process would repeat. For licenses requiring criminal background checks, that part of the process could take weeks.

Today, the NMLS converts this process from weeks to days. The NMLS (see below Nationwide Multistate Licensing System), is a licensing and records management tool for state nonbank regulators, where license requests for almost any nonbank are received, review and analysis conducted, information is registered and maintained, and licenses are issued electronically through the system.

## Monitoring through Industry Reporting

Gatekeeping extends beyond the licensure process through regular reporting. Much like banking, states require nonbanks to regularly submit information to regulators to monitor the condition, performance, and risk profile of individual institutions and the industry as a whole.

For all licensed companies, the minimum reporting requirement is annual license renewal. Through the renewal process, companies report updated licensing information, including credit reports, criminal background checks and financial disclosures. Importantly, companies must attest to the accuracy of renewals, ensuring the level of accountability necessary for consumer trust.

In addition to renewals, several nonbank industries must file a “call report.” A call report is an industry-specific list of data points companies must give to regulators on a regular basis. The term originated in banking, where banks would phone-in (“call”) their reports of condition to federal regulators. This term has carried over into nonbanks and is centralized through NMLS. [see NMLS Call Reports below]

The NMLS Call Reports are the only reports of their kind in the United States. The reports provide a wealth of detailed information states utilize to assess risk at both the industry and individual company level. Call report data give regulators the tools needed to target industries, companies and products based on risk, leading to a more efficient and safer nonbank industry.

## Compliance

Nonbanks are responsible for complying with state and federal law and rule, as well as official interpretations of those laws and rules. For regulators in the state nonbank system, the term “compliance” means the part of supervision responsible for determining that a company has adhered to the requirements found in law and rule.

A major compliance requirement found in every state law for every state licensed nonbank is “consumer disclosure.” Disclosure is the action of making unknown information known. In a loan transaction, a consumer has the right by law to know very specific things that are known to the lender (e.g., how much they are borrowing, the rate and fees to be charged, the terms of repayment, etc.). Likewise, in money transmission or debt collection the consumer has the right to know the actions taken by the nonbank that will have an effect on them (e.g., how will their money be handled, or what a debt collector is allowed to do when attempting collection). These things are “told” to the consumer through disclosures.

Disclosure requirements are very specific. Disclosures must look certain ways, contain certain information and be given at certain points in time. The nonbank retains documentation or evidence that they have handled the disclosure responsibility as required. Examiners then review this documentation testing for compliance.

## Financial Condition

When financial services companies operate without deposit insurance, sound financial health becomes an important aspect of consumer protection. Consumers put their trust – and their money – in nonbank financial institutions, and state regulators are charged with making sure neither disappear. When a consumer gives \$350 to a money transmitter, the states enforce laws that ensure the money is there tomorrow. In the period between mortgage approval and closing, the states enforce laws that ensure the company will not close and leave a prospective homeowner in the lurch. And if something does happen to the company, the states are there to ensure consumers have recourse.

State regulators have two primary tools to ensure sound financial condition. First, most states have established a minimum net worth requirement as part of the gatekeeping role. This requirement ensures that a prospective licensee has “skin in the game” and the minimum requisite amount of money to operate a financial services business. Second, states require financial services companies to post bonds with the state to protect consumers from losses borne out of failure or misappropriation. When all goes wrong, bonds provide the cushion needed to make consumers whole.

In addition to net worth and bonding, states have general financial safety and soundness requirements. Typically, these requirements are specific to an industry and institution, representing the typical bounds of sound financial practices. Much like in banking, these requirements are based on a broad statutory requirement to protect the public interest. In implementation, financial condition is closely related to that of banking: capital, asset quality, earnings, liquidity and sensitivity to market risk. Nonbanks must have sufficient capital to absorb losses, assets strong enough to support their business, profits sufficient

to ensure ongoing operations, funds liquidity appropriate for the ebb and flow of cash demands and a financial position not subject to substantial swings based on market changes or unexpected events. Among other measurements, states look to the following ratios to ensure financial safety and soundness:

- Operating margin
- Net margin
- Return on average assets
- Return on average equity
- Current ratio
- Working capital
- Debt to assets
- Equity to Total Assets

Appropriate levels of these ratios depend on the industry and institution. For example, liquidity is a paramount concern in money services businesses and mortgage servicing because of the cash-intensive nature of these business models. Liquidity is important for mortgage origination, but margins are paramount for mortgage companies because they must have sufficient capital to weather downturns in the real estate market.

Often overlooked in nonbanks, a strong financial condition is the backbone of any successful financial services market. The lack of deposit insurance has created specialized financial safety and soundness regimes designed to protect consumer funds, which has ensured a safe and vibrant nonbank market across the United States.

## Consumer Protection

Consumer protection can be thought of as ensuring no consumer harm through negligence, lack of oversight or intentional acts. Consumer protection language in state or federal law can be both generally broad and very specific. For example, the prohibited practices sections of a state law might state:

*It is a violation of this chapter for any person subject to this chapter to:*

- (1) Directly or indirectly employ any scheme, device, or artifice to defraud or mislead any person;*
- (2) Directly or indirectly engage in any unfair or deceptive practice toward any person;*
- (3) Directly or indirectly obtain property by fraud or misrepresentation;*
- (4) Fail to make disclosures as required by this law or federal law, or rules thereunder;*
- (5) Advertise any rate of interest without conspicuously disclosing the annual percentage rate implied by such rate of interest.*

The first three elements of this example section of law are generally broad. The nonbank cannot do certain types of things that would lead a person to be deceived or harmed. Elements 4 and 5 are much more specific: make disclosures as dictated elsewhere in the law and include something very specific when advertising. Consumer protection sections of state laws are crafted to cover both known

situations (“consumers need to know this so give them this”) and unknown situations (“people can be harmed by different kinds of bad acts ... don’t do any of them”).

Often, consumer protection or prohibited practices sections of state regulator enforced laws mirror state Unfair or Deceptive Acts or Practices (UDAP) laws (enforced by state attorneys general). In fact, violations of the prohibited practices sections of financial laws may be considered “automatic” violations of state UDAP laws and can even be subject to dual penalties under both laws. As such, the attorneys general and state regulators commonly join forces on matters that could be handled under either or both law sections.

The consumer protection role of the state system is to ensure that business practices do not result in consumer harm through negligence, non-compliant business practices or products, or intentional acts intended to enrich the nonbank to the consumer’s harm. Consumer protection violations are most often identified through routine examinations, investigations or the review of consumer complaints.

## Examination

Examination authority, granted through state law, is a key component to the states’ individual supervision programs. Conducting examinations of licensed companies allows state regulators to monitor the financial services and products offered to consumers in their respective states. It also gives regulators the opportunity to determine whether a company is operating in a safe and sound manner. The states commit a large portion of their resources to completing examinations, which generally take place on a continuing basis throughout the year.

From a state regulator’s perspective, the examination process typically includes the following components:

- ✓ Identify the Scope of the Review
- ✓ Prepare and Send Information Request to the Company
- ✓ Review of Company Documentation
- ✓ Document Analysis and Findings
- ✓ Prepare and Issue Final Report to the Company
- ✓ Determine the Outcome of the Review (Close or Move to Investigation/Enforcement)

These examination components align with what a traditional audit may look like for a company with one significant exception – the regulator determines the outcome or next steps for the company. The regulator may choose to simply close the examination with no further actions or may choose to take further action based on the findings of the review (i.e., conduct an investigation or pursue enforcement for documented violations).

However, before any examinations take place, the state’s first step in executing an examination program is setting the examination schedule, which is done by identifying companies to be examined and when the examination will take place. Generally, there are two different methods the states use to set an examination schedule: the cycle-based approach and the risk-based approach.

Cycle-based scheduling relies on specific dates related to a company to determine the date of their next examination. The specific dates considered in a cycle-based scheduling approach include: the original issue date of the license and the date of the last examination. Both dates are important for different reasons. The original issue date of the license impacts the decision of when to schedule the licensee's first examination. Some states are required by law to conduct an examination of their licensees within a certain time period of issuing the original license (e.g., 18 months), while other states follow a similar approach based on internal policy and best practices. Regardless of whether this policy is a requirement or a best practice, it allows regulators to establish a working relationship with a newly licensed company, with the intention of setting a successful path for financial condition, compliance and consumer protection.

The date on which a company was last examined also plays a significant role in the cycle-based scheduling approach; several states have a statutory requirement to examine all their licensees at least once within a specified time period, which is typically set at 36 or 60 months. For states with this requirement, the date of the last examination informs the agency as to when the next examination should take place for the company. However, as with the setting of the first examination, many states follow best practices in establishing an appropriate cycle of examination. For smaller state agencies, who may license thousands of nonbank companies, this can be a difficult requirement to meet.

States using the risk-based scheduling approach rely on company report data, complaints, information collected from other regulators and public records to make scheduling decisions. With this approach states prioritize their time and resources on the companies believed to pose the highest risk. Current data sources like the NMLS provide a rich and uniform dataset for regulators to leverage when scheduling and scoping their examinations.

### Components of an Examination

At the outset of an examination, state regulators will determine the scope of their review, which includes the operations and areas within the company to be evaluated. Full scope examinations generally include a review of all the activities taking place at a company, ranging from management decisions to individual consumer transactions. The scope of an examination is a contributing factor to the decision of how much resources (i.e., examiner time) an agency needs to commit to the job in order to complete the examination successfully.

The scope also drives other steps within the overall examination workflow. For example, when an examiner includes a review of the company's financial condition as part of the examination scope, then

## STATE REGULATOR ACCREDITATION

CSBS Accreditation involves an in-depth review of an agency's policies, procedures, and operations to determine if it meets the standards set forth by the CSBS Performance Standards Committee .

### Benefits of Accreditation

1. Obtain **guidance** and **assistance** through self-evaluation and self-improvement
2. Help **standardize** processes through documentation
3. Demonstrate the agency **meets the standards** for state supervision
4. **Share ideas** and **best practices** for state regulation of financial services
5. **Strengthen** state regulation by meeting a shared set of principles

the examination team will request the appropriate documentation from the company to complete that review, add conclusions to the report of examination and potentially rate the company's performance in this area. The examination scope brings into focus the amount of work that needs to be completed during the examination and gives insight into the topics that will be addressed in the report of examination.

When the scope is established the examination is set into motion. A formal information request is provided to the company to obtain the documentation and information needed to complete the review outlined in the scope. State regulators generally have full access to all licensees' books and records through authority granted by state statute. Failure to comply with a books and records request from a state regulator could have serious consequences for a licensee.

The review of company documentation is the most time-consuming, document intensive step within the examination process. The nonbank financial services industry is closely supervised, and with this supervision comes the need to document and disclose a significant amount of information about the activities being conducted. Licensees are required by law to maintain this documentation and make it available upon request to examiners.

Examiners leverage examination procedures and processes established by their state agency or by associations of state regulators established to support state agencies. These procedures act as a review guide for the examiners. In many states examination manuals and procedures are publicly available to provide transparency in the supervision process and to foster understanding of the regulator's expectations of industry. Nonbanks availing themselves of these materials either before an examination or on an ongoing basis are likely to find the supervisory process less daunting.

When the review is complete the results and analysis are documented in a report of examination, and in most cases are shared with the company. The results documented in the report can include citations of law for alleged violations, findings, recommendations and observations. If the report warrants a response from the company the states will require a formal written response within 30 to 60 days. To ensure that companies take the necessary steps to remediate the violations and findings identified during the examination, an examiner may choose to label said violations as Matters Requiring Attention (MRA).

Using this designation on a specific violation cited within the report elevates the significance of the issue. The MRA label usually comes with additional guidance from the regulator as to how the company should address the violation at hand. If a regulator labels a violation as an MRA within the report, it is safe to assume that the violation has not been sufficiently remediated by the company by the time the report is issued. It is important to note that not all MRAs are created equal. Some may require company management-level attention or in some cases board-level attention, where appropriate.

Once the company's entire response to the report is received and reviewed by the regulator, there are multiple options for the regulator to choose as a next step. These options include the following:

- Close the examination with no further action;
- Open an investigation to pursue issues identified in the report;
- Refer issues identified during the examination to other law enforcement agencies with jurisdiction over the matter; or

- Move the examination directly to enforcement proceedings.

The majority of examinations are simply closed with no further action taken by the regulator. In instances where significant violations were identified during the review, the examination team will refer the examination, or case, to the legal staff within the agency to address violations through a formal enforcement process (see Enforcement below). In the context of enforcement, the term ‘significant violations’ refers to violations that negatively impact consumers or the safety and soundness of the company. There are also instances where an examination team may refer the findings of an examination to a law enforcement agency. For example, if fraud is uncovered during an examination, a state agency will refer the case to the state police, FBI or any other law enforcement agency with authority over criminal statutes in that given state.

Examinations can vary widely in terms of the length, depth of review (i.e., scope) and outcome, but the steps examiners take to complete an examination are generally consistent, regardless of the type of nonbank. Examinations, by nature, are document-heavy and time-consuming for both the regulators and the companies. Given these facts, examination is an area within supervision that can benefit greatly from the use of technology, discussed later in this chapter (see RegTech).

The state system is in the process of developing a national examination system known as the State Examination System or SES (see State Examination System below), that will process and track state nonbank examinations. At this time informal assessments of the number of state examinations place the count as high as 30,000 examinations per year.

## Investigation

An investigation by a state supervisor is a process of careful examination or scrutiny to determine the truth of a matter. Investigations are sometimes thought of in two categories of authority: criminal investigation authority and administrative investigation authority. Defined simply, criminal investigations are conducted by “certified law enforcement officers” and administrative investigations are conducted by regulators with different authority. The primary difference between these two authorities are that criminal investigators have the ability to obtain search and arrest warrants and to execute those warrants. But both investigations are serious matters, and there are powers and authorities granted in regulator investigations that are not available to law enforcement (e.g., broad “books and records” authority that allow regulators to look at virtually anything produced or held by the regulated entity, the authority to charge the nonbank for investigation time and the ability to issue administrative subpoenas under the commissioner’s delegated authority).

To the nonbank, an investigation may not look much different than an examination. In fact, a regulator may use examiners as investigators and may not inform the entity that it is under formal investigation. Often an examination uncovers facts that cause the state agency to convert the matter to an investigation; however, this may only be noted internally by the state agency until such time as it is practical to inform the subject.

One indication that an investigation has begun is the issuance of an administrative subpoena. However, a subpoena is not always necessary, and some state agencies may rely on their broad examination authority to conduct the investigation.

Regulatory investigators are often examiners who have been provided additional training. It is common for examiners and investigators to attend trainings by or alongside law enforcement investigators (e.g., FBI, Secret Service, IRS, OIG, or state or local police). While the authorities may be different, the methods, techniques and skillsets are generally the same.

Investigations can be triggered by a variety of events or circumstances. These include examination findings, consumer complaints, tips from third parties or company insiders, or referrals from other regulators inside or outside of the state. An investigation does not mean that a company has committed a violation or done something wrong. It is a fact-finding endeavor that may or may not result in evidence that leads to a finding of violation. When an investigation results in insufficient evidence, the matter may be closed formally or informally, sometimes with the subject of the investigation never knowing that the investigation occurred.

Depending on the findings of the investigation it may be handled as an administrative enforcement action (see Enforcement below) or be referred to another regulator or law enforcement agency to pursue. When referred to law enforcement, the regulator investigator or examiner may become an “expert witness” for a prosecutor’s case. Such situations require the regulator to have additional knowledge of records custody and authentication and effective testifying skills in order to assist in a successful prosecution.

## Complaint Resolution

Managing consumer complaints is a supervisory responsibility of the states and is the primary means by which state financial regulators interface directly with the public. This area of supervision is somewhat unique in that there are three primary stakeholders, as opposed to two. These stakeholders include:

- *Consumers* who feel they’ve been harmed or treated unfairly;
- *Regulators* who are charged with protecting the citizens of their state;
- *Companies/Individuals* who are the subject of a complaint.

As mentioned earlier in this chapter, the handling of consumer complaints is typically viewed as a subset of investigation authority and is considered an isolated investigation. State agencies receive consumer complaints in a variety of ways such as by mail, email and telephone calls, but the most common is through an in-take form on the agency’s website. Once a complaint is received, the agency will kick off a short evaluation process to determine the following:

- Does the agency have jurisdiction over the complaint?
- What additional information does the agency need to investigate the complaint?
- If the agency has jurisdiction, was the consumer harmed?
- If the agency has jurisdiction, is it possible a violation of state or federal law occurred?
- What is the consumer’s desired outcome based on the complaint they submitted?

- What corrective action if any should the nonbank undertake?

Conducting this evaluation helps the agency determine the best course to a desirable resolution for the consumer, which is ultimately the goal in managing complaints. From a state regulator's perspective, the complaint management process (for complaints within their jurisdiction) typically includes the following steps:

- ✓ In-take and document the complaint;
- ✓ Evaluate the complaint to determine which agency has jurisdiction and for potential violations;
- ✓ Acknowledge receipt of the complaint to the consumer and company/individual as necessary;
- ✓ Conduct research on the complaint, obtain additional information and document interactions with all parties related to the matter;
- ✓ Pursue a resolution to the complaint that ensures the consumer's rights and protects their interests; and
- ✓ Close the complaint record and document the result. (Note: Reasons for closure typically include closed with explanation, closed with monetary relief, closed with non-monetary relief, duplicate complaint, invalid complaint, referred to further investigation or enforcement, and referred to another agency.)

It should be noted that not all complaints received by a state agency are processed by the receiving agency. In some cases, state agencies refer consumer complaints to other state or federal agencies which they believe have jurisdiction over the complaint. Regardless of how a state agency closes a complaint, whether it's through company refunds to the consumer or referral to another agency, it is important for several reasons to track how the complaint was processed.

In many cases state financial regulators are required to report to their governor's office and the general public on the number of complaints received in a given year, the type of complaints received and how those complaints were resolved. Sharing this information publicly offers transparency and can help inform policy development and the legislative process. For state regulators, the importance of documenting and reporting on complaints goes beyond measuring performance and supporting the legislative process; complaint data can be leveraged as a powerful tool within other areas of supervision, including license renewal and examination.

While there is yet no central database for state received consumer complaints, states receive and process tens of thousands of consumer complaints each year.

## Enforcement

Enforcement simply refers to compelling a nonbank to comply with law or rule. Unfortunately, enforcement is too often a necessary part of supervision. This is often the result of the following factors:

- Nonbanks are a relatively new financial services industry. Some areas of nonbank (fintech for example) are just now coming into existence and may be unaware or unfamiliar with the requirements and responsibilities for conducting business within the state system.

- Nonbanks are often small companies or individuals with less sophistication or resources devoted to complying with laws and regulations.
- Nonbanks, as opposed to banks, may have less capital investment and operate on thinner margins, which may incent the company to invest fewer resources in compliance, take more risks, charge disallowed fees, employ illegal marketing techniques or operate closer to the legal margins.
- In some sectors of the market, nonbanks may provide products and services more frequently to lower income individuals, minorities, immigrants, or people more desperate for financial services. Such individuals may not possess the personal finance skills, language, or educational background to protect themselves from unscrupulous or opportunistic sales practices.

Enforcement typically follows investigation, but there is no specific requirement that a state agency elevate a matter through specific supervision processes. For example, an agency may move directly to enforcement when a nonbank fails to pay a required fee or submit required information or when the evidence produced in an examination is sufficient to make the case. Such enforcement matters may be routine, with many actions filed simultaneously in “bulk” (e.g., end of year cleanup of failed license renewals).

Often, enforcement actions follow lengthy investigations that may take months or years to complete. Once complete, the legal process of administrative hearings (trials), final orders, appeals and civil court due process can take months or years as well. In general, state enforcement actions are costly, resource draining undertakings and state agencies are careful to be confident of their case before pursuing the matter to charges or resolution.

### State Supervisor Disciplinary Tools

In the most serious cases, states can revoke a license which effectively closes the company. Other disciplinary tools include suspension of the license for a certain period; license probation subject to specified actions or terms; reprimanding the license; and assessing monetary fines against the company. These are all typically public disciplinary tools.

State supervisors also utilize non-public disciplines, such as compliance agreements and memorandums of understanding, which can be subject to a variety of terms. These forms of discipline take place privately between the regulator and the entity.

Most state agency enforcement actions are considered administrative enforcement actions. This means the authority is derived from “administrative” law and must be conducted under very strict requirements of that law. Administrative actions may be “prosecuted” by the attorney general for the state agency, but often are prosecuted by the agency itself. All administrative cases, once filed, include the opportunity for a hearing before an administrative law judge, agency head or other designated official. Some state agencies employ their own administrative law judge, while others use a separate administrative arm of the government.

An administrative hearing is much like an informal trial. There are rules for process, conduct, evidence and witnesses. Hearings may last from minutes to weeks or longer depending on the case. Once the hearing is complete, the judge or other presiding officer enters a finding, frequently with a recommendation. Both sides in the case have the ability to appeal this finding. In most state agencies, the commissioner or agency head makes the final decision on the case and enters a final order. Disagreements at this stage may be appealed into civil court and be presided over by a court appointed judge.

At any point in an administrative enforcement case, the parties can enter into a consensual resolution called a consent order. Consent orders may be negotiated and entered even before the agency actually files charges. This is often the case with enforcement matters where the nonbank realizes it has committed violations and wants to avoid the expense and burden of a trial. In general, consent orders may contain whatever resolution the two parties agree to, including license revocation, penalties, restitution, or simply an agreement to correct problems going forward.

Enforcement actions and resolutions can take several forms. Some possible avenues are:

- **Cease and Desist Orders:** This category might include temporary or permanent orders to cease conducting any and all business or to cease from specific actions or activities that are deemed to be in violation of the law. In addition to administrative cease and desist orders a state agency may be able to seek a court ordered temporary restraining order or another injunction against the nonbank. Accessing the court system is somewhat rare and generally reserved for matters that an agency has very strong concern present immediate and continuing harm to consumers or others. Cease and desist orders are typically filed with the opportunity for an expedited hearing (e.g., within 20 days).
- **Charges or Statement of Charges:** This is the administrative equivalent of a lawsuit by the agency. The charges lay out the agency's legal authority, the background of the case, the violations alleged and often what the agency intends to order if successful in prosecuting the case. Charges will offer the defendant the opportunity for a hearing, which if requested, will typically be scheduled weeks or months in the future to allow both sides to prepare their case.
- **Final Order:** Typically, a final order is entered at the conclusion of an administrative hearing. However, if the defendant fails to request a hearing within the time period allowed, the matter can be closed in a final order containing whatever action the agency head deems appropriate and allowed by law.
- **Consent Order:** This is an order that contains whatever the two parties agree to settle for. It is signed by both parties and is a binding document that can be enforced by a court of law if necessary.
- **Memorandum of Understand (MOU):** An MOU, while binding on the parties, is considered a less formal form of settlement. Since an MOU is arranged outside of the administrative process some agencies are reluctant to pursue this avenue. However, MOUs can be very efficient and effective means of dealing with a specific matter or problem that saves both sides the cost of investigation, prosecution and defense.

While enforcement actions are seldom the first course of action for state regulators, enforcement is a serious responsibility and an integral part of the supervisory process.

# Today's Supervisory Environment

## Industry Responsibility in Supervision: The Three-Legged Stool

There is a fundamental understanding that nonbanks granted a license to conduct business in the state system are responsible for complying with all laws and rules and lawfully made directives or instructions of the regulators. While it may seem an elementary concept that a nonbank must comply with the laws governing its business, most laws state that fact explicitly. Following is an example of this type of statutory language from the Washington State Mortgage Broker Practices Act:

*RCW 19.146.220*

- (1) The director may enforce all laws and rules relating to the licensing of mortgage brokers and loan originators, grant or deny licenses to mortgage brokers and loan originators and hold hearings.*
- (2) The director may impose fines and order restitution and refunds against licensees, employees, independent contractors, agents of licensees, and other persons subject to this chapter, and may deny, condition, suspend, decline to renew, decline to reactivate, or revoke licenses for:*
- (a) Violations of orders, including cease and desist orders;*
  - (b) False statements or omission of material information on the application that, if known, would have allowed the director to deny the application for the original license;*
  - (c) Failure to pay a fee required by the director or maintain the required bond;*
  - (d) Failure to comply with any directive, order, or subpoena of the director; or*
  - (e) Any violation of this chapter.*

In supervision, there is a dual responsibility that lies with both the industry and the regulators. That responsibility is to ensure that business is conducted in a safe and sound manner. That assurance is accomplished through attention to three fundamentals of supervision: financial condition, compliance and consumer protection.

The nonbank is responsible for maintaining a sound financial condition, so it is able to carry through with its statutory and regulatory obligations; complying with the laws, rules and directives of its supervisors; and ensuring that consumers are treated appropriately and protected from harm. The regulator is responsible for examining the nonbank for sound financial condition, reviewing for compliance with laws, rules and other requirements; and investigating consumer protection.

Like the three legs of a stool, all three fundamentals must be in place. Otherwise the nonbank and its supervisory responsibilities will not stand. Each of these fundamentals is integral to the other and together complete the whole of nonbank supervision responsibility. For example, without sound financial condition, a nonbank will not have the wherewithal or financial stability to put in place and maintain good compliance management systems; without compliance or adherence to requirements consumers are likely to be harmed, and failures in consumer protection directly impact the nonbank's reputation and create real legal risk, both of which can result in negative outcomes for the institution's financial condition. Each leg plays a critical role in the integrity of the nonbank's operations, and if any of

the three legs is weak or missing, then the relationship between industry responsibility and supervisory oversight is compromised.

The three legs of the stool are discussed more fully below.

## Financial Condition

As stated previously, when nonbanks operate without the backstop of federal insurance, sound financial health becomes an important aspect of consumer protection. When consumers put their trust and financial needs in the care of a nonbank, that nonbank automatically assumes heavy responsibilities and duties of care, not just to that consumer, but to the management of the institution itself.

State regulators have an expectation that nonbanks will operate with a continually sound financial condition. To assist the institution in getting the financial condition component right, states establish minimum net worth requirements backed up with bonds to cover unexpected events.

In addition to net worth and bonding, states have general financial safety and soundness requirements. Typically, these requirements are specific to an industry and institution, representing the typical bounds of sound financial practices. Much like in banking, these requirements are based on a broad statutory requirement to protect the public interest. In implementation, financial condition is closely related to that of banking: capital, asset quality, earnings, liquidity and sensitivity to market risk. Nonbanks must have sufficient capital to absorb losses, assets strong enough to support their business, profits sufficient to ensure ongoing operations, funds liquidity appropriate for the ebb and flow of cash demands, and a financial position not subject to substantial swings based on market changes or unexpected events.

While examiners can test for sound financial condition, detection of problems typically occurs after deterioration has begun and corrective action is either costly or too late. Therefore, institutions have the first and most important role in financial condition awareness, understanding and proactive actions.

## Compliance

Nonbanks are responsible for complying with state and federal law and rule, as well as official interpretations of those laws and rules ... period. In a regulated environment, especially the regulation of financial institutions, where most laws and rules have been in place for decades, there is simply no excuse or leniency for noncompliance. This is true whether the noncompliance results from willful intent or lapses in oversight. Like financial condition, the first line of defense for compliance is the institution's own system and controls for compliance.

Both state and federal regulators review the institution's compliance management system (CMS) when assessing management's attention to compliance requirements. The review is incorporated in the overall or "composite" examination rating of the institution, with "1" being the highest and "5" being the lowest possible ratings. The following table from the multistate mortgage examination manual reflects the importance of management's attention to its CMS.

## Composite Rating

1

The highest rating of “1” is assigned to a financial institution that maintains a strong CMS and takes action to prevent violations of law and consumer harm. Financial condition is strong in all areas.

2

A rating of “2” is assigned to a financial institution that maintains a CMS that is satisfactory at managing consumer compliance risk in the institution’s products and services and at substantially limiting violations of law and consumer harm. This rating indicates that the institution maintains a satisfactory state of financial condition.

3

A rating of “3” reflects a CMS deficient at managing consumer compliance risk in the institution’s products and services and at limiting violations of law and consumer harm. This rating is an indicator that the institution’s financial condition is deficient.

4

A rating of “4” reflects a CMS seriously deficient at managing consumer compliance risk in the institution’s products and services and/or at preventing violations of law and consumer harm. “Seriously deficient” indicates fundamental and persistent weaknesses in crucial CMS elements and severe inadequacies in core compliance areas necessary to operate within the scope of statutory and regulatory consumer protection requirements and to prevent consumer harm. This rating indicates that financial condition is seriously deficient.

5

A rating of “5” reflects a CMS critically deficient at managing consumer compliance risk in the institution’s products and services and/or at preventing violations of law and consumer harm. “Critically deficient” indicates an absence of crucial CMS elements and a demonstrated lack of willingness or capability to take the appropriate steps necessary to operate within the scope of statutory and regulatory consumer protection requirements and to prevent consumer harm. This rating indicates financial condition is critically deficient.

The CFPB sums up attention to CMS in its supervision and examination manual: “To maintain legal compliance, an institution must develop and maintain a sound CMS that is integrated into the overall framework for product design, delivery, and administration across their entire product and service lifecycle. Ultimately, compliance should be part of the day-to-day responsibilities of management and the employees of a supervised entity; issues should be self-identified; and corrective action should be initiated by the entity. Institutions are also expected to manage relationships with service providers to ensure that service providers effectively manage compliance with federal consumer financial laws

applicable to the product or service being provided.”

([https://files.consumerfinance.gov/f/documents/cfpb\\_supervision-and-examination-manual.pdf](https://files.consumerfinance.gov/f/documents/cfpb_supervision-and-examination-manual.pdf))

## Consumer Protection

Consumer protection can be thought of as ensuring no consumer harm through negligence, lack of oversight or intentional acts. Consumer protection in the context of nonbanks is a concept, coupled with a body of laws and rules designed to protect the rights of consumers in financial transactions. Often, consumer protection is confused with compliance. However, compliance is the demonstration of complying with the laws and rules that are in place to protect consumers.

Unfortunately, consumer harms can occur even when an institution or its employees appear to follow requirements. For example, in a loan transaction, the Truth in Lending disclosure may be completed accurately and delivered in a timely manner. However, if a loan officer misleads the consumer about what the disclosure is telling them, then the institution has failed to protect the consumer. This was the case with certain high-profile predatory lending cases two decades ago (e.g., First Alliance Mortgage Company and Household Finance) where loan officers were trained to complete technically accurate disclosures but, in their sales presentation, deceived the consumers about what the disclosures meant.

Again, the nonbank itself is the first line of defense for the consumer in every transaction. Management and ownership of the institution have a vested interest in proactively taking care of consumers. Such care includes establishing a culture within the organization of protecting the customers it relies on for its own survival. This culture should be part of the institution’s systems, controls and employee training.

## Industry Self-Assessment and Self-Reporting

Institution management should have a strong desire to understand how well the company and its employees perform in the supervision context. Waiting for a regulatory examination to learn about strengths and weaknesses is never a good strategy. Not only does it indicate that management is unprepared to effectively run the institution, it signals to regulators that management doesn’t care much about the three legs of the stool: financial condition, compliance and consumer protection.

An attentive board and competent management already know where the company has succeeded and failed before the regulators arrive. In an ideal supervisory relationship, management is prepared to inform the EIC and the examination team about the company’s performance over the examination period (typically the prior two years or since the last examination). Rather than put the institution at a disadvantage, self-identification of weaknesses and violations, if corrected, presents management and the board in a very positive light with the examination team. Through self-assessment and self-reporting, management builds trust with the regulators, and that trust will carry the institution through the examination and beyond.

Think of it this way. If the problems or violations are apparent, the examination team is likely to find them anyway. When they do, the first thought is likely to be, “Did management know, and were they

withholding the adverse information or even trying to hide it from the examination team?” Such a position is not a good one for any licensee to find itself in. The result will likely be corrective action, restitution to borrowers, and if the violations are severe enough, monetary penalties. Further, management will have engendered unnecessary bad will with the regulators, which at a minimum will result in quicker follow up exams and reporting of findings and experience to regulators in other states.

Unfortunately, for years, some nonbanks have played the game of hiding violations and weaknesses from examiners. With many companies and certain industries, examiners have come to expect that deficiencies will be withheld, and violations hidden. Therefore, the examination team invests the time necessary to uncover the expected results (sometimes very technical and arcane violations), and then penalizes the company for those findings, which has come to be called “regulatory gotcha.” This of course causes the company to fear the regulators and hide even more when the next examination team arrives, perpetuating and continuing a ridiculous and costly cycle of “hide, hunt, punish.”

This type of interaction between the industry and regulator is not nearly as prevalent in bank regulation. This is probably because most banks view supervision and examiners as a healthy part of the industry’s life cycle, and from this view, trust and transparency has developed. Nonbanks can achieve this same kind of relationship with their regulators, and many have. Such a relationship for the nonbank begins with self-assessment and self-reporting.

Self-assessment means reviewing the company’s financial condition, compliance and consumer protection with a critical eye, similar to how the examination team would review the company. How can management do this? There are a few methods that are reasonably easy to implement and well worth the time and cost, and yes, most banks employ one or more of these methods:

- Hire outside professionals specializing in nonbank financial institution review. This can be an auditing firm, a consulting firm, a law firm, an individual CPA or even a former regulator. Hiring a firm that will tell management the truth rather than what management wants to hear is imperative.
- For compliance and consumer protection, conduct “real-time” transaction testing before and at the point of sale. There are many vendor applications that will test the transaction and provide a report of possible issues, giving management the opportunity to review and correct the problem before it becomes an irreversible violation.
- Establish an internal auditor and/or quality control or compliance position and give this staff direct reporting access to the board of directors and/or senior management. Such auditing or compliance staff should be familiar with the same examination manuals and materials used by the regulators. Most are publicly available:
  - MMC Mortgage Examination Manual and supplements is available at: <https://www.csbs.org/mortgage-examination-supplements>
  - CSBS Examiner Job Aides are available at: <https://www.csbs.org/job-aids>
  - CFPB Supervision and Examination Manual and other materials is available at: <https://www.consumerfinance.gov/policy-compliance/guidance/>
  - A variety of examination handbooks, including cybersecurity and IT can be found at: <https://www.ffiec.gov/>

- Train sales staff to do things right at the start.

So now, imagine a scenario where management is testing its transactions before consummation. That testing shows that if the transaction were to complete without intervention, the consumer would not receive accurate disclosure of costs and be overcharged for the transaction. But through real-time testing, management identifies the impending violation, corrects the disclosure issue and charges the consumer the appropriate amount. Consumer harm averted, violation averted and penalties avoided. But also, management has something positive to report to the examination team when they arrive: here's how our compliance systems work, here's what we found, here's what we did to keep things right. What manager wouldn't want to be telling this story?

## Culture of Compliance

*This section borrows heavily from FinCEN's Aug. 11, 2014 [Advisory to U.S. Financial Institutions on Promoting a Culture of Compliance \(FIN-2014-A007\)](#). The advisory was developed to guide financial institutions in the activities necessary to have a culture of compliance in BSA/AML responsibilities. Much of the advisory works equally well for other areas of compliance as well. When referring to compliance in this section, we are referring to all areas of compliance including consumer protection, BSA/AML, and cybersecurity. This section keeps some of the advisory as written and restates other parts for the purposes of this chapter.*

Regardless of institution size or business model, nonbanks with a poor "culture of compliance" are likely to have issues related to two of the three legs of the stool: compliance and consumer protection. A financial institution can strengthen its compliance culture by ensuring that (1) its leadership actively supports and understands compliance efforts; (2) efforts to manage and mitigate deficiencies and risks are not compromised by revenue interests; (3) relevant information from the various departments within the organization is shared with compliance staff to further review efforts; (4) the institution devotes adequate resources to its compliance function; (5) the compliance program is effective by, among other things, ensuring that it is tested by an independent and competent party; and (6) its leadership and staff understand the importance of reporting findings and corrective actions to regulators and its board.

A financial institution's leadership is responsible for performance in all areas of the institution including compliance and consumer protection. As applicable, an institution's leadership may include its board of directors, senior and executive management, owners and operators. These leaders are responsible for understanding an institution's responsibilities regarding compliance with consumer protection law, the BSA, or cybersecurity regulations and best practices, and creating a culture of compliance within the institution. The commitment of an organization's leaders should be visible both internally and externally, as such commitment influences the attitudes of others within the organization.

Compliance staff should be empowered with sufficient authority and autonomy to implement an institution's compliance program. An institution's interest in revenue should not compromise efforts to effectively manage and mitigate deficiencies and risks. An effective governance structure should allow

for the compliance function to work independently and to take any appropriate actions to address and mitigate any risks that may arise within or outside the institution.

For example, principal MSBs often derive a significant percentage of their revenue from the activity of their agents. When principal MSBs learn of possible inappropriate activity by an agent, the activity should be investigated thoroughly and appropriate action taken regardless of the impact on revenue. The findings from the investigation should be considered when determining whether an agent is terminated, and the sales unit should not have express or implied authority to veto the decision because of the agent's sales activity. Similarly, such responsibility would apply with lenders relying on brokers to solicit and originate new loans.

There is information in various departments within a financial institution that may be useful and should be shared with the compliance staff. For example, information developed by those in the organization combating and preventing fraud could also assist a financial institution in complying with its BSA/AML obligations. Similarly, legal departments should alert compliance departments to subpoenas received issued by government agencies to trigger reviews of related customers' risk ratings and account activity for suspicious transactions. Additionally, in a larger organization there may be multiple affiliated institutions that could benefit from sharing of relevant information across the organization.

A required element of any compliance program is the designation of an individual(s) responsible for coordinating and monitoring day-to-day compliance with consumer protection, the BSA, and cybersecurity. The individual(s) should be knowledgeable of consumer protection, the BSA and cybersecurity and have sufficient authority to administer the programs. For the programs to be effective, the institution should devote appropriate support staff based on its risk profile.

Appropriate technological resources should also be allocated to compliance. Institutions with higher risk profiles, including those with substantially higher volumes of activity, may need to utilize automated systems for identifying and monitoring transactions.

Components of an effective compliance program additionally include a proper ongoing risk assessment, sound risk-based customer and third-party vendor due diligence, appropriate detection and reporting of suspicious activity and compliance violations, and independent program testing. A financial institution's leadership should ensure that the party testing the programs (whether internal or external) is independent, qualified, unbiased and does not have conflicting business interests that may influence the outcome of the compliance program test. Safeguarding the integrity and independence of the compliance program testing enables an institution to locate and take appropriate corrective actions to address identified deficiencies.

## Cybersecurity and Information Technology Responsibilities

### GRAMM-LEACH-BLILEY ACT

The Gramm-Leach-Bliley Act requires financial institutions – companies that offer consumers financial products or services like loans, financial or investment advice or insurance – to explain their information-sharing practices to their customers and to safeguard sensitive data.

It also requires financial institutions to allow their customers to opt out of sharing their information with certain nonaffiliated third parties. (Federal Trade Commission, n.d.)

According to the National Institute of Standards and Technology (NIST), cybersecurity is the ability to protect or defend the use of cyberspace from cyber-attacks. Nonbanks are responsible for collecting and protecting highly sensitive information every day. This Personally Identifiable Information (PII) distinguishes consumers from one another (i.e. birthdates, driver’s license identification numbers, etc.). If a single nonbank is hacked, consumers, the institution and the marketplace are at risk.

The primary cyber threats to the nonbank industry are email compromise and network or server attacks. These occur because many companies do not host their own computing infrastructure. In addition, human error and insider threats will also always occur in IT. To prevent cyberattacks, companies are instructed to protect their data by following the cyber framework of:

- Identifying risks (the likelihood and potential magnitude of harm)
- Protecting systems, assets and data
- Detecting active threats to the systems
- Responding to cybersecurity events
- Recovering and restoring normal operations and services

But unless the nonbank is a large player, it is not often aware of or paying attention to its data and framework. State regulators are concerned that many small nonbanks are unaware and lack the sophistication to address the security aspects of the digital world.

Nonbank IT experts point out that technology outpaces regulation and nonbanks may be several years behind banks in cybersecurity implementation. To address these concerns CSBS has developed

Cybersecurity 101 – A Resource Guide for Financial Sector Executives (available at <http://www.csbs.org/cyber101>).

## State Regulator Supervision Responsibility

### Existing Supervision Processes

Nonbank supervision has been around for a while now. Most states have been supervising mortgage and consumer finance since the 1990s, with MSB supervision arriving for most states in the early 2000s, shortly after Sept. 11, 2001, and the USA PATRIOT Act of the same year. Individual state supervision, multistate supervision and state/federal coordinated supervision are well established processes. This section discusses these processes and the tools state nonbank examiners use to supervise the industry.

## Routine versus Risk

A state agency's examination responsibilities are typically centered on one of two approaches. The first approach is cycle-based, where an agency examines all their license holders at least once within a certain time period. In some cases, the agencies must comply with a state law requiring the agency to examine all their license holders within a specified time period, which is usually set at 36 or 60 months. Within this approach a state's responsibilities are clear – examine all the companies that are licensed with the agency on a regular basis as required by state law or agency policy.

The second possible approach is risk-based, where there is no mandate to examine all license holders, and there is a focus on risk from a consumer protection and safety and soundness perspective. To effectively pursue the risk-based approach and make informed decisions, a state agency needs access to data on the companies they license. Fortunately, state regulators have a rich data source to draw from – the NMLS. Within the NMLS, nonbank companies can provide information regarding their volume of activity, financial condition, corporate structure, insurance coverage and several other data points regarding the make-up of the company. State agencies also receive and process consumer complaints, which is another data source that can provide valuable information regarding the companies conducting business in their respective states. State regulators leverage this data to determine which companies pose the highest risk in their respective states, and therefore which companies will be prioritized for examination purposes.

Regardless of the approach a state uses to meet the agency's examination responsibilities, the amount of examiner resources available to an agency plays a significant role in how these demands are met. For example, if a state must examine all nonbank licensees every five years with a finite number of examiners, then the scope and length of each review will be constrained to meet the demands of this cycle-based approach. Given that an agency must assign at least one examiner to each examination scheduled, examiners' time and availability are two of the agency's most precious commodities.

## Independent State Supervision

While there is no actual count of the number of nonbank exams conducted by the state system each year, informal surveys and estimates place the number at as many as 30,000 exams per year. Most of these exams are individual or independent state exams, meaning examinations performed by a single state. A large nonbank could be examined 50 or more times in a single year, with each exam conducted under independent and sovereign state authority. Likewise, states conduct independent investigations, handle consumer complaints on an independent basis, and when necessary, file enforcement actions that involve just that state.

### Examinations

Traditionally, nonbank single state examination programs differ from state to state, but within the last 10 years there has been a shift towards uniformity. There are several reasons for this shift, but the primary force behind this change are the nonbank financial service providers who are leveraging technology to scale up operations quickly across state lines. In the early 2000's state regulators could easily tailor their examination programs to the needs of their consumers because the majority of their

nonbank licensees only operated in their state. At that time most nonbank companies only held a license in the state in which they were domiciled.

Even with the shift towards uniformity, the states continue to use their own unique examination programs. The components of these examination programs generally include the agency's:

- Examination Manual
- Examiner Training Resources and Materials
- Template Documents (e.g. report of examination)
- Company Information Request Lists
- Examination Procedures and Job Aids

In the past, when priorities and philosophical approach to the examination function varied among the states, the differences within their examination programs could be found in the individual components. For example, if one agency placed a higher priority on the review of a company's financial condition, then the direction offered in the examination manual and the corresponding examination procedures would differ from an agency that placed a lower priority on the financial condition review. Fortunately, the states are continuing to move past these philosophical differences and there is more alignment in the examination priorities, process and approach among the states.

#### Enforcement

Each state maintains a staff of investigators and enforcement attorneys. Larger states have more investigators and attorneys, but all states must have an independent mechanism and staffing to enforce state financial laws. As discussed previously, some states utilize the state attorney general for the prosecution of its cases, but the state nonbank agency itself conducts the investigation and typically files the charges. When matters are negotiated to resolution without a hearing or trial, the state regulator may conduct that negotiation itself without the assistance of the attorney general. But especially in the area of enforcement, state regulators do not have to go it completely alone. The state system is collegial and supportive, with states and state regulator associations offering each other training, advice and experiences that assist individual states in not reinventing the wheel with each new case.

#### Complaint Resolution

State regulators have multiple options through which they can resolve consumer complaints received by the agency. Beyond the traditional complaint processing model described earlier, examiners also can support the complaint resolution process through their examination work. When identifying the scope of an examination, examiners can look to the complaints the agency has received on the company during the examination review period. Examiners can then select the transactions for which the agency received a complaint and effectively investigate the claims of those complaints within the context of transaction review. This process is sometimes executed in coordination with the agency's complaint processing staff.

Agencies can also resolve complaints through an investigative process. If an agency receives several complaints on a company that are similar in nature, over a relatively short period of time, this will prompt an agency to begin an investigation. Like the examination process, examiners can then select the transactions for which the agency received a complaint and review those transactions as part of the

investigation. The common objective of investigations originating from complaints is to determine whether there are widespread consumer compliance or consumer protection issues. Regulators want to understand exactly how extensive the issues may be and what is the best path to a resolution for every consumer impacted by the issue, not just those who submitted a complaint. As mentioned, complaints are often viewed as isolated investigations, and this process illustrates the meaning behind that term.

## Multistate Supervision

Multistate supervision of nonbanks is where two or more states agree to join resources in a single effort rather than pursue separate, independent examinations or enforcement actions. Multistate supervision not only conserves the expenditure of precious state resources. The effect of these joint undertakings broadens the scope of review while leveraging the knowledge and skill sets of many trained regulators.

Informal multistate examinations and enforcement actions have been taking place since the late 1990s. However, in 2008, state mortgage regulators entered a cooperative agreement to formally share information and resources in multistate examinations and enforcement matters. The Nationwide Cooperative Agreement for Mortgage Supervision, signed by all states and the District of Columbia, Puerto Rico and the Virgin Islands, established the Multistate Mortgage Committee (MMC) to oversee multistate mortgage supervision.

The MMC is a representative body of state regulators authorized as an oversight body for multistate mortgage supervision. The MMC is comprised of 10 members, five appointed by the board of CSBS and five by the board of the American Association of Residential Mortgage Regulators (AARMR). The 10 representative states serve as a portal through which information is received and shared both among the states themselves and external stakeholders (e.g., state attorneys general, HUD, CFPB, DOJ). As a single point of contact of sorts, the MMC is able to efficiently channel information to the commissioners and agency leadership and carry out state directives on a national level. One of the primary responsibilities of the MMC is to identify, schedule and plan multistate mortgage examinations.

In 2012, the states again came together under the Nationwide Cooperative Agreement for MSB Supervision, forming a similar body to the MMC known as the MSB Examination Taskforce or MMET. The MMET is the state representative body for multistate MSB supervision. The MMET is comprised of 10 states, five appointed by CSBS and five by the Money Transmitter Regulators Association (MTRA). As with the MMC, the MMET focuses primarily on the multistate examination process.

The MMC and MMET are often referred to as “functional committees.” In recent years, the National Association of Consumer Credit Administrators (NACCA) and the North American Collection Agency Regulatory Association (NACARA) have formed functional committees to oversee multistate supervision in consumer finance and debt collection.

### Information Sharing

Information sharing is a key ingredient in multistate supervision. Information sharing improves state supervision by drawing upon the resources of many states. Through information sharing states are able

to “see” beyond state boundaries and identify practices taking place at the national level that previously appeared only at the local level. For example, a single state may uncover misleading advertising practices and unlicensed activity not detected by another state. At the same time, another state may detect disclosure issues with the same company. When the states share this information patterns of violation may begin to appear in ways that would not previously have been understood. In this sense, information sharing is not only beneficial to state regulators, but to a greater number of consumers as well.

But information sharing among the states accomplishes more than enhancing supervisory oversight or protecting a broader base of consumers. Information sharing also benefits the industry through reduced burden and cost. Industry members directly bear the cost of supervisory efforts. When state regulators share information, there is less duplication in information requests and less time invested in analyzing and reviewing the same information by the respective states; the cost savings that result from those efficiencies flow directly to the nonbanks being reviewed.

Information sharing among the states is effective and beneficial in licensing, examination, investigation and enforcement. In 2018, 24 state MSB regulators began an interstate license review effort designed to eliminate redundancy and speed up the time it takes for a money transmitter license applicant to obtain licenses in multiple states. Under the terms of a multi-state agreement, a single state performs the first phase of an application review and shares the information and approval with the other states, dramatically improving the time it would otherwise take to apply for licenses separately in all 24 states.

In 2019, a similar pilot concept was expanded to money transmitter examinations dubbed “One Company/One Exam.” A small number of states conduct a multistate examination while other states agree to await the results and rely on the multistate exam to satisfy their own state requirements. The intent of One Company/One Exam is to convert what would be many individual state exams into a single, shared examination.

#### Multistate Examinations

The foundation for multistate examinations was established through the multi-state cooperative agreements signed by nearly all state financial regulators with the proper supervisory authority. The cooperative agreements established consistent protocols for the agencies to follow and therefore implemented a consistent approach to multi-state supervision across the country. The cooperative agreements are publicly available and maintained on the CSBS website.<sup>12</sup>

The cooperative agreements established policy, procedures and the oversight process for multi-state supervision. To achieve the necessary level of coordination and oversight, the agreements also established the functional committees that oversee multi-state supervision. For example, the Nationwide Cooperative Agreement for Mortgage Supervision created the MMC. Similar committees have been formed through the other cooperative agreements, committees such as the MMET, the State

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<sup>12</sup> Nationwide cooperative agreements for mortgage and MSB can be found on the CSBS website: <https://www.csbs.org/cooperative-agreements>

Coordinating Committee (SCC) and similar functional committees created for consumer finance and debt collection supervision.

An important difference between single-state and multi-state examinations is the role of functional committees. For single-state examinations the functional committees do not have an oversight role, but for multi-state examinations they play a significant role. Some functional committee responsibilities within the multi-state examination workflow include:

- Setting the examination priorities and schedules;
- Approving examination scope and supervisory plans;
- Meeting with company management in certain instances; and
- Reviewing and approving reports of examination.

Even with this added layer of complexity with the functional committees, multi-state examinations generally follow the same workflow as single-state examinations. There are a few notable differences between the two, but from the company's perspective the only significant difference would be the size and depth of the review. Given the magnitude of multi-state examinations, in terms of the number of examiners, information requests, meetings with management, etc., there is no comparison to single-state examinations.

A typical single-state examination is staffed with one or two examiners, but a multi-state examination team can be staffed with as many as 20 to 30 examiners depending on the industry area of review and the size of the institution. The volume of work that is completed within one multi-state examination can equal the volume of work a small agency (with limited resources) completes over a matter of months. And from the company's perspective it is always preferable to have one large examination rather than multiple individual examinations, where many of the same questions are asked of the company, creating repetitive supervisory burden. When the states share resources and conduct multi-states examinations everyone benefits.

Today CSBS helps manage several of the administrative tasks related to multi-state supervision. There is an incredible amount of information that needs to be managed and communicated to regulators on a nationwide basis. From examination schedules to enforcement case updates, CSBS staff is constantly working to keep regulators informed on the topics and issues related to multi-state supervision and the work of the functional committees.

Multistate examinations provide another benefit seldom recognized by the industry. Nonbanks are required to pay an hourly examination fee plus the travel costs of the examination team. Single-state exams will frequently require the engagement of two or more examiners. For large companies examined every year by 20 or more states, airfare, hotel and other costs are considerable. A multistate exam with 20 participating states will typically send a small representative examination team onsite. Where individual state exams of the company would likely involve 40 or more examiners and their associated travel costs, a multistate undertaking may send only five or 10 examiners to the company's location, thereby saving the institution tens of thousands of dollars or more in travel costs alone.

## Multistate Enforcement

When the states complete a multistate examination, the findings are reviewed for any needed corrective action. When necessary, such action is conducted through a multistate enforcement action designed to incorporate each state's individual interests. Where possible, these actions are settled in a single consent order signed by all participating states. When a global settlement cannot be reached with the nonbank, each state must decide on filing independent enforcement orders. Even then, the content and timing of such orders can be coordinated. Such was the case in April 2017 when over 30 states filed simultaneous cease and desist orders against Ocwen Financial Corp., for national failings in servicing mortgage loans.

## Coordinated Supervision

Coordinated supervision is a term used to describe coordinated supervision between the CFPB and state regulators. Since the CFPB has jurisdiction over both depositories (banks and credit unions) and nonbanks, coordinated supervision covers both areas when the states join resources with the CFPB. The activity of coordinated supervision can be divided into two categories as follows:

**Single State and CFPB Coordination:** Here the parties share information about scheduled examinations and agree informally to conduct an examination simultaneously. Single state and CFPB coordination occur in the bank, credit union and nonbank spaces in a one to one relationship (e.g. UT Department of Financial Institutions agrees to "join" the CFPB on a specific bank examination).

**Multistate and CFPB Coordination:** Conducted in the nonbank space only, the CFPB and multiple states, orchestrated through the State Coordinating Committee (SCC) meet, schedule, plan and conduct examinations through formal processes. Most of the coordination occurs in this manner.

## Background on Coordinated Supervision

When the CFPB was formed in July 2011, state regulators and the CFPB already had an executed information sharing MOU in place. The MOU was signed by state agencies and the Department of Treasury, on behalf of the yet to be established CFPB<sup>13</sup>. In addition to the collaboration and coordination requirements under Title X of Dodd-Frank, the MOU is the document from which all coordinated supervision originates.

The MOU contemplated cooperation in the areas of supervision, enforcement and examiner training. Through this document the parties agreed to:

- i. Promote consistent standards for compliance examinations;
- ii. Efficiently use resources;
- iii. Promote efficient information sharing;
- iv. Effectively enforce federal consumer financial laws and state consumer protection laws; and

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<sup>13</sup> The Dodd-Frank Act signed into law in July 2010 did not formally establish the CFPB until July 2011. Through that initial year, "stand-up" of the CFPB was conducted under the auspices of the Department of Treasury.

- v. Minimize the regulatory burden on providers of consumer financial products and services operating in multiple states.

The parties further agreed to collaborate on examination procedures and exchange information, including confidential supervisory information.

In 2013, CSBS and CFPB crafted the CFPB-State Supervisory Coordination Framework, which was signed in May 2013 in Nashville, Tenn. The framework provides guidance on how the states and CFPB coordinate supervision for nonbank entities. The framework also provides guidance for information sharing, which is a robust part of coordinated supervision today (see Coordinated Information Sharing below).

In September 2013, six state regulator associations representing nonbank supervision signed the State Governance Agreement establishing the SCC and creating a multistate infrastructure promoting consistency, coordination, and communication for supervisory responsibilities coordinated with the CFPB.

#### State Coordinating Committee

The SCC is a 12-person committee charged with representing the state system of nonbank supervision with the CFPB under the 2013 CFPB-State Supervisory Coordination Framework. It is comprised of two members from each of the following regulatory associations:

- American Association of Residential Mortgage Regulator (AARMR)
- Conference of State Bank Supervisors (CSBS)
- Money Transmitter Regulators Association (MTRA)
- National Association of Consumer Credit Administration (NACCA)
- North American Collection Agency Regulatory Association (NACARA)
- National Association of State Credit Union Supervisors (NASCUS)

Each member has the responsibility to broadly represent the state system and its regulatory interests. Pursuant to its operating procedures, the SCC will have the responsibility to identify and coordinate the supervision of covered nonbank entities with the CFPB. The committee's responsibilities include:

- In concert with the CFPB, develop a comprehensive plan for coordinated supervision.
- Develop a list of nonbank entities potentially subject to examinations under the framework.
- Develop protocols for scheduling, sharing and updating examination schedules as necessary.
- Oversee the coordination between CFPB and state examination teams as appropriate.
- Monitor the direction, progress and results of examination teams.
- Coordinate enforcement or supervisory action under the framework when necessary.
- Establish procedures between the SCC and other parties to utilize resources to benefit the examination teams and the SCC in an efficient, effective, and confidential manner.

- Facilitate discussions on behalf of the State Regulators, as requested, with regulatory agencies of the states, of the federal government, or any law enforcement agency on matters within the scope of the SCC’s responsibilities.
- Track examination schedules and progress.

### Coordinated Information Sharing

As with multistate supervision, information sharing is at the core of coordinated supervision. Through information sharing the states and CFPB fulfill the cooperative relationship between the parties contemplated by Congress in Title X of Dodd-Frank. Through formal agreements and the framework, the parties preserve the confidential nature of the information shared. Information sharing fosters better understanding and awareness of the nonbank marketplace and facilitates more effective compliance reviews and consumer protection efforts.

To better foster information sharing SCC and CFPB leadership have several in-person meetings each year. In March, the two sides meet to discuss an overview of the current nonbank market which includes an analysis of the trends, threats and risks of each industry. In August, the SCC and CFPB meet to finalize the schedule for the next coordinated, yearlong exam cycle. In preparation for this meeting, each of the six regulatory associations of the SCC develop a list of entities they are interested in examining. The CFPB does the same, the lists are shared, and the companies of interest from both sides are selected for examination. There is a final fall meeting to conduct an after-action review of the year, determine areas of improvement and discuss opportunities for further collaboration.

To date, state regulators and the CFPB have coordinated more than 60 examinations of the largest nonbanks covering mortgage, payday lending, money transmission, auto finance and debt collection.

But possibly more important than the actual examinations that have been conducted is the information exchanged on thousands of independent examinations and the ease with which the two sides come together to understand and implement supervisory processes. In short, state regulators and the CFPB have shown state and federal coordination works and works well.

<b>Exam Reports Shared</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
States to CFPB	388	1561	83	296
CFPB to States	105	129	68	38

### Coordinated Examinations

In addition to single and multistate exams, state regulators conduct coordinated exams with the CFPB. These are multistate exams of the largest nonbanks conducted in concert with the CFPB. Coordinated examinations currently cover the mortgage, MSB, payday lending, auto financing and debt collection industries. These exams are more complex and involve multiple government jurisdictions, requiring an additional level of communication, coordination and information sharing.

Once the SCC and CFPB have selected institutions for examination, the next step in the planning and preparation process is requesting state participation and examination leadership through the regulator associations. The examiner in charge, or EIC, is responsible for planning the states' examination, assigning specific multistate work to state examiners, reviewing work performed by the exam team, coordinating the work of specialists, managing the preparation of the report of examination and maintaining communications with the entity. A single point of contact or SPOC serves as a mentor and adviser to and between the EIC and field examiners and acts as a resource to help address complex or sensitive issues. At the same time, similar leadership responsibilities take place with the CFPB.

The EIC and SPOC of a coordinated exam are usually senior examiners with a proven record of leading exam teams. However, coordinated exams require a great deal of examination planning and communication in order to effectively manage a "team" comprised of several states and a federal agency. To facilitate a successful process the SCC and CFPB host EIC/SPOC events twice per year as a mechanism for kicking off these examinations. The four leaders from each exam (two from states and two from CFPB) convene with the other coordinated examination teams for two days of examination best practices, administrative discussion and planning. These events have been held twice per year since 2016. After these kickoff events, the EICs and SPOCs from both sides continue to work together throughout the examination until delivery of separate but harmonized reports of examination (ROE). Collaboration efforts include regular check-in calls, conducting the onsite review of the company at the same time and sharing findings and draft ROEs before they are issued to the company.

#### Coordinated Enforcement

When appropriate, state nonbank supervisors and the CFPB coordinate enforcement efforts. Coordination includes sharing investigative information and analysis, consulting on charges to be alleged, timing enforcement filings and aligning case settlement. Coordinated enforcement commonly includes participation by multiple states, the CFPB, the state attorneys general, the DOJ, HUD and other federal agencies.

While all these parties exercise independent enforcement authorities, their goals are generally aligned, and the actions structured so as not to duplicate penalties or consumer restitution. Coordinated enforcement actions are significant undertakings that when organized effectively serve the public interest while lessening the burden a nonbank would otherwise experience from multiple non-coordinated actions.

#### State Examination Review Components

The review components selected for the examination essentially define the scope of the activity. The high-level review components for nonbank financial services examinations are similar, but the review items (e.g. regulations) within the components differ across business types and product lines. Below is a summary of the high-level review components of a nonbank financial services examination.

<b><u>Review Component</u></b>	<b><u>Description</u></b>
Compliance (Licensing & Reporting)	A review to ensure compliance with all state requirements as a condition of holding a license. The states impose minimum

	standards on license holders, and regulators must verify compliance with these items. Examples of these standards include net worth/capital, work experience and bonding requirements. In addition to licensing requirements, states also impose reporting requirements, such as filing a quarterly call report. Regulators verify that the reporting information is submitted timely and accurately.
Management & Operations	<p>A review of management and the systems established at the company. This review is often framed within the context of a Compliance Management System (CMS) review. A CMS review determines the capability of the board of directors and/or management to identify, measure, monitor and control the risks of the institution’s activities and to ensure a safe, sound and efficient operation in compliance with applicable laws and regulations. There are several elements to a CMS review, some which include:</p> <ul style="list-style-type: none"> <li>• Board and management oversight</li> <li>• Compliance management</li> <li>• Adherence to policies and procedures</li> <li>• Internal controls and corrective actions</li> <li>• Employee training</li> <li>• Consumer complaint response</li> </ul> <p>Examiners typically document observations and recommendations as part of this review and include these items in the report of examinations.</p>
Regulatory Compliance	<p>A review of transaction or activity data and financial condition for compliance with state and federal regulations and statutes. Violations of law cited in the report of examination are most commonly associated with this review component. Regulatory compliance reviews differ greatly across business types given that different state and federal laws are applicable to different business types. This review component is where state regulators fulfill their consumer protection duties, by ensuring compliance with items such as disclosures and fee requirements.</p>
Financial Condition	<p>A review of the company’s financial condition to determine the safety and soundness of the operation. There are typically five specific areas for review within this component:</p> <ul style="list-style-type: none"> <li>• Capital</li> <li>• Asset Quality</li> <li>• Earnings</li> <li>• Liquidity</li> <li>• Sensitivity to Market Risk</li> </ul> <p>Examiners utilize ratio and trend analysis to draw conclusions on the financial health of the company.</p>

<p>Cyber &amp; Information Technology</p>	<p>A review of the systems and technology implemented within the company’s overall information technology infrastructure. Systems are evaluated on functionality related to security and reliability. Recently state regulators formed a working group comprised of cybersecurity and IT professionals, which is in the final stages of developing a comprehensive, uniform work program. The program is based on the five functions of the National Institute of Standards and Technology (NIST) Cybersecurity Framework: identify, protect, detect, respond and recover. The work program will be deployed for use by all states, and there will be options to customize the program based off the size and complexity of the institution.</p>
<p>Fraud</p>	<p>A targeted review of transaction level data and financial statements for the purposes of identifying material misrepresentation or omission of documents and data for the purposes of financial/material gain. The types of fraud uncovered by examiners differ by business type. For example, within the mortgage industry there are very specific schemes used to commit fraud that would not be possible in other financial transactions (e.g., Air Loan – a straw buyer is duped into purchasing a non-existent property). Under certain circumstances examiners are permitted to review Suspicious Activity Reports (SARs) and Currency Transaction Reports (CTRs) filed by financial institutions, which provide helpful guidance in uncovering the types of fraudulent schemes used in the market today.</p>
<p>BSA/AML</p>	<p>A review of the company’s formal plan and actions to prevent money laundering or the financing of terrorist activities. There are four specific areas for review within this component:</p> <ul style="list-style-type: none"> <li>• Internal controls and procedures</li> <li>• Designation of a compliance officer</li> <li>• Training (for employees and management)</li> <li>• Independent testing (of the program)</li> </ul> <p>Examiners look for complete, accurate and updated documentation from the company to complete this review.</p>

## State Supervisory Tools Today

State regulators have several supervisory tools to support their work. These tools vary in size, format and complexity. Below is a summary of the tools state regulators use to license and supervise the companies within their jurisdiction.

### Nationwide Multistate Licensing System

#### NMLS Overview

The Nationwide Multistate Licensing System (NMLS) is the system of record for nonbank and depository, financial services licensing at the state level and registration at the federal level.<sup>14</sup> In these jurisdictions, NMLS is the official system for companies and individuals seeking to apply for, amend, renew and surrender license authorities managed through NMLS (<https://nationwidelicencingsystem.org/about/Pages/default.aspx>).

Each state nonbank regulator holds the legal authority to license. Although CSBS owns and manages the system, neither CSBS nor NMLS grant or deny licenses. NMLS is an online system used by both state regulators and the companies and individuals they supervise, founded on the concept of multi-state information sharing and collaboration. The NMLS has hundreds of thousands of users, many of whom use the system daily.

Prior to NMLS, it was difficult for states to identify and prevent bad actors from obtaining a license in their state when that license had been suspended or revoked in another state. NMLS linked state regulators in real time, a paradigm shift from a labor-intensive method of telephonic and email information sharing. In solving this challenge, NMLS simultaneously solved the challenge faced by companies seeking a license in multiple jurisdictions.

#### NMLS History

The late 1980s through 1990s saw a dramatic shift in the mortgage origination market with the demise of the savings and loan industry and advent of the mortgage broker. In 2003, state banking and mortgage regulators began discussing development of a state-based licensing system for mortgage lenders, brokers and loan officers. The purpose of a state-based system was to provide (a) more transparency to regulator and industry stakeholders, (b) an electronic internet portal for greater speed and efficiency, (c) greater uniformity in state regulation through uniform processes and forms for license applications, amendments and renewals, (d) workflow processing functionality for regulators, and (e) a system with robust security protocols. A 2006 CSBS survey found that 44 of 50 state agencies used disparate paper applications to license the mortgage industry prior to NMLS.

The original vision was to include a licensing structure for nonbank financial services industries regulated by state agencies. Given the significant transformation in the mortgage industry, it was selected as the first industry for inclusion in what was then called the Nationwide Mortgage Licensing System. While

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<sup>14</sup> At the federal level, registered mortgage loan originators or RMLOs are captured in the system.

this concept was new for CSBS, states had been participating in a nationwide licensing system since the early 1980s for the securities industry (known as the Central Registration Depository).

In 2004, CSBS began the process of working with state and industry stakeholders to develop four NMLS uniform licensing application forms for companies, control persons (owners, officers and directors), branches and mortgage loan originators (MLOs). System development began in late 2005 and NMLS went live on Jan. 2, 2008, as a voluntary system with seven state agencies. By year-end, 43 state agencies were either using NMLS (19 agencies) or had committed to start using NMLS (24 agencies).

When the financial crisis hit in August 2007, limited nationwide data was available for the mortgage industry. In July 2008, Congress passed the Secure and Fair Enforcement for Mortgage Licensing Act of 2008<sup>15</sup> (the SAFE Act) that established minimum standards for MLOs, including education, testing, criminal and credit requirements, and a mortgage call report. The SAFE Act gave states the opportunity to meet the SAFE Act MLO professional minimum standards, but if they did not, HUD would administer these standards (in addition to existing state licensing requirements). Within 18 months, all states passed SAFE Act-enabling legislation to meet the federal MLO standards. The SAFE Act also required all depository MLOs to be registered through NMLS.

All state agencies transitioned licensed MLOs onto NMLS by the end of 2010. In 2011, the federal banking agencies and the Farm Credit Administration required depository mortgage loan originators to be registered through NMLS (referred to as RMLOs). In 2012, CSBS expanded the use of NMLS to three other nonbank industries: money services businesses (MSB), consumer credit and debt industries. Currently, 64 state agencies and five federal agencies participate in NMLS. Of the 64 state agencies, 59 agencies use NMLS for mortgage licensing, and 47 agencies use NMLS to manage licensing for other nonbank entities.

## SECURE AND FAIR ENFORCEMENT FOR MORTGAGE LICENSING ACT OF 2008 (SAFE ACT)

The SAFE Act was enacted in 2008 and mandates a nationwide licensing and registration system for residential mortgage loan originators (MLOs).

The SAFE Act prohibits individuals from engaging in the business of a residential mortgage loan originator without first obtaining and maintaining annually:

1. For individuals who are employees of covered financial institutions, registration as a registered mortgage loan originator and a unique identifier (federal registration)
2. For all other individuals, a state license and registration as a state-licensed mortgage loan originator, and a unique identifier (state licensing/registration)

The SAFE Act requires that federal registration and state licensing and registration be accomplished through the same online registration system, the Nationwide Mortgage Licensing System and Registry. (Consumer Financial Protection Bureau, 2012)

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<sup>15</sup> See 12 U.S.C. Sec. 5101–5116, Title V of the Housing and Economic Recovery Act of 2008 (Pub. L. 110–289, 122 Stat. 2654, 12 U.S.C. 5101 et seq.) as amended by Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) (Pub. L. No. 111–203, 124 Stat. 1376).

## NMLS Today

As required by the SAFE Act, an NMLS Unique Identifier (NMLS ID) is permanently assigned by NMLS to each state-licensed or federally registered MLO/RMLO. NMLS also assigns an NMLS ID to each nonbank company, branch, and control person that maintains a single account in NMLS. Once assigned, an entity's NMLS ID cannot be changed. The NMLS ID granted to MLO/RMLO originators and companies allows regulators to monitor licensed entities and individuals across state lines to ensure a provider will not escape regulatory supervision in one state simply by crossing into another state. The NMLS ID also allows consumers and the industry to easily identify and research specific originators' histories and qualifications through [NMLS Consumer Access](#) [see below].

The benefit of the NMLS ID has been recognized by the FHFA and HUD. Both federal agencies require that any loan purchased or securitized by Fannie Mae and Freddie Mac or submitted for insurance by the Federal Housing Administration (FHA) must include the NMLS ID for the mortgage company and individual MLO that originated the mortgage loan. Additionally, the FHA collects the NMLS ID of all individuals and entities participating in the origination of FHA loans. The NMLS ID is also widely used by the private sector, particularly investors and compliance management providers, to ensure that purchased loans are being made in compliance with federal and state laws and to track performance levels of originators.

As more and more nonbank financial service providers leverage today's technology these companies can scale up operations quickly, and therefore need to be licensed in multiple states as efficiently as possible. NMLS was designed to facilitate this need. When companies begin the licensing process in NMLS, they complete a single uniform application and submit to all state regulators where a license is desired. Prior to NMLS application in multiple states was a repetitive and time-consuming process.

## NMLS as an Examination Tool

In addition to the many efficiencies NMLS brought to licensing, the system is also an effective tool for examiners. Company records in NMLS are filled with valuable data for examiners to use in their review. The NMLS holds call report data for certain business types, financial statements, legal formation information, insurance bond information and much more. Examiners regularly utilize the company data in NMLS to determine the size and scope of their examination and verify that the information a company submitted in NMLS is accurate and updated.

It is difficult to overstate the value and effectiveness of NMLS to supervisory responsibilities. The system changed the supervision landscape for all regulator and industry stakeholders and is a model for other systems that CSBS is building today, like SES [see Near Future RegTech – The State Examination System].

## NMLS Call Reports

Currently there are two nonbank call reports covering mortgage origination and servicing activity, and money services businesses. The NMLS Mortgage Call Report launched in 2011, marking the first standardized information collection of quarterly financial and origination data from state-licensed residential mortgage lenders, as required by the SAFE Act. The Mortgage Call Report collects quarterly mortgage activity and either quarterly or annual financial data from all state licensed or registered

companies. Some states have eliminated their unique annual state reports because the MCR collects sufficient information to satisfy their reporting needs, while other states are evaluating their current reporting requirements in conjunction with the MCR.

The MSB Call Report deployed in April 2017. This report has helped streamline MSB reporting, improve compliance with the industry and create the only comprehensive database of nationwide MSB transaction activity. To date, 28 state agencies have adopted the MSB Call Report. Seventeen of these states have eliminated state-specific reporting requirements in favor of the NMLS MSB Call Report, and another five are considering doing so.

The mortgage and MSB call reports are the only reports of their kind in the United States. With this wealth of detailed information, states can assess risk at both the industry and individual company level. Among other things, call report data is leveraged for risk scoping examinations and offsite monitoring.

### Other Tools Through NMLS

In 2010, CSBS launched [NMLS Consumer Access](https://www.nmlsconsumeraccess.org), a fully searchable website (<https://www.nmlsconsumeraccess.org>) that allows consumers to view information concerning companies, branches and individuals that are state-licensed or federally registered in NMLS for the mortgage, MSB, consumer lending and debt industries. CSBS offers a subset of the public data available in NMLS Consumer Access in a business-to-business data format through a subscription service. Making the data available in a full dataset format expands the reach of the SAFE Act to further meet compliance and fraud prevention goals by supporting companies who service the mortgage industry with data and loan origination products. CSBS also has information sharing memoranda of understanding for NMLS licensing and/or call report data with several federal agencies, including CFPB, FinCEN, FHA, FRB and OFR.

Since its launch in 2008, CSBS has continued to add additional functionality to NMLS for the benefit of state agency and industry stakeholders. These functionalities include mortgage and MSB call reports, electronic surety bond processing, licensing and control person wizards, and data analytics for examiners. A more detailed discussion of some of these functionalities can be found below under MCR Data Tools for Examiners.<sup>16</sup>

### NMLS 2.0 Outlook

NMLS 2.0 is a multi-phase effort to rebuild NMLS on a modern platform. NMLS 2.0 will enable state regulators to move from a forms-based system to a data-driven, risk-focused system for managing licensing, registration and financial reporting for nonbanks. State regulators and industry stakeholders — whose input is helping to shape development of the new system — have participated in NMLS 2.0 feedback sessions and demos at the NMLS Annual Conference & Trainings, as

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<sup>16</sup> CSBS aggregates and publishes NMLS licensing and call report data at: <https://nationwidelicensingsystem.org/about/Pages/Reports.aspx>

well as the AARMR, MTRA, NACCA and NACARA conferences throughout 2018. State regulators and industry stakeholders will continue to collaborate for a successful NMLS 2.0 development and launch.

## Boards, Committees, Task Forces and Work Groups

The state system of nonbank supervision has developed structures of cooperation and agreed governance designed to enhance supervisory processes at the national level. The root of these structures is found in the legal underpinnings of each state's statutory authority. In other words, an individual regulator can only do at the national level what it is authorized to do at its own state level. But when these individual authorities are brought together through official representative groups the states create a powerful and effective system of supervision.

These structures may be formal or informal, but they are always anchored in individual state authority. For example, the states may use formal agreements to establish representative committees that are authorized through the agreement to conduct supervisory activity on behalf of all states. The individual states are not compelled to rely on this process and may exert their independent authority at any juncture, but the process allows participating states to choose or consent to the representation if it benefits the state's position. A discussion of these structures in order of "hierarchy" follows:

### Association Boards

There are five primary state regulator associations that represent the state system at the national level (see The Role of State Regulator Associations below). These associations are incorporated as nonprofits to support state regulators in policy, process, communications and educational training. There are associations covering all the major nonbank industry areas: mortgage, MSBs, consumer finance and debt collection. The members of each association are the state agencies themselves, and more specifically, the head of each agency. Each association is governed by a board of directors established under by laws of the association and elected to specific terms by members. These boards set policy as agreed by the majority of the association's voting members. Again, no individual, sovereign state is compelled or required to follow policy set by the elected boards, but typically the member states find it advantageous and effective to do so. An example of an association board is the CSBS Board of Directors, comprised of 20 elected state officials each serving one-year terms.

### Committees and Task Forces

Committees and task forces are created to carry out the policy directives of the associations or the individual states by formal agreement. A committee or task force may be created by an association board informally charged with representing the states or by signed agreements of the states formally establishing such representation. Some committees are established by a vote of the association's full membership rather than the association's board of directors. Committees help regulators leverage scarce resources, harmonize otherwise differing policies and create standards that help improve the system.

Some committees are referred to as functional committees because they are tasked with administering certain functions of state supervision. For example, the MMC is a functional committee established to oversee multistate mortgage examinations. In this role, the committee makes decisions on behalf of the individual states in the system that have agreed to such representation. Although the MMC does not have legal standing of its own, each state has entered a legal agreement “empowering” the MMC to perform necessary functions in the orchestration of complex multistate exams. Without the MMC, states could still join forces and share information, but it would likely occur with less focus, strategy and consistency.

### Work Groups

Work groups are often established by committees to fulfill development of processes and procedures or implement certain elements of the states’ agreed policies. For example, a work group may be established to draft examination procedures directed by a committee that fulfills a strategic policy direction of an association. Work groups may not hold the “authority” to establish a procedure, but they are comprised of the subject matter experts who know how to create the procedure, which is approved by the committee and often brought back to the association board for a formal vote or endorsement. An example of a work group is the Risk Profiling Group (RPG) established by the MMC, representing the states through the Nationwide Cooperative Agreement for Mortgage Supervision. The RPG is tasked with identifying examination risk metrics to be used at the multistate level to assess the apparent risk of a mortgage company. Such risk profiling helps determine when an examination should be scheduled based on the apparent risk of the company.

## The State Examiner’s Toolkit

State regulators have established supervisory programs at both the single-state and multi-state levels. Many of the multi-state supervisory programs were created by the functional committees, and act as a guide for individual states looking to add depth to their individual state programs. Numerous states have adopted the standards set by the functional committees, which fosters consistency across states as they execute their individual programs. The common components within these supervisory programs typically include a manual, templates and procedures.

Some state regulators have chosen to make their examination programs available to the public, which is also an approach many federal financial regulators take. Offering supervisory programs publicly provides transparency in the oversight process employed by regulators and is a practice that industry stakeholders appreciate. The MMC made the choice to provide its examination program to the public, and it is available on the [CSBS website](#).

### Supervision Manual

The manual is a critical component of an overall supervisory program. The purpose of the manual is to set expectations, requirements and timelines for the individuals responsible for completing the review work. The supervisory manual sets the tone for the program, and when used properly creates a

consistent work product from examiner to examiner across the agency. Supervisory manuals can include the following items:

- Established policy and high-level procedures for completing examinations and investigations;
- Guidance on timelines;
- Expectations for workpapers and documentation;
- Information on quality assurance and work product requirements;
- Review components to be included in examinations and investigations; and
- Information on examination rating systems.

## Supervision Templates

Templates are used frequently when conducting a supervisory activity and are yet another tool that promotes consistency. Some examples of templates used in the examination process include the following:

- Report of Examination (formal agency issued document communicating examination results to the licensee);
- Scope Memo (justification for the scope selected);
- Entry Letter (initiating the examination);
- Information Request List (requesting documentation from the company);
- Workpapers (document the results of the review);
- Violation Write-ups (standard language used to cite violations in a consistent manner); and
- Close-out Letter (formal closure of the supervisory activity).

## Supervision Procedures

Procedures, regardless if they apply to examinations or investigations, are meant to guide examiners in the review of company documentation and information request responses. Procedures are particularly helpful for less experienced examiners that need assistance in the review process. An examination of a financial service provider typically includes a large volume of documents and having examination procedures to guide the review process is important to the success of the supervisory program.

## Reports and Supervisory Letters

There are multiple ways in which a state regulator can communicate the results of their work. The most common way to provide examination findings to the company is through the report of examination, which is almost always developed from a template. Supervisory letters are also issued by regulators to communicate findings of a review and are best characterized as abbreviated reports of examination.

The report of examination is the most significant document prepared in the examination process. There are legal consequences with respect to the information provided to the company in the report. It is imperative that examiners use templates to effectively communicate the findings of the examination in a format that is approved by their agency.

A report of examination or a supervisory letter can include more than just a list of findings and violation citations. These documents often include recommendations, guidance on compliance and best practices to follow. These documents are communication tools that regulators can leverage to establish a solid working relationship with the companies they supervise.

## Regulatory Technology (RegTech)

RegTech is commonly described as the technology that supports the management of regulatory processes, particularly for the financial services industry. There are several RegTech platforms that state financial regulators use daily, some of which were developed by state regulators themselves with the backing of CSBS. The most notable RegTech platform developed by state regulators is the NMLS. However, there are other RegTech platforms state regulators rely upon regularly to support their supervision efforts. Below is a summary of the notable RegTech platforms state regulators use today.

### [MCR Data Tools for Examiners](#)

In 2011 the functionality of the NMLS expanded to include a new module to intake Mortgage Call Report (MCR) data. The moment state licensed mortgage companies began filing call reports on the NMLS, state regulators had access to an incredibly valuable data source. Nationwide mortgage loan origination activity volume data for nonbank entities was simply not available prior to the filing of MCRs in NMLS. This event transformed the way state mortgage regulators approached their supervisory processes, particularly at the multi-state level.

With all this data, the states had to figure out a way to harness this information effectively. This need prompted SRR to build, in consultation with state regulators, what is called the MCR Analytics application. It is an application designed to support mortgage supervision by providing company risk indicators and financial condition metrics. The MCR Analytics application drastically improved the way state regulators can risk profile mortgage companies.

In 2015 state regulators created a new tool using MCR data that allows examiners to auto-generate a formatted report that includes origination volume data, financial condition ratios and loan originator activity. The report is titled the Mortgage Examiners Report. Within the tool, examiners can simply select the company, the applicable state(s) and filing quarters for an examination period under review and the application will provide a company-specific report that assists examiners in their pre-examination scoping responsibilities. In 2017 mortgage examiners across the country generated nearly 10,000 Mortgage Examiner Reports to support their supervisory activities.

Within the Mortgage Examiners Report there is a company profile that includes licensing information and identifies the peer<sup>17</sup> group to which the company belongs. The report also includes information regarding potential unlicensed MLO activity, where the application cross-references licensing dates from the NMLS, with the activity for loan originators in the MCR quarterly filings. Having this information in a concise document has helped improve the consistency and effectiveness of state mortgage regulators' examination efforts.

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<sup>17</sup> A peer group is a group of companies of the same type and approximate size.

In 2018, the mortgage servicing edition of the Mortgage Examiners Report was developed and released. The application that produces this report functions similarly to the mortgage origination edition but offers a different set of risk indicators relevant to mortgage servicing operations.

SRR also developed an MSB Call Report and the corresponding intake functionality in NMLS. Just as licensed mortgage companies must submit MCR filings, MSBs must now file call reports in NMLS. SRR is working to develop data analytics applications for the MSB Call Report, just as they did for the MCR. The impact and benefits of this effort will equal those realized by mortgage regulators.

#### Compliance Review Technology

In 2008, state regulators began the process to modernize the supervisory approach for examinations. Given the size and complexity of mortgage loan files, and the amount of time it takes to manually review a single loan file a change was needed. The MMC led the charge to achieve this change by advocating for the use of technology that assists examiners in reviewing loan transaction data. An automated compliance review system allows for computational and transactional review of a larger statistical sample (i.e. a sample size much larger than any amount an examination team could ever review manually). This automated review can include an analysis of virtually every loan originated or funded by the institution. This approach also provides pre-screening for manual file review (if needed) and assists in determining the ultimate scope of the examination, thereby allowing for a more targeted and risk-based approach to the examination. The benefits of leveraging technology within this portion of the examination are enormous.

Given this background, in 2009 state mortgage regulators selected ComplianceEase<sup>®</sup> (a product offered by LogicEase Solutions, Inc.) as their automated compliance tool of choice and have continued to use this compliance software ever since. State regulators have experienced some challenges in implementing this software into their supervisory processes over the years, however, in 2019, CSBS undertook an initiative to reconcile and integrate data uploads from mortgage loan origination systems into the software. As of early August, three national summits have been held with regulators, industry and technology vendors to develop solutions for effectively using the compliance technology to examine mortgage originators.

#### Existing Real-Time Technology

Some state regulators have been employing real-time supervision technology in the nonbank space since 2001 through a public/private partnership with Veritec Solutions of Jacksonville, Fla. While the technology has been primarily limited to small loans (e.g., payday loans), there are also solutions applicable to other nonbank areas as discussed below.

#### Concept

States, through law or rule, require certain nonbanks to upload individual transaction information to the system where it can be viewed by regulators in virtually real-time. Depending on the law, the nonbank may be restricted from providing more than one loan at a time to consumers, charging additional fees on existing loans, or other state mandated limitations. The database effectively prohibits the nonbank from violating the law by making the transactions “testable” before they are consummated.

## History

In 2001, the Florida Legislature determined that there was a public need to better regulate payday loans. The primary problem faced by Florida (and other states) was the propensity of consumers to take out multiple payday loans from multiple lenders at the same time, thereby compounding not only their indebtedness, but an ever-increasing cost to service the loans. Borrowers found themselves trapped in a cycle of costly debt.

Florida Senate Bill 561 established regulatory requirements that limited the number of loans a consumer could take out to a single outstanding loan statewide and prevented a lender from extending any loan for an additional fee. The Veritec data base was created to solve a compliance problem associated with the new requirements ... the ability of industry to know whether another lender had an outstanding loan with a consumer and the ability for regulators to “see” that no consumer had more than one loan at a time. The solution also partnered a private enterprise with government, allowing the innovation of private sector technology without expensive development and management costs by government.

This payday real-time data base and the public/private partnership concept gained attention of other states and today 14 states employ Veritec for payday lending, as well as check cashing and mortgage origination monitoring.

1. State of Alabama Deferred Presentment Services Database
2. State of Delaware Short-Term Consumer Loan Transaction System
3. State of Florida Deferred Presentment Transaction System
4. State of Florida Check Cashing Database System
5. State of Illinois Consumer Reporting Service Database Transaction System for Payday, Installment Payday, CILA Title-Secured, and Small Consumer Loans
6. State of Illinois Anti-Predatory Lending Database
7. State of Indiana Small Loan Transaction Database System
8. Commonwealth of Kentucky Deferred Presentment Transaction System
9. State of Michigan Deferred Presentment Transaction System
10. State of New Mexico Payday Loan Transaction System
11. State of North Dakota Deferred Presentment Database System
12. State of Oklahoma Deferred Deposit Transaction System
13. State of South Carolina Deferred Presentment Transaction System
14. Commonwealth of Virginia Payday Lending Database System
15. State of Washington Small Loan Transaction System
16. State of Wisconsin Payday Loan Transaction Database System

Consumers have the ability in states employing this technology to register complaints and report violations via multiple channels including a toll-free customer support center.

The system captures transaction-level information in real-time throughout the lifecycle of each payday loan which enables real-time examination reporting. The system provides the capability to look at statewide information across all licensees including transaction-level detail for all loans as well as to drill down on specific information. Comprehensive reporting is based on 100% of the captured data for

licensee transaction activity including all affiliated locations as well as activity driven through licensee websites.

This real-time, transaction-level reporting allows states to be more effective and efficient through a variety of reports, alerts and audit tools. This reporting capability enables regulators to conduct due diligence prior to an on-site examination and often reduces the amount of time required to conduct an examination, improving the accuracy of examinations, and lowering the frequency of on-site examinations.

Beyond payday lending, Veritec provides a similar “cloud-based” anti-predatory mortgage loan regulatory database for the Illinois Department of Financial and Professional Regulation and supports a toll-free call center to handle regulatory questions from the business and consumer communities. The Illinois Anti-Predatory Mortgage Program has established an effective regulatory environment for the broker-originated mortgage industry that provides for consumer protection with minimal interruption to the businesses that provide mortgage products. (Veritec Solutions, n.d.)

#### Near Future RegTech – The State Examination System

CSBS is developing the State Examination System (SES), a complimentary suite of functionality to support the examination, investigation, enforcement and complaints processes for state regulators and the companies they supervise. This system will be the first of its kind – no other multi-state examination exists today.

With SES, states will have a powerful tool to manage and execute their supervisory responsibilities and ensure the state license remains the top choice for nonbank financial service providers nationwide. SES will transform many of the supervisory processes state regulators use today by focusing on information sharing, multi-state collaboration, risk-based analytics and best practices. SES will also simplify cumbersome, paper-based processes used today, allowing examiners to focus more of their time on evaluating company operations and less time on administrative tasks.

In SES, state regulators will be able to grant access to their scheduling plans, supervisory work, concerns and other information with authorized agencies for companies they supervise jointly. SES will be the first examination system to include an information sharing component between states. By leveraging technology, SES will facilitate more efficient information sharing before, during and after supervisory activities are conducted. Regulators and companies will benefit from improved communication across state lines, with the goal of reducing regulatory burden for companies while helping state agencies maximize their resources. SES will encourage multistate supervision, foster a reduction in the number of examinations companies experience and allow regulators to eliminate duplicate supervisory efforts.

SES will also leverage data analytics to improve how companies are selected for supervisory activities. With the use of NMLS data, coupled with the new data from SES, state agencies will be better positioned to respond to risks, tailor supervision programs across industries, and continually refine the supervision process through informed metrics. The data analytics tools within SES will be dynamic; built to adapt to market conditions by allowing regulators to use different data points and risk factors.

SES will foster best practices across regulatory agencies. For example, if a state agency develops an innovative and effective approach to a supervisory challenge, the method can be shared quickly across

other agencies. The uniformity and consistency SES offers will improve the supervisory experience for companies across the country.<sup>18</sup> SES will be piloted in late 2019 and launched in 2020.

## Supervision Resources

Each state nonbank agency must commit a considerable amount of resources to supervision of the industry. Resource commitment is necessary to meet statutory requirements, industry oversight, consumer expectations and regulator best practices (e.g., agency accreditation and examiner certification). By far, the largest expense to an agency is the cost of employing and maintaining a highly trained staff. While the agencies themselves provide for most of their own resource needs independently, the state system also relies on outside sources of support to augment an ever-growing demand for competent and professional supervision.

## The Role of Associations

State regulators have established regulator owned and controlled associations to supplement their training, policy, technical, technology and communication needs as a system. By orchestrating these needs as a system, rather than 50 plus independent organizations, the states are able to combine efforts and leverage scarce resources, often exponentially. These state nonbank regulator associations are:

- American Association of Residential Mortgage Regulator - <https://www.aarmr.org/>
- Conference of State Bank Supervisors - <https://www.csbs.org/>
- Money Transmitter Regulators Association - <https://www.mtraweb.org/>
- National Association of Consumer Credit Administration - <http://naccaonline.org/>
- North American Collection Agency Regulatory Association - <http://www.nacaraweb.org/>

As each association name implies, the associations have specific areas of focus, with the exception being CSBS. CSBS, the association of state bank commissioners, is the largest and oldest of all state regulator associations. Founded in 1902, CSBS focused entirely on bank supervision until the 2000s. While state bank commissioners and their agencies have been responsible for supervising nonbanks since shortly after their inception, the rapid growth of nonbanks around the start of the century caused the commissioners to expand CSBS's role into direct support of the nonbank area.

With a staff of over 125 and a presence in the nation's capital, CSBS provides the commissioners and their professional staff the ability to connect and respond at the global level. With its size leverage CSBS was a natural selection for development of NMLS and the expansion of training programs into the nonbank space. Today CSBS provides national level policy, process development, training and support to field examiners and enforcement staff. Through the State Regulatory Registry LLC and NMLS, CSBS and AARMR together provide state nonbank regulators with powerful technology for licensing, reporting, analysis and examination.

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<sup>18</sup> See SRR 2018 Annual Report: <https://www.csbs.org/system/files/2019-02/2018%20SRR%20Annual%20Report.pdf>

Beyond CSBS, the other four state regulator associations provide a forum for policy development and training of state regulators. These associations allow the states to focus on very specific supervision areas (i.e., mortgage, MSBs, consumer finance and debt). They leverage the system's expertise through volunteer boards, committees and work groups, allowing the states to have a harmonized, unified and national presence for specific industry disciplines.

## Industry Associations

Industry associations like the Mortgage Bankers Association, the Consumer Financial Services Association of America, or the Financial Services Center of America play key roles in the supervisory process. Through industry associations, nonbanks learn of changes in law and regulation and receive training in best practices around compliance and consumer protection. These industry associations also play a vital role in bringing regulators in contact with the industry. Annually or more often, industry associations hold meetings and training events where both state and federal regulators are invited to attend and provide perspectives on supervision. These opportunities not only allow regulators to inform the industry about regulatory expectations but provide a non-confrontational venue for industry and their regulators to meet and discuss concerns, seek clarification, or simply build relationships that can be leveraged when issues arise.

## Federal Agency Resources

State and federal regulators in the nonbank space have developed relationships around collaboration, support and sharing of resources. This is especially true with the CFPB, an agency that employs dozens of former state nonbank regulators, some in key policy making positions. The states, through CSBS, exchange examination resources and training materials. Such exchange not only supplements both sides' resources, it strengthens and deepens a relationship that began in the earliest days of the CFPB's standup. Through CSBS, both sides share and learn about issues, areas of supervisory focus, and best practices for supervision. From the CFPB, the states can obtain quick interpretations of federal law and regulation and how to analyze for violations that are a focus of CFPB examinations. Prior to the CFPB, interactions with federal regulators in the nonbank space ranged from nonexistent to cumbersome. Congress's directives to collaborate and coordinate contained in Title X of the Dodd-Frank Act, combined with an agency leadership that truly believes in supporting the state system, the CFPB is a significant resource for state nonbank regulators.

When it comes to enforcement of BSA and AML matters, FinCEN is a ready partner and investigative resource to state agencies. While the matters dealt with in this area are often of a highly confidential nature, FinCEN provides the states with vital information and analysis in this complex area of supervision.

## Additional Federal Agency Resources

Through CSBS, state nonbank supervisors have established other federal agency relationships that provide training, advance information on emerging issues and risks, and the opportunity to consult on examination and enforcement matters. While these opportunities are less formal and less frequent than the relationships with CFPB and FinCEN, they nevertheless augment the states' supervisory resources, and at times lend vital support in enforcement matters. Some of these agencies include: FHFA, HUD, the FFIEC, DOJ, U.S. Department of Treasury, the Federal Reserve Board of Governors, OIG, the Office of Foreign Assets Control (OFAC), the Office of Financial Research (OFR), the Internal Revenue Service (IRS), and the U.S. Secret Service.

Another “quasi” federal agency that the states are actively engaging through CSBS is Ginnie Mae. While not technically a regulator, Ginnie Mae is backed by the full faith and credit of the federal government and actively applies rules, policies and controls similar to a regulator. Ginnie Mae is collaborating with state regulators on better understanding standards for the mortgage industry and assists in spotting issues that could become matters requiring greater regulator attention.

## Training, Certification and Accreditation

Supervision of the nonbank industries requires a trained licensing, examination and legal force. The state commissioners leverage the state regulator associations to provide vital education to office staff, field examiners, attorneys and agency management. Training is provided in both classroom settings and distance learning formats. Examiners in specific nonbank areas can obtain certifications of professional achievement through CSBS, identifying advanced levels of expertise, knowledge and leadership.

Through CSBS, state nonbank agencies earn “accreditation” status, evidencing the agency's depth of supervision expertise and commitment to resources. The CSBS Mortgage Accreditation and newly established MSB Accreditation programs involve an in-depth review of an agency's policies, procedures, and operations to determine if it meets the standards set forth by the Performance Standards Committee. A state seeking accreditation for the first time or a state seeking its five-year re-accreditation must complete the self-evaluation questionnaire, which includes several sections broken into multiple topics. The agency is asked to answer a series of questions and rate themselves against the corresponding standard. The agency can add documentation to support its answers and ratings. An accreditation review team comprised of current and former regulators conducts onsite accreditation reviews and determines the agency's ability to obtain or renew accreditation status.

### Benefits of the Accreditation Program

1. Obtain **guidance** and **assistance** through self-evaluation and self-improvement
2. Help **standardize** agency processes through documentation
3. Demonstrate that the agency **meets the standards** for state mortgage and MSB supervision
4. **Share ideas** and **best practices** for state regulation of financial services
5. **Strengthen** state mortgage and MSB regulation by meeting a shared set of principles

More information on CSBS accreditation programs and the CSBS Accreditation Handbook for State Agencies can be found at: <https://www.csbs.org/departments-accreditation>.

## Conclusion

States must retain their ability to respond to the needs of their community: ensuring that consumers are protected while at the same time fostering an environment conducive to commerce. As we identified in Chapter One, nonbanks are increasingly playing a large and integral role in many aspects of the financial services industry. Moreover, not only are their number increasing, but the roles they play also finds them responsible for the well-being of consumers in an increasing share of the financial marketplace. State regulators are the primary supervisors of nonbanks, placing them at the forefront of oversight. As the laboratories of democracy, they have substantial experience in balancing consumer protections with concerns for developing efficient markets.

In supervision there is a dual responsibility that lies with both the industry and the regulators. That responsibility is to ensure that business is conducted in a safe and sound manner. That assurance is accomplished through attention to three fundamentals of supervision: financial condition, compliance and consumer protection. Industry and regulators share this responsibility. As a condition of licensing the industry is tasked with the weighty responsibility of maintaining sound financial condition, adhering to compliance requirements, and protecting the interests of consumers with whom they transact business. State regulators are responsible for monitoring financial condition, testing for compliance with laws and regulations, investigating situations of consumer harm and seeking remediation and remedies in appropriate circumstances.

CSBS has developed tools on behalf of the state system that not only support effective supervision but provide industry with efficient mechanisms and processes for licensing, reporting and self-assessing at the institution level. By establishing a culture of compliance and employing best practices of self-assessment and self-reporting, management builds trust with the regulators, and that trust can help carry the institution through the examination and beyond.

RegTech is helping the state system to more effectively focus its resources based on institution risk, leading to a more efficient and safer nonbank industry and reducing the burden of both examinations and enforcement actions. The consumer protection role of the state system is to ensure that business practices do not result in consumer harm through negligence, non-compliance, or intentional acts that enrich the nonbank to the consumer's harm.

There is a fundamental understanding that nonbanks granted a license to conduct business in the state system are responsible for complying with all laws and rules and lawfully made directives or instructions of the regulators. Compliance with the foregoing should not be a contest between industry and regulators, but rather a relationship based on trust and an understanding that the core principles discussed in this paper can be beneficial to all.

In the coming years, state regulators intend to reengineer nonbank supervision through a paradigm shift in thinking and approach. Where new tools and information give consumers confidence in the industry and its supervision. Where industry self-assessment reduces burden and incentivizes a culture of compliance. And where real-time supervision through technology fosters a constructive and progressive future, and a regulatory approach of “trust but verify” works for all concerned.