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Narrowing of Licensing Exemption Under California Finance Lenders Law for Consumer Lenders and Brokers

*Henry M. Fields, Joseph Gabai, and Dina Kushner**

The California Department of Business Oversight has issued a new regulation that will eliminate a statutory licensing exemption under the California Finance Lenders Law for nonbank operating subsidiaries and affiliates of banks that are engaged in lending and/or brokering consumer loans. The authors of this article explain the regulation and its potential impact.

The California Department of Business Oversight (the “CDBO”) has issued a new regulation that will eliminate a statutory licensing exemption under the California Finance Lenders Law (the “CFL”) for nonbank operating subsidiaries and affiliates of banks (among other entities) that are engaged in lending and/or brokering *consumer* loans. The regulation will take effect on September 28, 2016.

Operating subsidiaries and affiliates engaged in lending and/or brokering *commercial* loans only will not be affected by this regulation, despite initial proposals by the CDBO to the contrary.

BACKGROUND

Section 22050(a) of the California Financial Code provides an exemption for licensing under the CFL for:

any person doing business under any law of any state or of the United States relating to banks, trust companies, saving and loan associations, insurance premium financing agencies, credit unions, small business investment companies, community advantage lenders, California business and industrial development corporations when acting under federal law or other state authority, or licensed pawnbrokers when acting under the authority of that license.

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Under long-standing interpretations, this exemption has been construed to apply not only to banks but also to subsidiaries of banks. These interpretations were based on the rationale that such entities, albeit not banks themselves, were doing business under federal and state laws “relating to banks” (including federal and state laws regulating the activities of bank subsidiaries). In addition, based on this rationale, bank holding companies and their nonbank subsidiaries (and foreign banks regulated as bank holding companies under the International Banking Act of 1978) have been regarded as doing business under federal law—the Bank Holding Company Act—“relating to banks.”

The initial version of Section 1422.3 (the “Regulation”) of Title 10 of the California Code of Regulations would have eliminated the license exemption for any “nondepository operating subsidiary, affiliate, or agent” of a national bank (or of a federal savings association). A later version of the Regulation would have eliminated the license exemption for any nonbank operating subsidiaries, affiliates, and agents of state banks (among other entities). The principal intent of the proposed Regulation, based on the background provided by the CDBO,¹ was to permit the CDBO, under the CFLL, to regulate bank subsidiaries that engaged in consumer lending. The text of multiple versions of the proposed Regulation, however, had a significantly broader reach.

PUBLIC COMMENTS

During the public comment periods relating to certain versions of the Regulation, certain commentators objected to the proposed Regulation on the grounds, among others, that the proposed Regulation provided an overly constrictive interpretation of the statute and was not necessary. Others argued that, at a minimum, the proposed Regulation should not affect any lenders and/or brokers affiliated with banks, if such lenders or brokers are engaged solely in lending or brokering commercial,² rather than consumer,³ loans.

¹ Notice of Rulemaking Action and Initial Statement of Reasons (PRO 03/13).

² A “commercial loan” is a loan with a bona fide principal amount of \$5,000 or more, or any loan under an open-end credit program, the proceeds of which are intended by the borrower for use primarily for other than personal, family, or household purposes. The definition applies regardless of whether the loan is secured or unsecured, and regardless of the nature of any security for the loan. The lender is permitted to rely on any written statement of intended purposes signed by the borrower. *See* Cal. Fin. Code § 22502.

³ A “consumer loan” includes any loan of less than \$5,000 and any other loan “the proceeds of which are intended by the borrower for use primarily for personal, family or household purposes.” The lender is permitted to rely on any written statement of intended purposes signed by the borrower. *See* Cal. Fin. Code §§ 22203 and 22204.

IMPACT OF THE REGULATION

The CDBO's final version of the Regulation incorporates these comments and reads as set forth in Exhibit A. In sum, it withdraws the exemption for entities doing business under federal or state law relating to banks that engage in lending and/or brokering consumer loans.

The Regulation will become operative on September 28, 2016, at which time any consumer lenders and/or brokers that are covered by the Regulation must be licensed under the CFLL. As the licensing process can be a lengthy one, lenders and/or brokers that will be covered by the Regulation should consider commencing the licensing process promptly.

Bank subsidiaries and affiliates should review their lending operations carefully to determine whether the Regulation will require them to obtain a CFLL license. For example, a bank subsidiary or affiliate that is principally engaged in commercial lending, but which occasionally offers consumer loans to select customers on an accommodation basis, will not be able to provide those consumer loans without obtaining a CFLL license because the Regulation applies if a company makes even one consumer loan. Or, given the fact that the CFLL defines a "consumer loan" to include commercial purpose loans of less than \$5,000, a bank subsidiary or affiliate that offers small commercial purpose loans of this magnitude will require a CFLL license as a result of the Regulation. In addition, even where a bank subsidiary or affiliate remains outside of the licensing requirements of the CFLL, it should consider other licensing and regulatory issues as applicable (*e.g.*, licensing issues under the California Real Estate Law, usury, adherence to safety and soundness standards, compliance with Bank Secrecy Act and anti-money laundering laws, etc.).

EXHIBIT A

Final Text of Section 1422.3

§ 1422.3. Certain Consumer Lenders and Brokers Not Exempt from Licensure.

- (a) A nondepository lender or broker that engages in the business of making or brokering consumer loans in this state is not exempt from licensure under subdivision (a) of section 22050 of the Financial Code unless that nondepository lender or broker is a bank, trust company, savings and loan association, insurance premium finance agency, credit union, small business investment company, community advantage lender, California business and industrial development corporation when acting under federal law or other state authority, or

a licensed pawnbroker when acting under the authority of that license.

- (b) For purposes of this section, nondepository “lender or broker” means a finance lender as defined in section 22009 of the Financial Code or a broker as defined in section 22004 of the Financial Code, and the finance lender or broker is also (1) a bank holding company or subsidiary of a bank holding company, as defined in chapter 17 of title 12 of the United States Code (commencing with section 1841), (2) a savings and loan holding company or a subsidiary of a savings and loan holding company, as defined in section 10 of the Home Owners’ Loan Act (12 U.S.C. § 1467a), or (3) a subsidiary of a bank, trust company, savings association or credit union, where the terms “bank,” “trust company,” “savings association” and “credit union” have the definitions ascribed to such terms in chapter 1 of division 1 of the Financial Code, and the term “subsidiary” means a subsidiary as defined in title 10, section 10.170 of the California Code of Regulations. For avoidance of doubt, the term “bank” includes a national bank, as such term is defined in section 189 of the Financial Code, and the term “savings association” includes a federal savings association or federal savings bank that is chartered under section 5 of the Home Owners’ Loan Act (12 U.S.C. § 1464).
- (c) This section shall become operative 180 days after the effective date of this section.

Note: Authority cited: Section 22150, Financial Code. Reference: Sections 22004, 22009, 22050, and 22100, Financial Code.