State of North Carolina
OFFICE OF THE COMMISSIONER OF BANKS

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RE: Declaratory Ruling 2003-01 concerning the Mortgage Lending Act

Dear Mr. Bost:

This will respond to your recent inquiry, in your capacity as counsel to the North Carolina Association of Mortgage Professionals, regarding so-called "net branching." You have requested that the Commissioner issue a declaratory ruling on whether and under what circumstances, if any, a licensee under the Mortgage Lending Act may lawfully operate net branches in this state.

This declaratory ruling is being issued in response to your inquiry pursuant to N.C. Gen. Stat. § 150B-4 and 4 NCAC 3B .0105. It is an interpretation of the North Carolina Mortgage Lending Act, a statute that the Office of the Commissioner of Banks ("OCOB") administers and enforces. For the benefit of the mortgage lending industry, a copy of this declaratory ruling will be posted on the OCOB website. In addition, a copy of this ruling will be mailed to each holder of a mortgage broker or mortgage lender license and to attorneys who have appeared before the Commissioner as representatives of licensees or applicants.

For the purposes of this declaratory ruling, reference to "Article 19A" means Article 19A of Chapter 53 of the North Carolina General Statutes, N.C. Gen. Stat. §§ 53-243.01 through 53-243.16. Reference to the "Act" means the Mortgage Lending Act which was Senate Bill 904 enacted as Chapter 393 of the 2001 Session Laws, including the amendment to the Act which was effected by Section 3 of Senate Bill 1066, enacted as Chapter 399 of the 2001 Session Laws. Both of these enactments were codified as Article 19A of Chapter 53. The Act replaced former Article 19 of Chapter 53 of the General Statutes which was entitled "Registration Requirements for Makers of Mortgages and Deeds of Trust on Residential Real Estate." Former Article 19 was a registration statute that was determined by the North Carolina General Assembly to be ineffective in the prevention of practices in the mortgage lending market that were harmful to consumers and contrary to the public interest.

Under the Act, mortgage lenders, mortgage brokers, and loan officers are required to be licensed before engaging in the business of mortgage lending or mortgage brokerage, unless exempt. A comparison of Article 19A with former Article 19 clearly demonstrates that the General Assembly was intent on imposing individual responsibility and accountability upon participants in the mortgage market. The particular requirements are discussed below; however, it is important to note at the outset that, as to any applicant for any license, the Commissioner must find "that the financial responsibility, character, and general fitness of the applicant are such as to command the confidence of the community and to warrant belief that the business will be operated honestly and fairly…" N.C. Gen. Stat. § 53-243.05(i).

The Act requires that each individual loan officer be licensed and subjects such persons to additional affirmative requirements in order to maintain such license. The Act requires that loan officers be natural persons at least 18 years of age. Loan officers other than those who were subject to the so-called grandfather provisions must take an approved mortgage fundamentals course and satisfactorily complete a written examination or possess residential mortgage lending education or experience that the Commissioner deems equivalent to the course. They are required to take annual continuing education in order to enhance their professional competence. In addition, active loan officers must be employed by a licensed mortgage broker or lender.

The Act requires licensing for mortgage brokers and lenders and subjects them to significant additional requirements. It imposes no requirement that a licensee adopt a particular form of business entity in order to be licensed---e.g., it is possible that an individual could be licensed as a mortgage lender or broker---but whatever the form of organization, a mortgage lender or mortgage broker must have at least one individual officer or owner who meets the statute's three-year experience requirement and who is designated to serve as the firm's managing principal. In addition, at each branch of a licensed mortgage broker or mortgage lender firm, the licensee must designate an individual with at least three years experience as its branch manager to supervise the business at that branch.

The Act imposes individual responsibility and accountability on mortgage brokers, lenders, and their supervisory employees in numerous ways. A licensed firm must designate to the Commissioner a managing principal "who operates the business under that person's full charge, control, and supervision." Each branch must also have a branch manager who carries the same responsibilities for each branch. Further, the affirmative duties imposed on mortgage brokers by G.S. § 53-243.10 apply to any firm that brokers loans and to the individually licensed loan officers who work for such firms. This same emphasis on individual responsibility can be seen in the enumeration of prohibited activities and again in provisions granting the Commissioner disciplinary authority over licensees and even over exempt or non-licensed persons who violate the Act.

Based on the plain meaning of its provisions, the Act clearly requires:

1. Personal responsibility on the part of licensed <u>loan officers</u> for their behavior in the conduct of mortgage lending.

2. Personal accountability and potential liability on the part of <u>branch managers</u> and <u>managing principals</u> who supervise licensed loan officers in the conduct of the mortgage business.

3. Responsibility of <u>licensed firms</u> to supervise and manage the behavior of all individuals in the firm's employ who are engaged in the mortgage business, with potential liability of the firm for any breaches of that duty.

With that reading and understanding of the Act clearly before us, let us turn to the subject of your inquiry, so-called "net branching." We note that this term is not specifically defined by the Act.

Recent pronouncements of the federal government are helpful in defining "net branching" with greater specificity. The U.S. Department of Housing and Urban Development issued Mortgagee Letter 00-15 ("ML00-15") to all HUD-approved Mortgagees on May 1, 2000. In ML00-15, HUD recognized that the term "net branch" does not have a universal definition, but HUD still sought to warn against prohibited branch arrangements. HUD found that "some HUD/FHA-approved mortgagees are engaged in the practice of taking on an existing, separate mortgage company or broker as a branch and allowing that separate entity to originate insured mortgages under the approved mortgagee's HUD mortgagee number." HUD barred such "... arrangements as a way for independent brokers to originate FHA mortgages without meeting HUD's application and asset requirements." HUD did not seek to prohibit a business arrangement "wherein the branch manager's compensation is based upon the (net) profit of the branch.... Such an arrangement is, essentially, an alternative compensation program for the branch manager and is an acceptable branch arrangement if all other branch requirements are met...".

The guidance issued by HUD in this letter is consistent with the Mortgage Lending Act passed by the North Carolina General Assembly. The conduct of a mortgage business through the use of the business model now known generally as "net branching" was anticipated by our legislators and is prohibited by the Act. To the extent that a licensee seeks to shift responsibility and accountability to the branch manager and away from the licensed firm which purports to operate a location as a branch, such arrangement is unlawful under the Act.

OCOB will consider the totality of the facts and circumstances surrounding a branch operation in its effort to interpret and enforce the Act. OCOB will include a review of operations and compensation agreements (collectively, "Agreements") in its future examinations of licensees. In conducting its reviews, OCOB may regard any provision or arrangement that seeks to circumvent or undercut the underlying principles of the Act outlined above as a violation of the Act. Among the provisions or conditions that OCOB would regard as possible indications of an unlawful net-branching arrangement would be a provision or arrangement that:

1. Requires the branch manager to obligate himself or herself for contractual relationships with vendors to the branch such as leases, telephones, utilities, and advertising, or for ownership of branch personalty, including bank accounts for operating expense funds.

2. Imposes upon the putative branch manager an obligation to indemnify the licensed firm for operational liabilities incurred at the branch.

3. Requires the putative branch manager to personally pay or cover operating expenses of the branch if funds are not available to do so from an operating account.

4. Attempts or tends to shift the common law rights and responsibilities of the master-servant relationship away from that described as “employee” to that of “independent contractor.” Included here would be provisions that attempt or tend to isolate employment relationships to the branch and not to the licensed entity, or provisions which purport to utilize or permit IRS Form 1099's rather than IRS Form W-2's for federal income tax reporting compliance.

5. Seeks to shift ownership or equity in the licensee to the branch manager in an effort to assign a license or shift control of the licensee without complying with G.S. § 53-243.06(c).

6. Permits or requires a loan officer to operate out of his or her residence as the primary place of business without the licensee designating that address and licensing it as a branch or without a qualified person being both designated as the branch’s manager and actually performing that supervisory function.

7. Calls for the branch or its manager to pay to the licensee a fee for each transaction conducted at that branch or a periodic, franchise-type fee regardless of activity.

8. Allows for a branch or branch manager to operate with little or no supervision or control by the licensee—e.g., where internal audits and controls are weak or non-existent, or where no effective compliance review program exists.

9. Allows for a branch or branch manager to market the products of the licensee independently from the licensee; or to offer products or services different from those of the licensee; or to maintain lines of credit, warehouse agreements, or other investor agreements that are separate from those of the licensee.

10. Allows for or requires the putative branch to have a name or operate under a name other than the name of the licensee.

In light of the supervisory responsibilities of branch managers, managing principals and licensed firms, we expect upon examination to see a clear recognition of this hierarchy. We expect to see policies and programs centered on “quality control” whereby the licensed firm ensures that its branch managers, loan officers, and other employees comply with applicable state and federal laws. We expect to find systems and procedures that ensure that errors or problems at the loan officer, branch, or firm level are caught before the mortgage enters into the secondary markets. We expect licensed firms to allocate resources so that the knowledge and skills of industry participants are continuously enhanced.

OCOB has, since the enactment of Act, maintained that "net branching" as that term is commonly used in the mortgage lending industry is contrary to the purposes and provisions of the Act. Nonetheless, we recognize that some loan officers have unintentionally become branch managers in such "net branching" arrangements. We strongly recommend that such individuals leave such relationships immediately; continued participation in unlawful "net branching" arrangements will jeopardize individual licensure. In extricating themselves from such unlawful arrangements, we would caution loan officers to fulfill their duties and obligations to current customers and avoid damaging consumers. While it should be obvious that the Commissioner cannot condone or permit the violation of the Mortgage Lending Act by individual licensees, it should also be obvious that harm to consumers, which the Act was passed to prevent and to remedy, should not be the result of a licensee's rush to compliance. OCOB will endeavor to work through such marginal cases as they arise. However, we wish to be clear on a central point: when unlawful "net branching" arrangements are found by this agency, we will enforce the Act as swiftly and aggressively as our resources allow.

I trust that this is responsive to your inquiry, and we look forward to continuing our work with the industry in a way that benefits North Carolinians.

Very truly yours,

Joseph A. Smith, Jr.
Commissioner of Banks