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TO THE
HOUSE COMMITTEE ON
CONSUMER PROTECTION & COMMERCE

THE TWENTY-SEVENTH STATE LEGISLATURE
REGULAR SESSION OF 2013

Wednesday, February 6, 2013
2:30 p.m.

TESTIMONY ON H.B. NO. 836
RELATING TO ESCROW DEPOSITORIES

THE HONORABLE ANGUS L.K. MCKELVEY, CHAIR,
AND MEMBERS OF THE COMMITTEE:

My name is Iris Ikeda Catalani, Commissioner of Financial Institutions ("Commissioner"), testifying on behalf of the Department of Commerce and Consumer Affairs ("DCCA") in strong support of this administration bill, House Bill No. 836.

This bill has two main purposes. First, it updates the escrow depositories law to more realistically address the responsibilities and operations of escrow depositories as they conduct business today. Second, it authorizes the Commissioner to investigate and conduct hearings on possible violations of the escrow depositories law, and it provides remedies to stop unlawful actions that would endanger the public. These

changes are needed to better regulate the industry and protect consumers in view of the higher stakes posed by larger and more sophisticated financial transactions handled by today's escrow depositories. Since the last significant revision to the State escrow depositories law was more than 25 years ago, I invited all the escrow companies to meet with me during the summer and fall of 2012 to discuss modernization amendments for this law.

In an escrow transaction, an escrow depository is hired to receive, hold, and deliver money and instruments affecting title to real property in accordance with an agreement of the transacting parties. Real estate purchase contracts typically require that funds be deposited with an escrow company prior to closing in an amount covering the full purchase price of the property. Escrow depositories also handle proceeds of mortgage loan refinance transactions. With the high value of Hawaii real estate – and the median price of a single family home on Oahu currently around \$600,000 – it is not uncommon for an escrow to involve hundreds of thousands of dollars. For luxury home transactions and commercial real estate transactions, multi-millions of dollars may be entrusted to escrow depositories.

We expect the escrow depositories that we regulate to operate with a high level of integrity. Still, in view of the large sums of money they continuously handle, and taking into account observations from the nationwide financial crisis, the Commissioner needs the meaningful investigation and enforcement tools that this bill provides, to

protect consumers. In other states, escrow depositories and agents have been involved in perpetrating, aiding or abetting mortgage fraud schemes and stealing from escrow accounts, as well as being duped into wiring millions of dollars from an escrow account to an unauthorized recipient.

Under current law, the Commissioner has the power to investigate information furnished by an escrow depository applicant, Section 449-7, Hawaii Revised Statutes ("HRS"). This bill would expand this power and authorize the Commissioner to investigate and conduct hearings regarding possible violations of Chapter 449, whether or not the investigation stems from information furnished by an escrow depository applicant. It would also give the Commissioner the authority to subpoena witnesses and documents, receive affidavits and oral testimony, and conduct contested case hearings. As well, it authorizes the Commissioner to hire qualified persons to help with the implementation or investigation of any claims. This would be similar to the authority already vested in the Commissioner with respect to financial institutions, money transmitters, and the mortgage loan origination industries, pursuant to Chapters 412, 489D, and 454F, HRS.

This bill also provides enforcement powers. For most consumers, a home purchase is their single largest financial transaction. As escrow depositories are entrusted with significant amounts of consumer funds in these transactions, the Commissioner must be able to take swift action to protect the public should the need

arise. Section 1 of the bill gives the Commissioner the authority to issue temporary and permanent cease and desist orders against escrow depositories to stop risky or illegal practices. It also sets out standards and procedures for issuance of such orders, with an eye toward balancing consumer protection interests and keeping a company in business.

Section 3 changes the administrative fine that can be imposed on an escrow depository licensee following notice and an opportunity for a hearing. The law currently authorizes an administrative fine for a “willful” violation of Chapter 449. The “willful” standard is not defined by statute, but it typically connotes an intentional or malicious result or an act done with an unlawful intent. This is inconsistent with an escrow depository’s legal responsibility of a “trustee” for all moneys and instruments received.

The “willful” violation standard is also much more generous than the level of conduct allowed by other industries that the Division regulates, and the Commissioner sees no justification or need for this. For example, the Commissioner has the authority to impose fines on other licensees as follows: for a false or misleading statement made negligently or knowingly by a mortgage loan originator (HRS Sec. 454F-12); for misrepresentation or concealment by a mortgage servicer (HRS Sec. 454M-6); for a money transmitter’s failure to make a report or statement lawfully required by the Commissioner (HRS Sec. 489D-23); and for a financial institution’s material violation of law or a rule (HRS Sec. 412:2-609).

Consequently, this bill removes the “willful” violation requirement for imposition of an administrative fine. It should be noted that a separate provision of existing law exonerates escrow depositories from certain unintentional violations of law. This bill also increases the maximum administrative fine from \$5,000 per violation, to \$10,000 per violation or failure to comply with any order. The bill adds a special civil penalty of up to \$10,000 if a violation is targeted at or injures an elder. This focus on protecting elders is in line with a recent report by the Honolulu Prosecutor’s Office that most crimes against elders involve financial fraud, and that crimes against elders doubled between 2009 and 2012.

The bill increases minimum net capital requirements of an escrow depository from \$50,000, to \$100,000, in Section 4. It also removes the performance bond alternative for satisfying the net capital requirement. The Commissioner submits that this provision was agreed to by the escrow companies who met during the summer/fall meetings.

In Section 7, the bill increases the fidelity bond minimum requirement from \$25,000 to \$100,000, and generally raises the amount of the permissible deductible. Section 8 increases errors and omissions insurance from \$100,000, to \$250,000. With increases in real estate values and escrows in the past 25 years, potential claims and losses have increased as well, warranting the higher bonding and insurance requirements. The bill gives the Commissioner the flexibility to allow a licensee to

deposit a security device such as a bond to satisfy fidelity bond and errors and omissions insurance requirements. The Commissioner submits that these changes have been agreed to during the summer/fall meetings with the escrow depositories.

Section 5 of the bill requires an escrow depository to give the Commissioner advance notice of change of its business manager designee and branch manager designee(s). Definitions for “branch manager” and “branch office” are set out in Section 2. It is important to have a designated responsible person overseeing the operations at branch offices to confirm all company policies and procedures are followed by staff who work away from the principal place of business.

In Section 6, the bill establishes a fee for the transfer or change in control of an escrow depository license. This fee will help cover the work of the Commissioner and the Division which must evaluate and respond to the required transfer or change application. In Section 9, fees for maintaining a license, various approvals, examinations and investigations are increased or specified. The current statutory examiner rate of \$40 per hour was established in 2001, and this bill seeks to raise the rate to \$60 per hour for both examinations and investigations, with a view toward having the licensee and escrow depositories program contribute toward the Division’s cost to service an escrow depository and the industry.

Representatives of the escrow depository industry met with the Commissioner in 2012, and indicated their agreement with the increased bonding requirements and fee schedule changes proposed in this bill.

Self-Funding Requirement Necessitates Requested Fee Changes

To provide context for the fee changes proposed by this bill, the Commissioner submits the following. The Division is responsible for the licensure, examination and supervision of state-chartered and licensed banks, trust companies, savings and loan associations, financial services loan companies, credit unions, escrow depositories, money transmitters, mortgage servicers, mortgage loan originators and mortgage loan originator companies. It is the only entity that monitors the regulatory compliance, safety and soundness of these industries – the federal government does not provide such oversight – and the Division carries out its duties in order to protect the rights and funds of depositors, borrowers, consumers and other members of the public.

Overall, the Division's revenues are inadequate to fully fund its operations, including the filling of all authorized positions and covering the Division's share of the departmental overhead. Notwithstanding the extraordinary efforts of Division staff, the Division is currently backlogged between 120 and 180 days in its licensing work due to understaffing. The Division appreciates having previously been allocated 34 staff positions to carry out its responsibilities. However, the current fee HRS fee structure generates revenue that is sufficient to fill only 28 positions. Consequently, six allocated

positions, all of which are “permanent,” are vacant. So while there is a clear need for additional staff to appropriately carry out the Division’s mandates and to protect the public, the Division is not in a position to cover the ongoing cost of these permanent positions until its revenue streams are changed and made sustainable.

Division’s staff vacancies adversely affect the State’s economy and the public’s security in a number of ways. Businesses that are otherwise ready to open may have to wait months to obtain approval on their initial license applications, despite best efforts of the Division and its staff. They must postpone hiring employees and generating revenue that would increase the State’s tax base. Licensees who do not apply for license renewals well before the end of the year may end up in a similar predicament, unable to lawfully conduct business after their license expires, and in limbo until the Division can confirm satisfaction of license renewal requirements and issue a license renewal. For the public, the Division’s personnel shortage means potentially months of delay in its examination of licensees which handle billions of dollars of consumer financial transactions annually. It also potentially means months of delay in the Division’s discovery of licensees that could benefit from the Division’s assistance and monitoring to help them restore their financial viability and strength. In an extreme case, a staff shortage could mean that the Division cannot discover and investigate questionable licensee conduct and circumstances in time to avert massive financial harm to the public.

The Division needs more funds to appropriately carry out its mission. In determining the best way to generate the funds, a guiding principle is that the revenues from each of program must be sufficient to cover the Division's cost of operating that program. Revenues schedules for program fees and rates are predetermined for the Division, as they are set out in the Hawaii Revised Statutes.

With specific regard to the escrow depositories program, it ran extremely large deficits in FY11 and FY12. To provide the minimum oversight, it cost the Division \$234,544 to operate the program, while it generated revenue for the Division of \$35,205, leaving the Division to cover the \$199,339 shortfall. In FY12, the program ran a larger deficit, this time in the amount of \$250,459. The most recent results are as follows:

Escrow Depositories Program	FY11	FY12
Program Cost to Division	\$234,544	\$293,914
Less Program Revenues	\$35,205	\$43,455
Program Deficit to Division	(\$199,339)	(\$250,459)

Clearly, under the fee schedule set by Chapter 449, HRS, the escrow depositories program is fiscally unsustainable for the Division. The minimum oversight includes review of the safety and soundness of the company and examination of a company on an 18 to 24 month cycle. The Division would like to enhance its program to: (1) provide

additional oversight throughout the year to companies who may have compliance issues, and (2) provide additional training to the Division's examiners and licensees to learn about the risks associated with the new compliance regulations.

The Commissioner submits that the fees changes for the escrow depositories program set out in this bill is a compromise and will not cover the cost of oversight and this industry will continue to be subsidized by the other industries. After having run an aggregate deficit on the program in just the past two years of nearly \$450,000, the Commissioner respectfully submits that requested changes in fees are both necessary and appropriate.

As the Division focuses supervisory, regulatory, and examination attention on State licensees, it expects the industry to be more responsive and compliant with state and federal laws, and that in turn, consumers will be better protected.

For many years, the Division has executed oversight of the escrow depositories industry taking into account federal policy set out by the federal government agencies and most recently by the Consumer Financial Protection Bureau ("CFPB"), and increasing federal government regulations. With financial transactions becoming increasingly sophisticated and scammers targeting our population, the Commissioner submits that changes to the Hawaii escrow depositories law proposed by this bill are needed to better protect consumers and promote greater soundness of escrow depositories.

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For these reasons, DFI strongly supports this administration bill, House Bill No. 836, and respectfully asks that the measure be passed.

Thank you for the opportunity to testify. I would be pleased to respond to any questions you may have.