Dear

Thank you for your letter concerning the Federal Deposit Insurance Corporation’s supervisory activities pertaining to FDIC-supervised institutions that facilitate transactions involving online short-term lenders. As you know, FDIC staff recently met with the staff of many of the signers of the letter to discuss this issue. We appreciate the opportunity to discuss the FDIC’s supervisory approach regarding institutions’ relationships, either direct or indirect, with third-party payment processors and merchants that may pose a higher risk of illegal or fraudulent transactions, including online short-term lenders.

The FDIC, as primary regulator of state-chartered financial institutions that are not members of the Federal Reserve System, is responsible for supervising these institutions for safety and soundness and for compliance with consumer protection laws, the Bank Secrecy Act and information technology requirements. Relationships with third-party payment processors and merchants engaged in higher risk activities, including certain online lenders, can pose significant risks for financial institutions in these areas because, ultimately, the bank can be held responsible for the transactions which it facilitates.

Currently, a number of states have laws that either prohibit or restrict certain types of lending. When a bank has a customer relationship with a company whose business line is prohibited or restricted in at least some states, the bank must take reasonable measures to ensure that the company is operating only where the activity is legally permitted. To the extent the activity is permitted but restricted, the bank should take reasonable steps to ensure that the company is complying with applicable law. In addition, the bank must consider whether the activity is being performed by the business in compliance with federal law. If the bank, through its customer relationship, is facilitating activity that is either impermissible in a state or being performed in an illegal manner under state or federal law, the bank can be exposed to both legal and reputational risk. As regulator, we are responsible for ensuring that banks fully appreciate these and other risks, and take reasonable measures to address them.

As challenging as it can be for banks to understand the risks involved in the activities of a direct customer, the difficulty is magnified when the activities involve third parties. For example, banks often process customers’ Automated Clearing House (ACH) transactions to credit or debit a bank account of another party. In carrying out this service for their customers, banks may enter into a relationship with a non-bank entity, known as a third-party payment
processor, which, in turn, has relationships with hundreds or even thousands of merchant customers. The majority of transactions passing through financial institutions and payment processors represent legitimate transactions initiated by reputable merchants. These functions typically are performed at a low cost and can provide a valuable service to both individual consumers and business customers.

However, in recent years, the FDIC has found that some supervised banks may have relationships with payment processors that process payments for businesses that present a greater risk for conducting illegal or fraudulent transactions, and that supervised banks may not have fully developed systems and procedures to identify and manage the risks of this activity. Since banks that facilitate illegal or fraudulent activity run the risk of being held accountable for such activity, it is the bank’s responsibility to monitor transactions flowing through it. Merchants that engage in higher risk activities include an array of different types of businesses, including, but not limited to: telemarketing entities, debt consolidation and forgiveness programs, online gambling-related operations, credit repair services, government grant or will-writing kit providers, online tobacco or firearms sales, pharmaceutical sales, sweepstakes, and magazine subscriptions, as well as online short-term lenders.

The FDIC has provided information to our supervised banks, which are primarily state-chartered community banks, for several years to raise awareness of the various risks of direct and indirect processing relationships. Additionally, other regulators also have issued guidance regarding payment processing. Moreover, a review of these relationships, both direct and indirect, is a component of our examination process. When we find instances of institutions not properly managing relationships with merchants engaged in higher-risk activities, the matter is discussed with bank management and usually noted in the institution’s examination report. If deficiencies are not addressed, the bank also ultimately may be the subject of an enforcement action.

1 FDIC guidance on this topic includes:
   - Managing Risks in Third-Party Payment Processor Relationships, Summer 2011 Supervisory Insights Journal; and

2 Other agency guidance includes:
   - The FFIEC Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual;
   - The FFIEC IT Examination Handbook, Retail Payment Systems Booklet;
   - FinCEN Advisory, FIN-2012-A010 Risk Associated with Third-Party Payment Processors dated October 22, 2012;
   - OCC 2008-12, Payment Processors: Risk Management Guidance dated April 24, 2008;
   - OCC Bulletin 2006-39, ACH Activities: Risk Management Guidance dated September 1, 2006; and
Our supervisory efforts to communicate to banks the elevated risks associated with merchants that engage in higher risk activities are intended to ensure that institutions perform the due diligence and monitoring necessary to mitigate the risks presented by these relationships. In order to address any confusion about our supervisory approach, we plan to issue a Financial Institution Letter for the banks we supervise to make it clear that the FDIC’s focus is the proper management of the banks’ relationships with their customers, particularly those engaged in higher risk activities, and not underlying activities that are permissible under state and federal law. In addition, we have reiterated to our Regional Directors, who will in turn communicate to our field examiners, that communications with banks in relationships with merchants engaged in higher-risk activities must be consistent with FDIC policy. We appreciate your bringing this matter to our attention and the opportunity to clarify our supervisory approach.

Again, thank you for sharing your concerns. If you have additional questions, please contact me at (202) 898-3888 or Eric Spitler, Director of Legislative Affairs, at (202) 898-7140.

Sincerely,

Martin J. Gruenberg