



The Need For Regulatory Cooperation In Bank Due Diligence Procedures

Federal Regulatory Interagency Meeting

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Agenda

- Introductions
- Background
- The shared problem:
 - Third Party Merchant Processors
- State and Federal efforts to address this problem
- Proposed solution:
 - Increasing Financial Institutions' Due Diligence Requirements
- Next Steps



Preventing Fraudulent, Illegal and Questionable Activity

- Payments Systems Issues:
 - Telemarketing Fraud
 - Illegal Activities
 - Questionable Business Practices (Payday Loans)
- Primary Cause:
 - On-line Third Party Merchant Processors (over 90%)

The ACH Network Connection:

- Internet tobacco retailers and telemarketers have moved almost exclusively to the ACH network
- Telemarketers have moved to the check collection system using demand drafts or remotely created checks to avoid ACH scrutiny

Problematic Issues

- Unclear due diligence requirements from regulators
- Financial Institutions' intransigence
- NACHA
- Primary culprits



Traditional Third-Party Processing

- Third-party
 - Originates and receives ACH transactions for financial institution directly to ACH Operator (e.g. Fiserv, NCR, EDS, etc)
 - Performs back-office operations (DDA posting, etc)
 - Payroll Processors (ADP, Paychex)
 - Bill Payment Providers (Checkfree)
- Financial institution
 - Responsible for all third-party processor activity in most cases without direct knowledge of what is submitted until settlement
 - Low risk: no history of abuse or fraud by traditional third party processors



Third Party Merchant Processor

Third Party Merchant Processor payment services:

The merchant sets up his store with products and pricing. The payments for Internet or Telephone purchases are processed through the services of the Third Party Merchant Processor though it appears as if the actual merchant is doing the entire process. The actual merchant then becomes a supplier and the shipper of the goods.

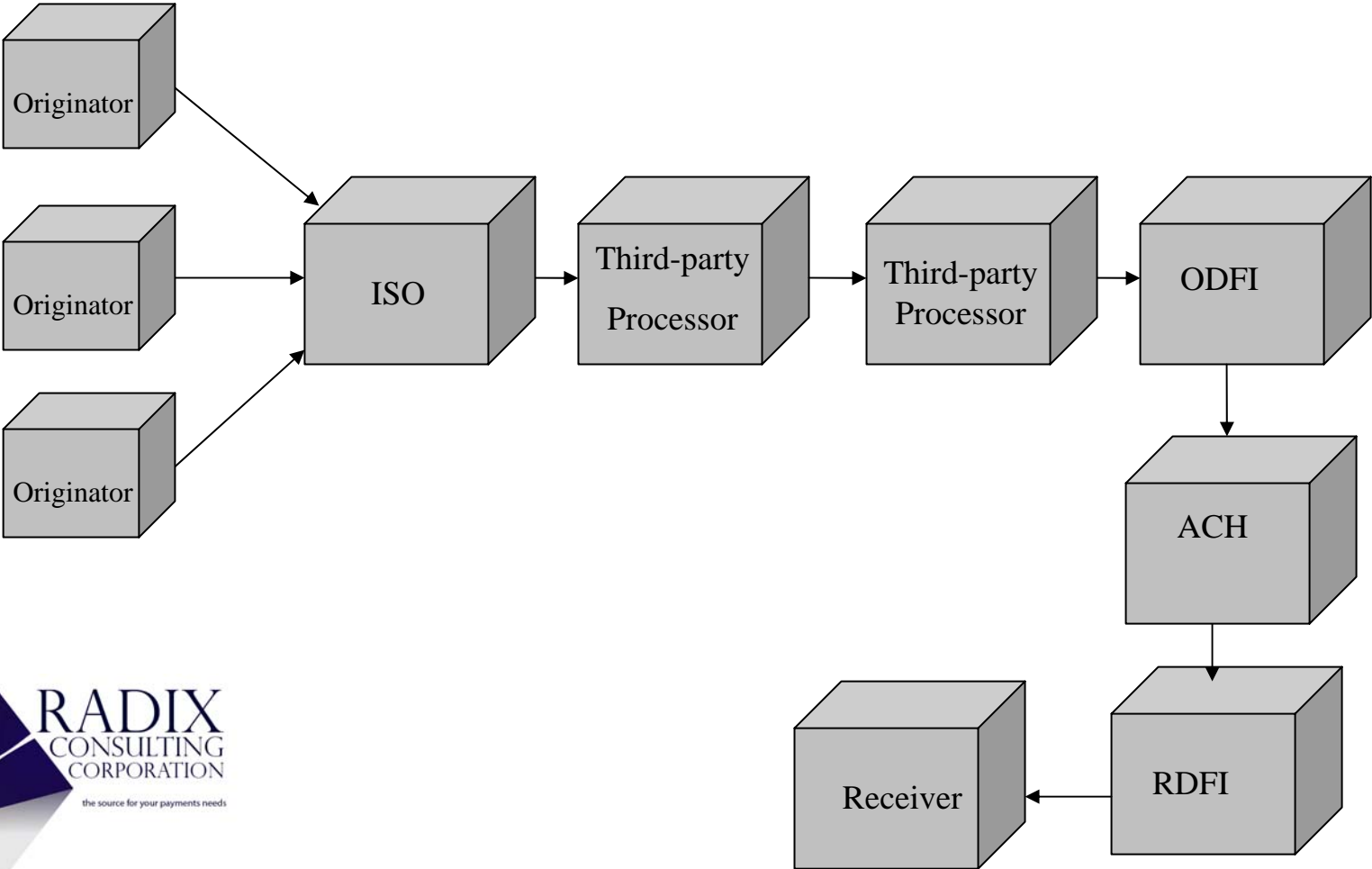


Complex Third-Party Merchant Processor Arrangements

- One or more third party processors
- One or more Independent Sales Organizations (ISO)
- Originating for merchants and service providers unknown to ODFI
- **As a Bank Examiner questions you need to ask:**
 - **Who are the originators?**
 - **What is their business?**
 - **Is it the type of originator the bank should do business with?**
 - **How are the authorizations obtained?**
 - **Does the third-party apply same KYC policies as the bank?**



Complex Third-Party Model - Who is your customer?

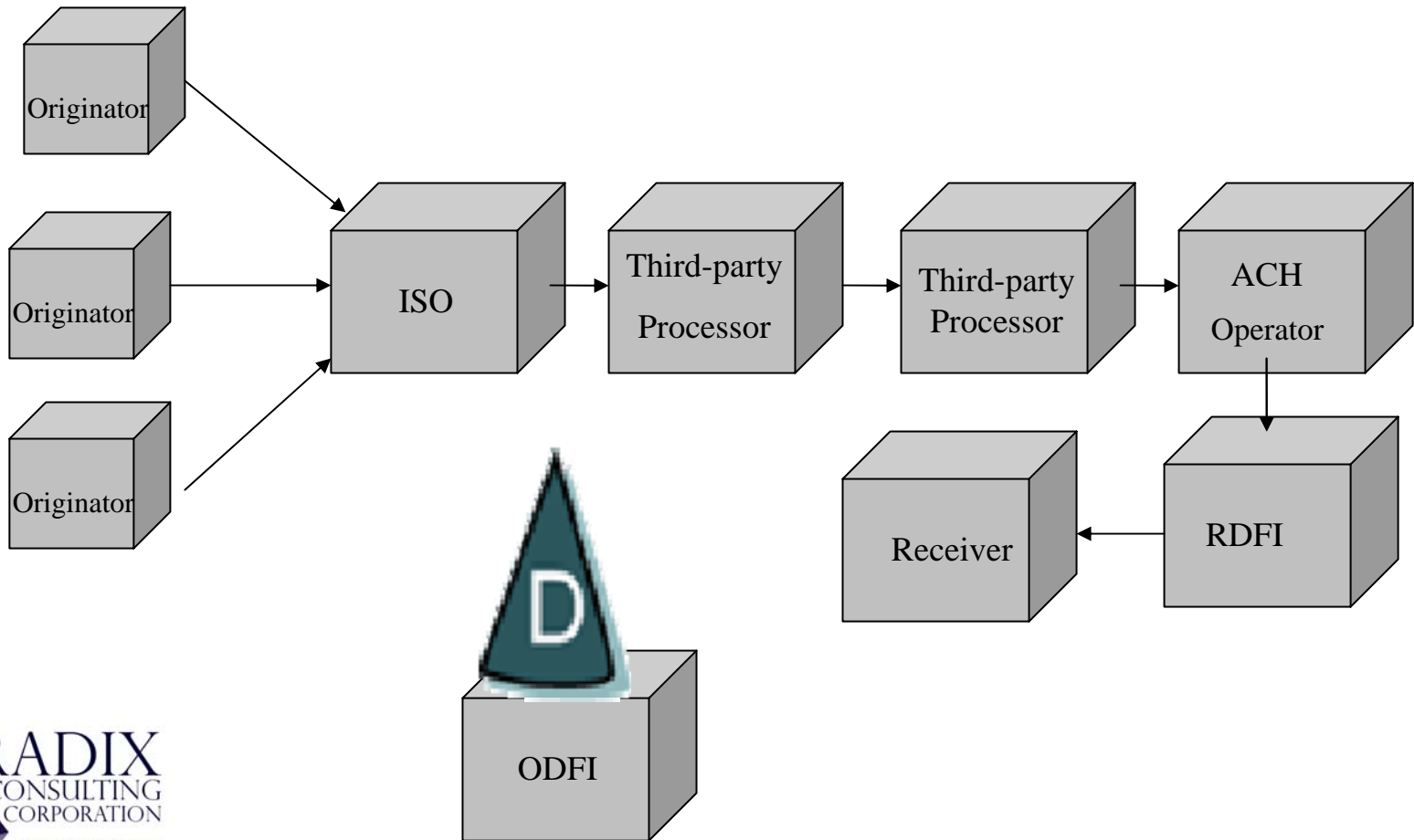


Worst Third-Party Payment Processor Model

- Third-party
 - Rents bank routing number and is directly connected to the ACH network
 - May originate ACH transactions for other third-party processors
 - Other third-party processors may submit transactions for many ISOs
- ODFI
 - Has no knowledge of forward or return activity until settlement
 - Lack of thorough due diligence process on the third-party processor and does not know their customers
 - Risks are the same as the complex model but there is less control of the risks



Worst Third-Party Model - Who is your customer? What are they doing?



Financial Institution Risks from Third-Party Merchant Processor Arrangements

- ODFI Exposure
 - Credit risk – for customer funding
 - Return item risk – on debit transactions
 - Reputation risk
 - Breach of warranty – long term liability
 - ACH fraud loss

Know Your Customer Means

- Obtaining the Merchant's:
 - name, address, and phone number,
 - type of business or principal business activity,
 - taxpayer ID number
- Cross-checking the Merchant's and principals' provided information

Know Your Customer Means

- Reviewing the Merchant's website address, products and services;
- Reviewing the Merchant's sales history;
- Visiting the Merchant's location
- Using unique company identifiers for each Merchant or Third Party Merchant Processor; and
- Outlining Merchant termination procedures.

Know Your Customer's Customers

- Require each Third Party Merchant Processor with which it does business *by agreement* to:
 - Identify each originating Merchant and conduct a due diligence review of such Merchant; and
 - Identify each Secondary Third Party Merchant Processor and require that Secondary Processor to perform the same due diligence review of its own customers.



Know Your Customer's Customers

- Requiring all ACH system participants to:
 - Consent to be bound by the National Automated Clearing House Association (“NACHA”) Rules, *and*
 - Affirm that all transactions comply with State and Federal laws.
- Requiring Third Party Merchant Processors to:
 - Stop origination services for any Merchant or Third Party Processor who violates or fails to meet the Third Party Processors’ due diligence procedures



Know Your Customer's Customers

- Terminate Merchants and Secondary Processors that:
 - Provide inaccurate Merchant information;
 - Fail to timely identify new Merchants, independent sales organizations or other Secondary Processors;
 - Fail to terminate Merchants engaging in illegal activities, or
 - Offer demand drafts to avoid ACH return scrutiny.



Know Your Customer's Customers

- Semi-annually, banks should:
 - Review the Merchant listings provided by each Third Party Merchant Processor;
 - Perform background checks on a random sample of Merchants supplied by each Third Party Processor.

Summary

- States and Federal regulators have a shared problem:
 - Third Party Merchant Processors
- The solution requires:
 - Specific due diligence requirements for banks and third party merchant processors, and
 - An examination of such agreements and risk control protocols by Federal regulators.



Questions

Next Steps

- Regulator reaction to proposed solution
- Can standard due diligence procedures be applied by all regulators?
- Regulatory proposal for solution to the problem
- How to regulate third-party merchant processors
- Additional steps the states can take
- Determine further need for discussion
- Next meeting if necessary



Thank You

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