

GUIDANCE FOR MANAGING THIRD-PARTY RISK



FDIC

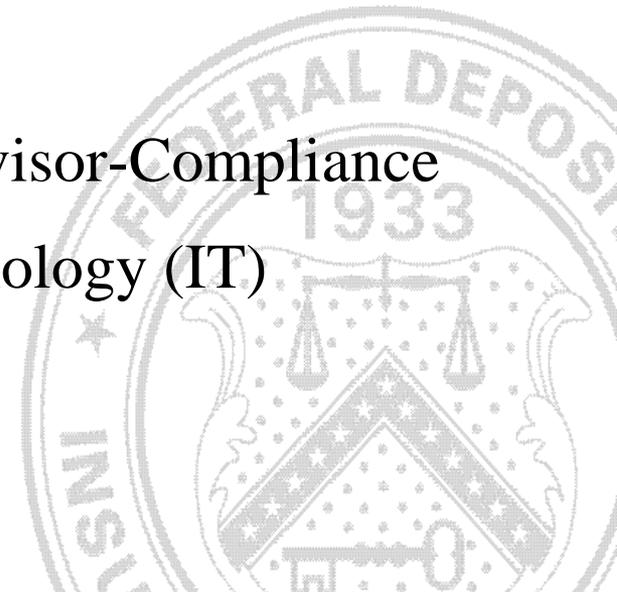
**Dallas Region
Banker Outreach Program
April 3, 2012**

Introduction

FIL-44-2008, Guidance for Managing
Third-Party Risk

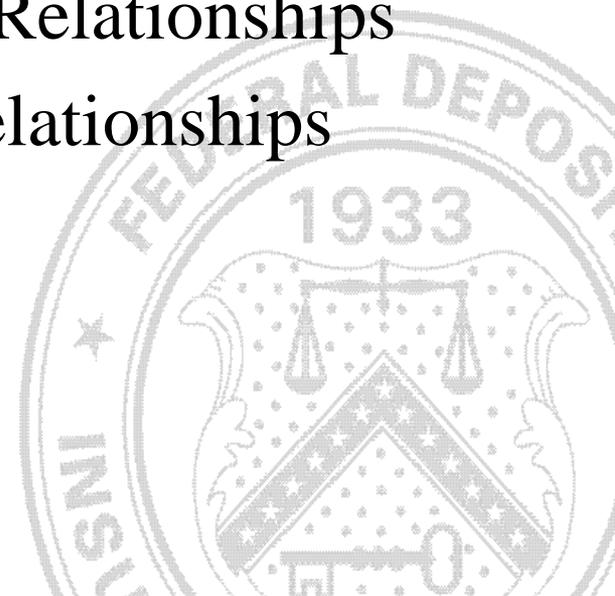
FIL 127-2008, Guidance on Payment
Processor Relationships

- Presenters:
 - Linda Wallace, Field Office Supervisor-Compliance
 - Reuben Smoke, Information Technology (IT)
Examiner



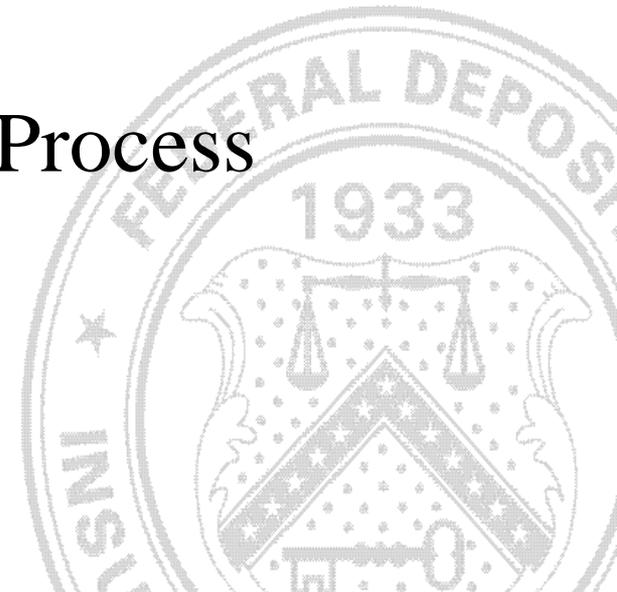
Agenda

- Background
- Potential Risks Arising from Third-Party Relationships
- Risk Management Process
- FDIC Supervision of Third-Party Relationships
- Third Party Payment Processor Relationships
- Questions
- Closing Remarks



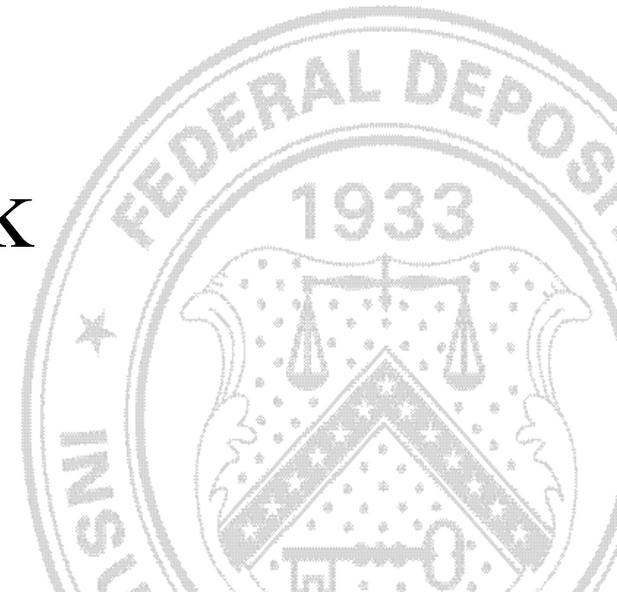
Background

- Third-Party Relationships Defined
- Third-Party Uses
- Third-Party Risk Management Process



Potential Risks to the Bank

- Strategic Risk
- Reputation Risk
- Transaction Risk
- Operational Risk
- Credit Risk
- Compliance Risk
- Legal Risk



Risk Management Process

Four Elements of Risk Management

- Risk Assessment
- Due Diligence
- Contracting
- Oversight



Risk Assessment

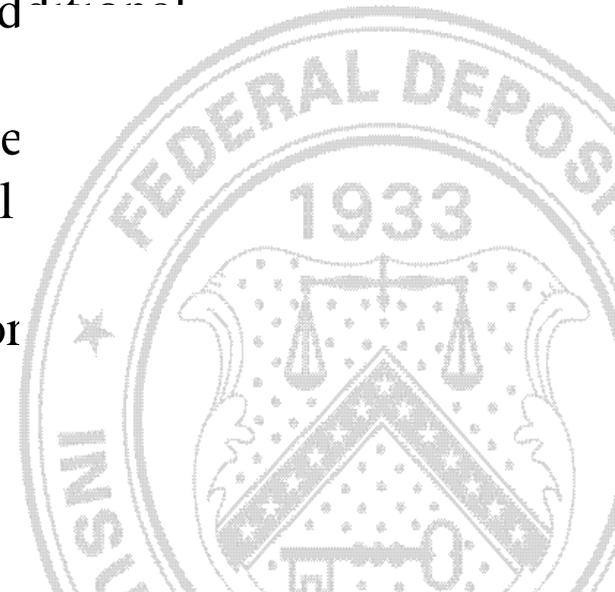
- Strategic Fit
- Cost/Benefit
 - Dollars and Risk/Reward
 - Management Capability
 - Long-Term vs. Short-Term



Due Diligence

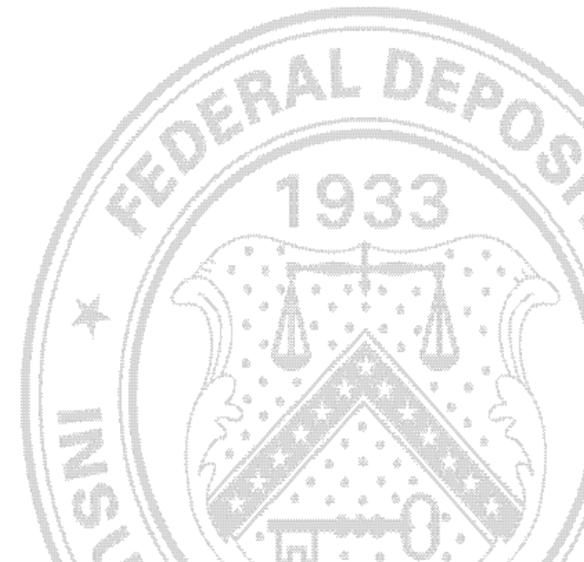
Third-Party Evaluation Criteria:

- Financial indicators
- Experience and Ability
- Strategies and Goals
- Business Continuity Plans
- Adequacy of management information systems
- The ability to perform using current systems or are additional investments required
- Scope of controls, privacy protections, and audit coverage
- Knowledge of relevant consumer protection and civil rights laws and regulations
- The existence of any significant complaints, regulator actions, or litigation against the company
- Significance to the third-party
- Business Reputation
- Use of Subcontractors
- Insurance Coverage



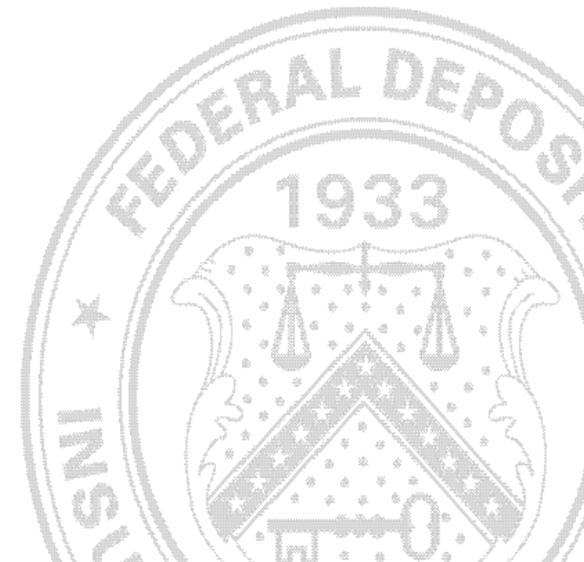
Contract Structuring & Review

- Scope
- Cost/Compensation
- Performance Standards



Contract Structuring & Review

- Reports
- Audit
- Confidentiality & Security



Contract Structuring & Review

- Customer Complaints
- Business Resumption & Contingency Plans
- Default & Termination



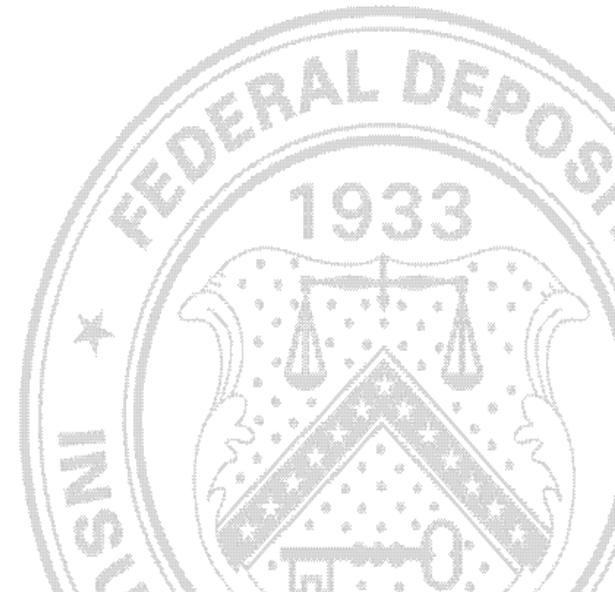
Contract Structuring & Review

- Ownership and License
- Indemnification
- Limits on Liability



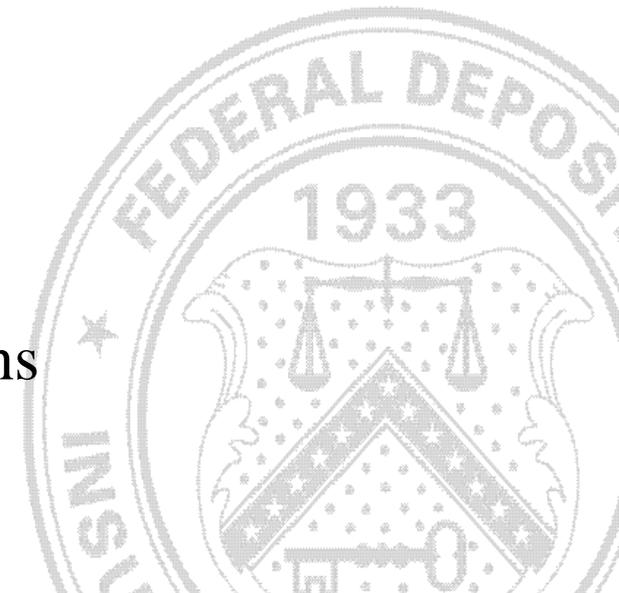
Oversight

- Board and management are responsible
- Monitoring
- Report to Board



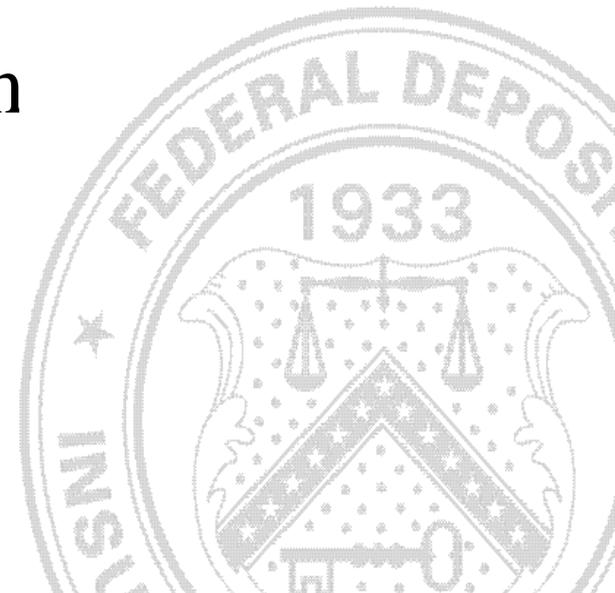
Bank Service Company Act

- Primary Federal Regulator Notification
- Third Party Relationships involving:
 - Check or deposit item processing
 - Core processing
 - Preparation and mailing of checks, statements, notices, etc.
 - Any other clerical, bookkeeping, accounting, statistical, or similar functions

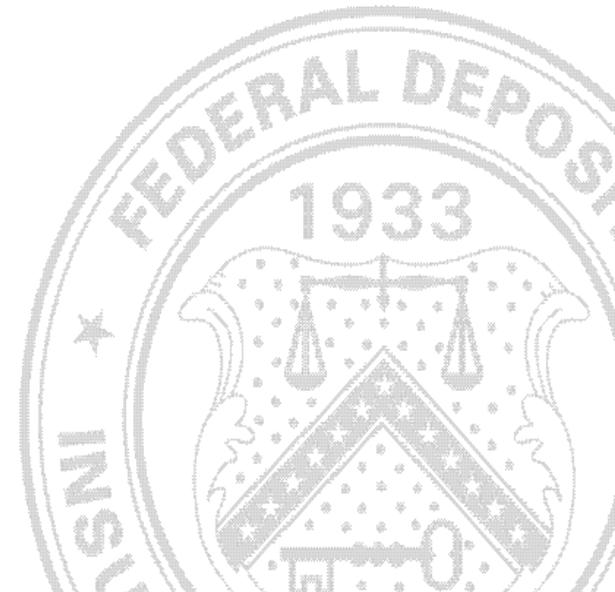


FDIC Supervision of Third-Party Risk Relationships

- Board and Management Responsibility
- Examination Procedures
- Report of Examination Treatment
- Corrective Actions



Third Party Payment Processor Relationships



In the News....



**FTC Press Release:
December 22, 2010**

“FTC Charges Massive Internet Enterprise with Scamming Consumers Out of Millions Billing Month-After-Month for Products and Services They Never Ordered”

“Defendants Allegedly Created 51 Shell Companies to Carry Out Deception”

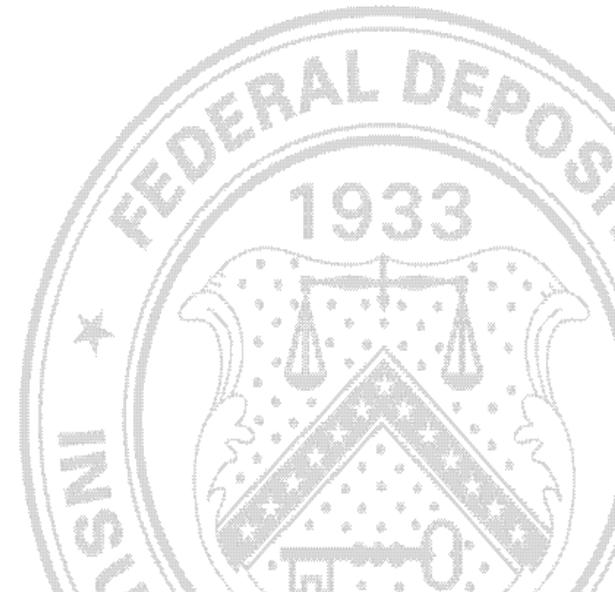
Third Party Payment Processors

TPPPs: What they are?

A deposit customer that uses its banking relationship to process payments for third-party clients

Third-Party Clients

- Legitimate?
- High Risk

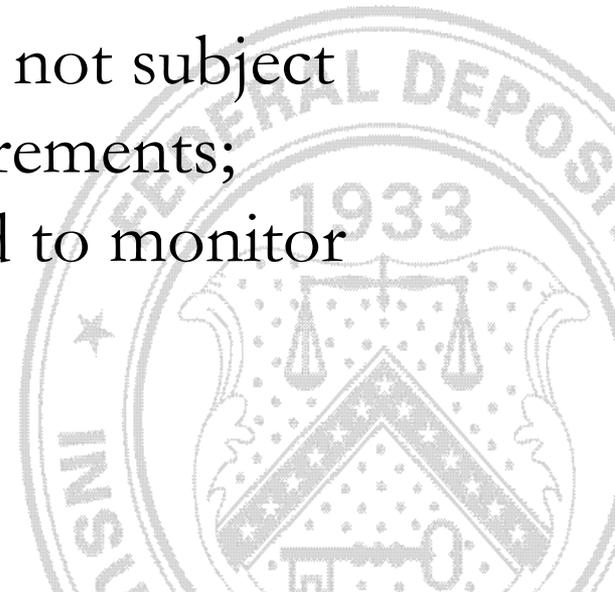


Third Party Payment Processors

TPPPs: What they are not?

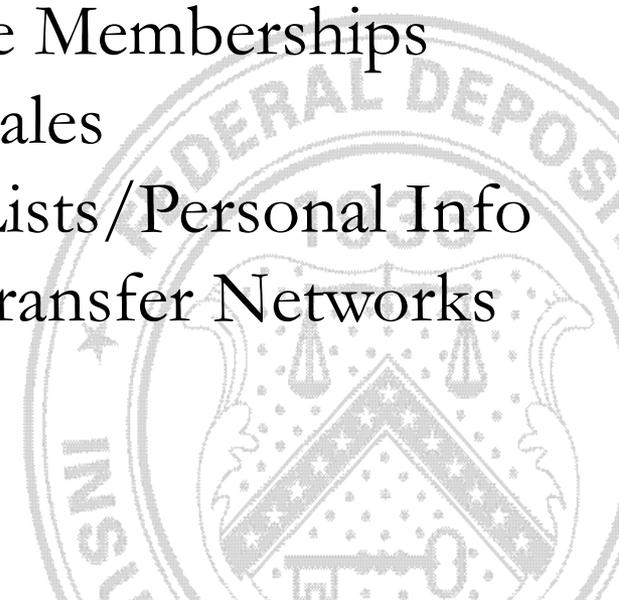
TPPPs are not technology service providers performing work on behalf of financial institutions

- Currently, TPPPs generally are not subject to BSA/AML regulatory requirements; therefore, they are not required to monitor for suspicious activity



High Risk Clients/Activities

- Ammunition Sales
- “As Seen on TV”
- Cable Box de-scramblers
- Coin Dealers
- Credit Card Schemes
- **Credit Repair Services**
- Dating Services
- Drug Paraphernalia
- Escort Services
- Firearms Sales
- Fireworks Sales
- **Gambling**
- Get Rich Products
- **Government Grants**
- Home Based Charities
- Human Growth Hormone
- Life Time Guarantees
- Life Time Memberships
- Lottery Sales
- Mailing Lists/Personal Info
- Money Transfer Networks



High Risk Clients / Activities

- Pyramid Type Sales
 - **Pay Day Loans**
 - Pharmaceutical Sales
 - Pornography
 - Ponzi Schemes
 - Racist materials
 - Raffles
 - Surveillance equipment
 - Sweepstakes
 - **Telemarketing**
 - **Tobacco Sales**
 - Travel clubs
-
- ❖ Any activity that is illegal
 - ❖ Any business that wants to avoid more stringent monitoring scrutiny



Typical Payment Types

- Remotely Created
Checks/Demand Drafts
- Automated Clearing House
(ACH)



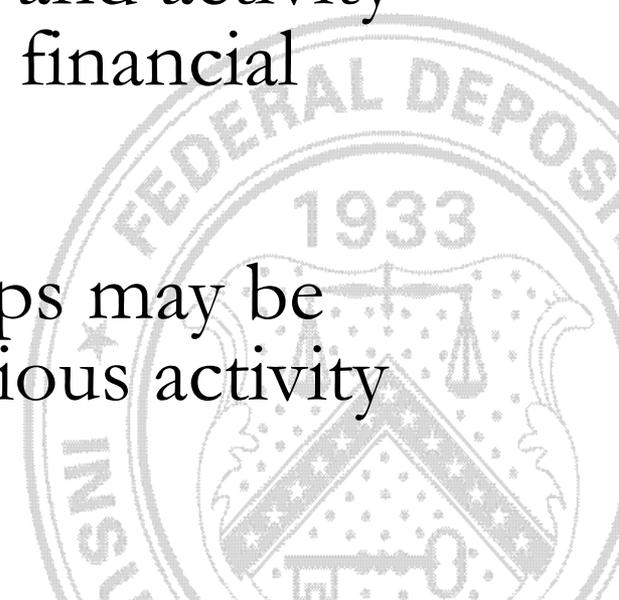
Warning Signs/Red Flags

- Consumer Complaints (i.e., unauthorized, misrepresented, merchant strong-armed consumer into providing account information)
- High volume activity
- High rates of unauthorized returns/charge backs
- High fee income associated with activity



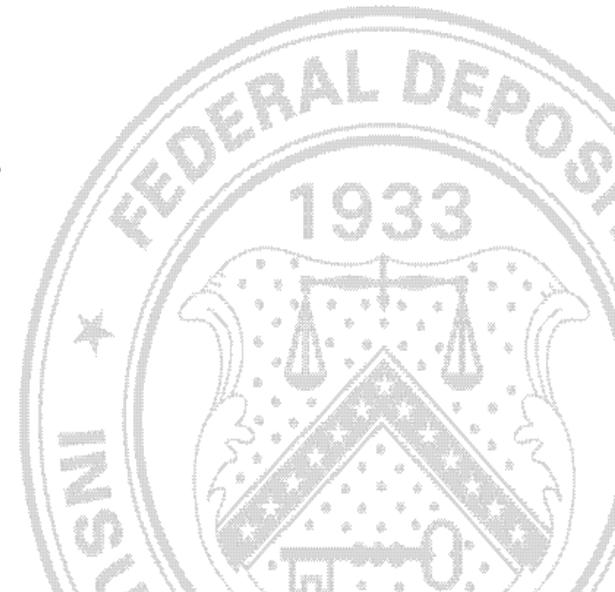
Warning Signs/Red Flags

- TPPPs have been targeting problem institutions with the promise of income and capital
- TPPP likely to use more than one financial institution to process payments and activity may periodically move between financial institutions
- One or more of the relationships may be terminated as a result of suspicious activity



Due Diligence & Underwriting

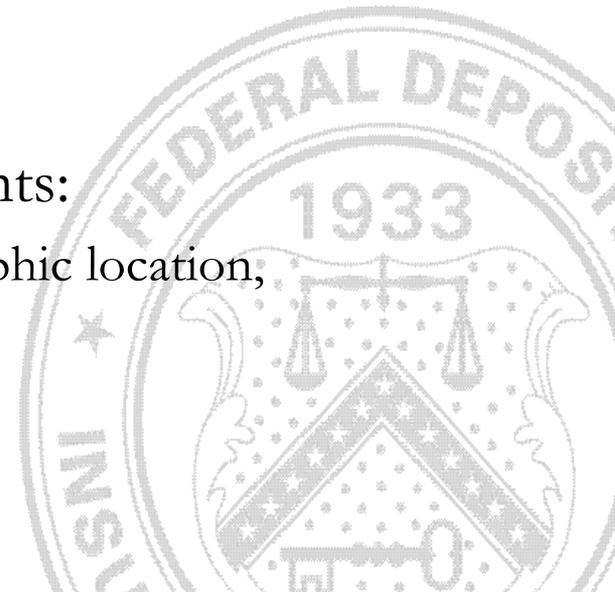
- Policies and procedures
- Processor approval program that extends beyond credit risk management
 - Background check of the payment processor and its clients
 - Authenticate the processor's business operations and assess the risk level



Due Diligence & Underwriting

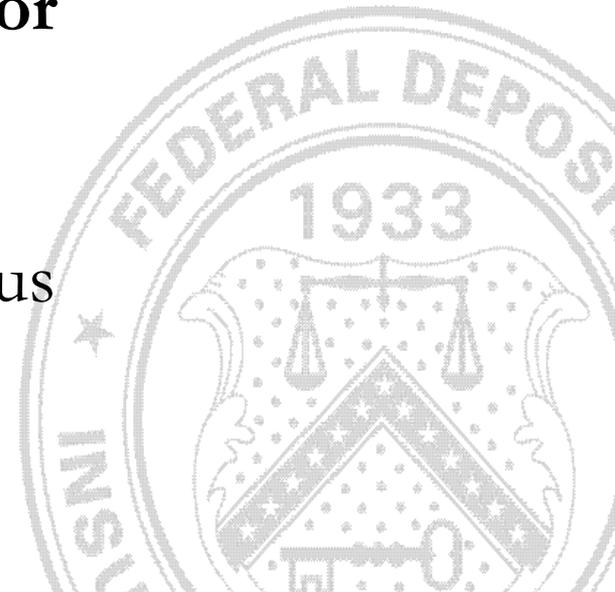
Assessment of processors should include:

- Review promotional materials, including Web sites, to determine the target clientele.
- Identify the processor's major customers.
- Review corporate documentation.
- Visit the business operations center.
- Review information on merchant clients:
 - Name, principal business activity, geographic location, and sales techniques.



Ongoing Monitoring

- Monitor for **consumer complaints**
- Monitor other financial institution complaints
- Monitor for **high rates of returns or charge backs**
- Monitor for other types of suspicious activity



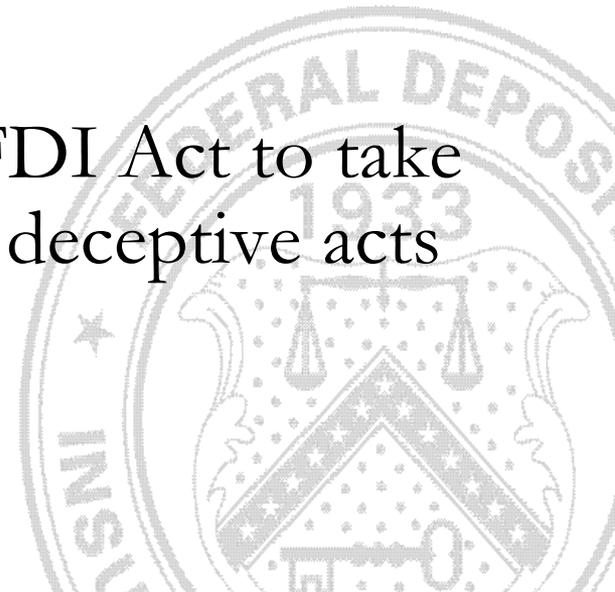
When a Bank Suspects Fraudulent Activity

1. File a Suspicious Activity Report
2. Require the TPPP to cease processing for that specific client
3. Terminate the relationship with the TPPP



Unfair and Deceptive Practices?

- A bank may be viewed as **facilitating a TPPP's or a client's fraudulent or unlawful activity**
- Section 5(a) of the FTC Act prohibits “unfair or deceptive acts or practices affecting commerce” and applies to all persons engaged in commerce, including banks
- Authority under section 8 of the FDI Act to take appropriate action when unfair or deceptive acts or practices are discovered

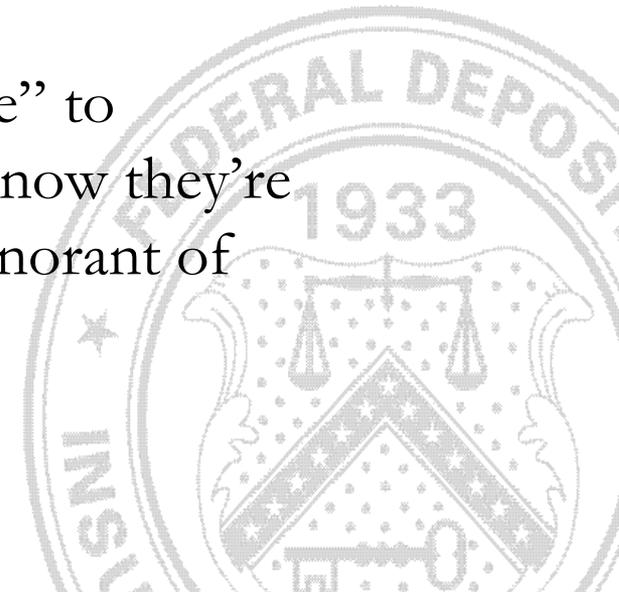


Unfair and Deceptive Practices?

FTC Telemarketing Sales Rule –

Designed to “curb deceptive and abusive practices associated with debt relief services.”

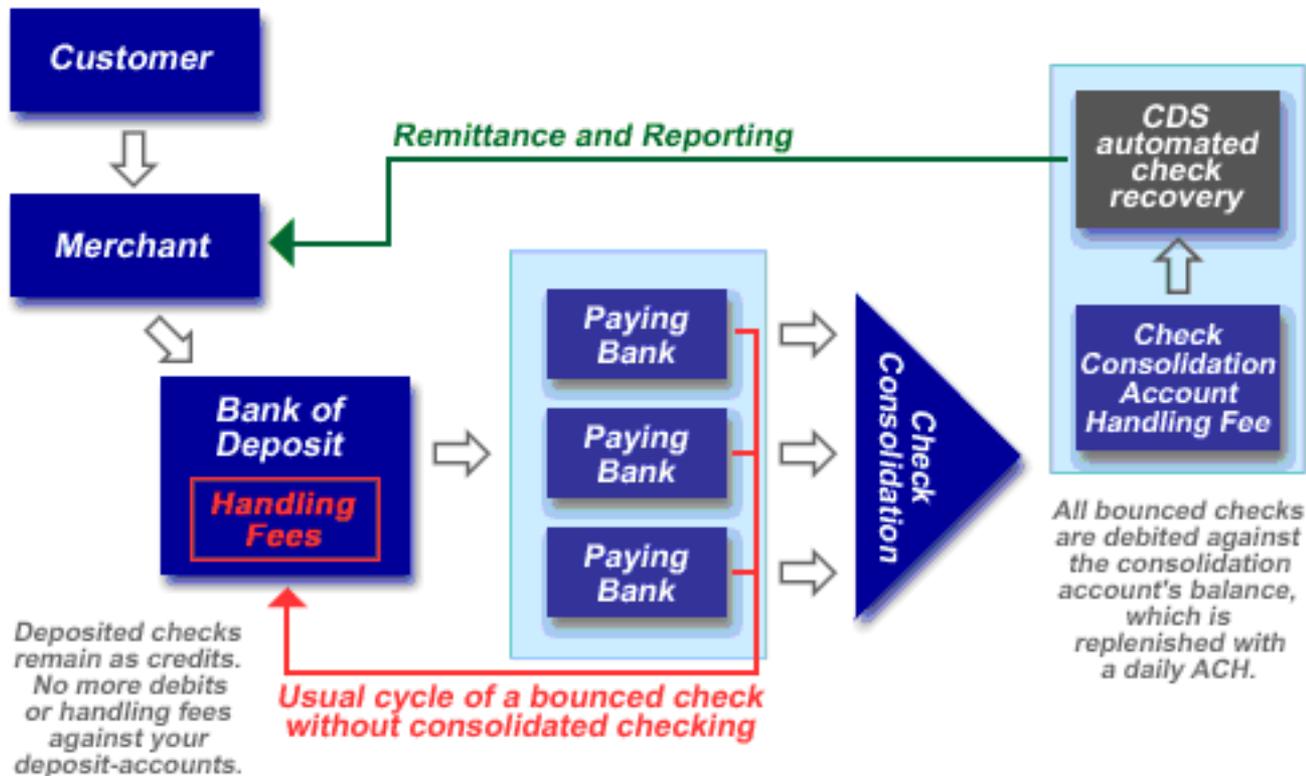
- Illegal to charge up front fees for debt relief services
 - Disclosure expanded related to debt relief services
 - Can’t make false claims about the services
-
- It’s illegal to provide “substantial assistance” to another company (TPPS or client) if you know they’re violating the Rule or remain deliberately ignorant of their action.



A New Wrinkle?

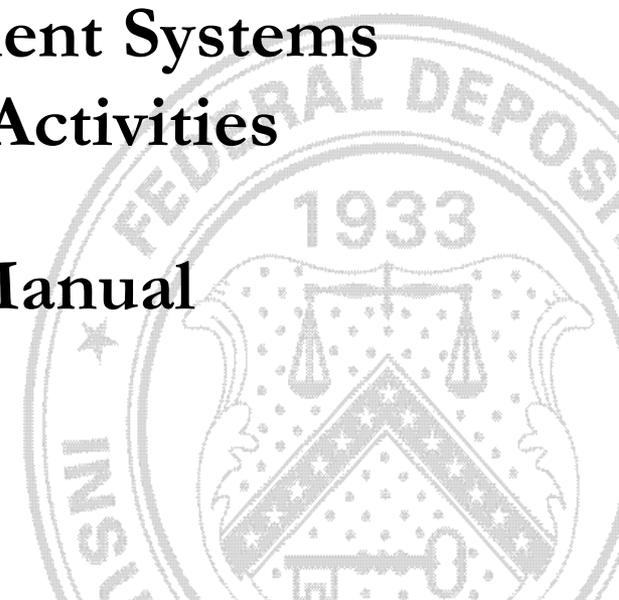
Return Check Consolidation Services

- May be used to disguise high rates of return



Regulatory Guidance

- **Guidance on Payment Processor Relationships (FIL-127-2008), dated November 7, 2008**
- **Guidance for Managing Third-Party Risk (FIL-44-2008), dated June 6, 2008**
- **FFIEC Handbook on Retail Payment Systems (March 2004) – Coverage of ACH Activities**
- **FFIEC BSA/AML Examination Manual**



References

- FIL 127-2008 Guidance on Payment Processor Relationships
- FIL-44-2008 Guidance for Managing Third-Party Risk
- FFIEC IT Handbooks
 - Outsourcing Technology Services
 - Supervision of Technology Service Providers
- FIL-105-2007 Revised IT Officer's Questionnaire
- FIL-52-2006 Foreign-Based Third-Party Service Providers
- FIL-27-2005 Guidance on Response Programs
- FIL-121-2004 Computer Software Due Diligence
- FIL-23-2002 Country Risk Management
- FIL-68-2001 501(b) Examination Guidance
- FIL-50-2001 Bank Technology Bulletin: Technology Outsourcing Information Documents
- FIL-22-2001 Security Standards for Customer Information
- FIL-81-2000 Risk Management of Technology Outsourcing
- FIL-49-1999 Bank Service Company Act

Questions?

Thank you!

