

FEDERAL RESERVE BANK OF NEW YORK

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CHESTER B. FELDBERG
EXECUTIVE VICE PRESIDENT

AT-10674
December 14, 1993

To the Chief Executive Officer of Each State
Member Bank, Bank Holding Company and Branch
or Agency of a Foreign Bank in the Second
Federal Reserve District:

The staffs of the federal financial institutions regulatory agencies and the Federal Trade Commission have recently been investigating deceptive practices in regard to credit card-related merchant activities at insured depository institutions. We want to alert you regarding this problem because a bank has already failed as a result of improper credit card-related merchant activities, and we have recently learned that some individuals and companies, who were associated with that failure, are attempting to sell arrangements similar to those that caused the bank failure.

The attached Interagency Advisory describes some questionable credit card-related activities and offers some suggestions on how best to avoid any difficulties in this area. The Interagency Advisory is being issued by the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and National Credit Union Administration.

Please direct any questions regarding this matter to Kevin J. Clarke, Domestic Banking Department, at (212) 720-2181.

Sincerely,

Chester B. Feldberg

Attachment

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of the Comptroller of the Currency
Office of Thrift Supervision

November 15, 1993

Interagency Advisory

CREDIT CARD-RELATED MERCHANT ACTIVITIES

The enforcement staffs of the federal financial institutions supervisory agencies, as well as the staff of the Federal Trade Commission, have received reports that some individuals and companies are engaging in deceptive practices in regard to credit card-related merchant activities at financial institutions. These matters are being actively investigated by the staffs of several of the agencies. This advisory alerts you to possible suspect merchant and credit card agent activities and requests that you communicate with your staff about possible problems that may arise as a result of such activities.¹

Merchant credit card activities basically involve the acceptance of credit card sales drafts for clearing by a financial institution (the "Clearing Institution"). For the Clearing Institution, these activities are generally characterized by thin profit margins amidst high transactional and sales volumes. Typically, a merchant's customer will charge an item on a credit card, and the Clearing Institution will give credit to the merchant's account. Should the customer dispute a charge transaction, the Clearing Institution is obligated to honor the customer's legitimate request to reverse the transaction. The Clearing Institution must then seek reimbursement from the merchant. Problems arise when a merchant is not creditworthy and is unable, or unwilling, to reimburse the Clearing Institution. In these instances, the Clearing Institution will incur a loss.

Clearly, in order to avoid losses and to ensure the safe and profitable operation of a Clearing Institution's credit card activities, the merchants with whom they contract for clearing services should be financially sound and honestly operated. To this end, safe and sound merchant credit card activities should include clear and detailed acceptance standards for merchants. A Clearing Institution should scrutinize prospective merchants with the same care and diligence that it uses in evaluating prospective borrowers. Also, financial institutions engaging in credit card clearing operations must closely monitor their merchants. Controls should be in place to ensure that early warning signs are recognized so that problem merchants can be removed from a Clearing Institution's program promptly to minimize loss exposure. In cases of merchants clearing large dollar volumes, a Clearing Institution should establish an account administration program that, at a minimum, incorporates periodic reviews of the merchants' financial statements and business activities. In addition, a Clearing Institution should establish an internal periodic reporting system of merchant account

¹ This is not the first time that such activities have been identified. In 1990, the OCC issued an advisory to its national banks alerting them to many of these same activities.

activities, regardless of the amount or number of transactions cleared, and these reports should be reviewed for irregularities so that the Clearing Institution alerts itself quickly to problematic merchant activity. Also, Clearing Institutions should, of course, follow the guidelines that are established by the card issuing networks.

Another recent problem with merchant activities involves Clearing Institutions that sometimes engage the services of agents, such as an independent sales organization ("ISO"), in their merchant programs. ISOs solicit merchants' credit card transactions for a Clearing Institution. In some cases, the ISOs actually contract with merchants on behalf of Clearing Institutions. Some of these contracts are entered into by the ISOs without the review and approval of the Clearing Institutions. At times, Clearing Institutions unfortunately rely too much on the ISOs to oversee account activity. Federal regulators have found several instances in which Clearing Institutions have not properly monitored the activities of ISOs. In these cases, Clearing Institutions have permitted ISOs to contract with disreputable merchants, such as some telemarket businesses that engage in fraudulent transactions. These problem merchants later experience high charge-back activity due to questionable sales schemes and other improper practices. Because of the poor financial condition of the merchant, or ISO, or both, these Clearing Institutions ultimately incurred heavy losses. At least one bank has failed as a direct result of such activity.

A financial institution with credit card clearing activities that engages an ISO should develop its own internal controls and procedures to ensure sound agent selection standards. ISOs that seek to be compensated solely on the basis of the volume of signed-up merchants should be carefully scrutinized. When engaging the services of a third party, such as an ISO, in connection with any aspect of its operations, a Clearing Institution should adequately supervise the ISO's activities; and it should, of course, reserve the right to ratify or reject any merchant contract that is initiated by an ISO.