

## Credit Card Related Merchant Activities

Examiners should evaluate the above-captioned function against the following control and performance standards. The Standards represent control and performance objectives that should be implemented to help ensure the bank operates in a safe and sound manner, and that the entity's objectives are carried out. Associated Risks represent potential threats to the bank if the standards are not achieved and maintained. The Standards are intended to assist examiners in analyzing important functions that may warrant additional review. All of the following Standards may NOT need to be considered at every bank. Conversely, these do NOT represent all of the control and performance standards needed for every bank. Examiners should continue to use their judgement when assessing risk.

Standards	Associated Risks
<b>MANAGEMENT AND CONTROL</b>	
<p>The board of directors maintains a written merchant processing policy and procedures manual.</p> <p>Policies and procedures are in place for chargeback processing.</p>	<p>An inadequate merchant processing policy may expose the bank to greater financial, settlement, chargeback, fraud, and underwriting risks.</p> <p>The policy and practices may not be compatible with current market conditions and the bank's strategic plan.</p> <p>Officers and employees receive inadequate guidance in administering the merchant processing program resulting in excessive and unnecessary risks to capital and earnings.</p> <p>Inadequate chargeback policies and procedures could result in contingent liabilities and losses for the acquiring (processing) bank.</p>
<p>The merchant approval, Independent Service Organization (ISO), and agent bank policies are adequate and contain prudent underwriting criteria.</p>	<p>Inadequate merchant approval policies may result in dealings with undesirable accounts and poor file documentation.</p> <p>Poor underwriting criteria may result in elevated credit risk.</p> <p>Without adequate ISO underwriting standards, the bank could be exposed to ISOs with poor financial condition and unqualified management.</p> <p>Insufficient guidance for agent bank underwriting may lead to increased financial, legal, and credit risk.</p>
<p>Management prepares separate, pro-forma budgets for the merchant banking department.</p>	<p>Management may be unable to detect inefficient operations through comparing actual performance against projections.</p>
<p>The board and management receive appropriate merchant-related reports on a timely basis.</p> <p>Management uses exception reports as part of an early warning system to detect merchant fraud.</p>	<p>Senior management may lack the necessary information to appropriately oversee merchant processing activities.</p> <p>An inadequate early warning system could hinder the bank's ability to control losses. Without exception reports, management is unable to</p>

Standards	Associated Risks
	monitor activities falling outside of acceptable parameters.
Prudent controls exist for merchant and ISO activities, including performing a thorough review of all merchants.	Management is unaware of the merchant's financial risk, type of business, location, principals, etc.  Inadequate control over ISO activities could result in unacceptable or unreliable ISO practices, performance, or financial reports.
The department receives internal or external audit coverage, or both.	Inadequate audit coverage may prevent management from evaluating and controlling risk associated with retail merchant processing.
<b>PERFORMANCE</b>	
The reserves for chargebacks (merchants, agents, and ISOs) are adequate.	Losses resulting from merchant chargebacks that exceed reserve accounts could impair earnings and capital.
Contingency plans have been developed and reviewed for all parties involved in the settlement process.  Controls over reserve accounts are adequate.	The absence of contingency plans may result in a failure to settle and increase credit and liquidity risk to the bank.  Dollar amounts of reserve accounts could be manipulated.  Infrequent reviews of reserve accounts could lead to inadequately funded reserves.
Chargebacks are prudently monitored.	Management may be unaware of the volume and causes of chargebacks.
Fraud detection procedures exist (may be unique for each merchant).	Generic exception parameters, when universally applied to merchants, may not necessarily identify unusual activity.
Management reviews and maintains financial information on agent banks.	Increased financial risk may result from management's inability to monitor the agent bank's financial performance.
The bank's pricing system and cost control measures are adequate.  Servicing operations meet profit targets.	Since merchant processing involves narrow profit margins and high transactional and sales volume, improper pricing could quickly eliminate any profits for the department.
Management implements proper controls over reserve accounts.	Dollar amounts of reserve accounts could be manipulated.  Infrequent reviews of reserve accounts could lead to inadequately funded reserves.

## Credit Card Related Merchant Activities

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

### IMPORTANT

1 Prior to completing this module, examiners must determine the scope of the examination of Merchant Credit Card Related Activities. The scope of the review should be commensurate with the perceived level of risk in this area. Consider the following factors when determining the scope:

- 1 A Total dollar sales volume of credit card related merchant activities processed.
- 1 B The bank's capital structure.
- 1 C Management's expertise as disclosed in previous examination reports, audit reports, other correspondence, and discussions with management.
- 1 D Risk profile of the merchants. (Examples of higher risk business include mail order, telemarketing, retailers selling goods and services for future delivery, and merchants selling low quality products or services.)
- 1 E Prior losses from merchant chargebacks over the past several years.
- 1 F Any contingent liabilities arising from the bank's processing activities.

### POLICY AND PROCEDURAL CONSIDERATIONS

2 Determine if the retail merchant processing policies, procedures, and practices are adequate for the bank's activities.

2 A Determine if the merchant processing policy and procedures include the following broad areas of concern: (Note: A formal policy may not be necessary for banks with minimal activity.)

- 2 A1 1. Establishes clear lines of authority and responsibility.
- 2. Identifies the risks and limits the amount of risk the bank is willing to accept.
- 3. Places limits on the individual and aggregate volume of the bank's merchant activity. (Management should set limits on the amount of sales volume processed that correlates with the bank's capital structure, management expertise, and risk profiles of the merchants.)
- 4. Requires written contracts between all third parties.
- 5. Establishes criteria for the acceptance of merchants.
- 6. Requires the development of procedures to monitor the activities of each merchant including the engaging of agents such as Independent Sales Organizations (ISO's).
- 7. Addresses criteria for determining appropriateness of merchant reserve accounts.
- 8. Establishes guidelines for the periodic review of merchant creditworthiness.
- 9. Develops criteria for contracting with any ISO to act as agent for the bank (independent sales organization).
- 10. Establishes guidelines for handling policy exceptions.
- 11. Establishes guidelines for accepting agent banks.

12. Requires review of all contracts and applications by legal counsel familiar with merchant processing.

2 B Determine if the retail merchant processing procedures manual provides for the following issues: (Banks with minimal activity may not need a formal procedures manual.)

- 2 B1 1. Establishing new business.
2. Monitoring existing business.
3. Dealing with ISOs.
4. Handling complaints from merchants.
5. Performing settlement procedures and wire transfers.
6. Processing merchant chargebacks.
7. Training new and existing personnel.

## MANAGEMENT

3 Determine management's ability to successfully operate the retail merchant banking department. Consider implementing the following procedures:

3 A Conduct interviews with the staff and review operating results of the department.

3 B Determine if current staffing levels are appropriate for present and future growth plans.

4 Determine if management's plans for the department are clear and communicated to the staff. (Note: The plan may be included in the bank's overall strategic plan. Coordinate with Management and Internal Control Evaluation Module.)

5 Review MIS reports and determine if they adequately inform management of all activities and results.

6 Review the blanket bond policy to ensure merchant processing activities have sufficient coverage. (Note: Servicers are typically not covered under a bank's fidelity coverage.)

## AUDIT

7 Review the credit card merchant processing sections of internal and external audit reports.

8 Determine if management reviews and appropriately responds to audit findings.

9 Review the scope, frequency, and adequacy of the audit function to determine that all merchant processing operational areas are addressed. A good audit program will identify contraventions of internal policy, VISA or MasterCard regulations, and written contracts.

## MERCHANT UNDERWRITING STANDARDS AND MONITORING PROCEDURES

10 Evaluate management's system for ensuring compliance with the merchant approval policy.

10 A Review a sample of recently approved merchants' files to determine compliance with policy guidelines. The sample should include merchants solicited directly by the bank, through ISOs, and through agent banks. The merchant approval policy should provide for clear and measurable underwriting standards for merchants. Verify that these standards are maintained and the files contain, at a minimum, the following items:

- 10 A1 1. A credit bureau report on the principal of the business.
2. Financial information on the business (typically received annually).
3. Sales tax number for the business (tax ID number).

4. Evidence of review of previous merchant activity (recent monthly statements from the previous processor).
5. Onsite inspection report.
6. Signal merchant processing agreement detailing all activities.
7. Estimate of the merchant's projected sales activity.
8. Merchant application listing type of business, location, principal, etc.
9. Corporate resolution, if applicable.

10 B Verify that management determines why a merchant has or is switching banks (could indicate excessive chargebacks with previous processor).

11 Select a sample of merchant reserve accounts and review for compliance with the merchant contract.

12 Determine if exceptions to merchant approval policies are approved, reasonable, and documented.

13 Determine if merchant applications are reviewed by a person having adequate credit experience.

14 Determine if merchant reserve accounts are kept separate from their operating accounts and not commingled with other merchant reserve accounts. (Note: Commingling accounts makes it difficult to ensure management is not using the cashflow generated from one merchant's activities to cover the remittance requirement of another merchant. This practice can disguise insufficient reserve levels.)

15 Review the composition of merchant customers for concentrations of industries, geographic areas, or other factors.

## **SETTLEMENT PROCESS**

16 Review the scope and results of the most recent audit of the settlement processes. Determine if the audit reviews prudent controls over the settlement process.

17 Review MIS reports. Determine if they adequately inform management of the department's activities and results.

18 Review the settlement process to determine the flow of funds, the parties involved, and who controls funding and settlement.

19 Review a sample of contracts and determine financial liability of all parties.

20 Review a sample of contingency plans for parties involved in the settlement process. If ISOs perform merchant servicing tasks, review the reasonableness of their contingency plans as well.

## **CHARGEBACK PROCESSING**

21 Review the adequacy of the chargeback monitoring procedures:

21 A Determine if the bank generates chargeback reports.

21 B Evaluate the adequacy of the chargeback system. Determine if the system can perform the following tasks:

- 21 B1 1. Quantify outstanding chargebacks.
2. Identify the age of the chargebacks.

3. Prioritize the chargeback research process.
4. Measure the efficiency of the chargeback process.

21 C Review significant trends in volume (dollar and number of accounts) and aging of chargebacks.

22 Determine the bank's policy for writing off stale chargebacks. Adversely classify stale chargebacks accordingly.

23 Determine how the bank evaluates the adequacy of its chargeback systems. Inquire about how the bank plans for contingencies, such as large merchant bankruptcies where a large volume of chargebacks occurred.

24 Determine how management reflects merchant chargeback losses on internal reports. (Management should produce reports that identify which chargebacks are attributed to individual merchants.)

### **INDEPENDENT SERVICE ORGANIZATIONS (ISO)**

**Only complete if the bank uses ISOs. ISOs solicit merchants' credit card transactions for an acquiring (clearing) bank.**

**Note: ISOs have assumed an increased role in retail merchant processing activities. ISOs rely heavily on sales commissions; therefore, examiners must ensure the ISOs don't overlook the quality of retail merchants with which they contract.**

25 Review a sample of ISO contracts and check for compliance with the policy. In general, the contracts should include the following information:

25 A The financial compensation and payment arrangements.

25 B Fee structure. (Fees should be tied to performance such as the volume of sales transactions, number of merchants, and chargeback activity.)

25 C Required security deposits by the ISO to offset potential merchant losses. These deposits should bear a reasonable correlation to the level of sales volume generated by the ISO.

25 D Remedies to protect the bank if the ISO fails to perform.

25 E Requirement for monetary transactions to be handled directly between the bank and the merchant.

25 F Prohibitions concerning the ISO's ability to assign the agreement or delegate responsibilities to a third party.

25 G Criteria for acceptability of merchants.

25 H Control of future use and solicitation of merchants.

25 I Allowable use of the name, trade name, and logo of both the bank and the ISO(s).

25 J Frequency and means of communication and monitoring of each party.

25 K Records each party must maintain, as well as allow access by the institution to the records.

25 L Frequency and type of financial statements to be required of the ISO.

- 25 M Warranties that all consumer laws are followed.
  - 25 N Handling and responsibility for merchant chargebacks.
  - 25 O Onsite inspections by bank employees.
- 26 Review a representative sample of ISO credit files and check for compliance with policies. The files should contain the following items:
- 26 A A current financial statement on the principal(s) and the ISO. The type of financial statement should correlate to the size of the company.
  - 26 B An initial onsite inspection of the ISO performed by a bank employee. Additional inspections should be performed periodically based upon performance.
  - 26 C Evidence of bank and trade references.
  - 26 D A credit report on the principal(s) of the ISO.
  - 26 E A criminal check on the principal(s) of the ISO.
- 27 Review management's analysis of the financial stability of the ISO(s). Determine if the ISO reserve accounts are consistent with the condition of the company and the volume of business generated.
- 28 Review the bank's procedure for monitoring the activities of the ISO(s). (The bank should perform due diligence on all ISOs and subcontracted ISOs.)
- 28 A Determine if management reviews ISO operational audits.
  - 28 B Determine if management reviews the ISO's past performance for a history of misleading advertisements or inappropriate activities.
  - 28 C Determine if management reviews the ISO's sales methods, customer service practices, and overall operations.
- 29 Determine if the bank has registered all ISOs with VISA or MasterCard.
- 30 Determine if management reviews promotional material used by ISOs and attends sales training sessions for ISO salespersons.
- 31 Determine if management regularly reviews the propriety of system access codes for those ISOs with access to the bank's data processing system (to ensure information's integrity).
- 32 If the ISO is performing servicing tasks, determine if management requires an audit of the ISO's system.
- 33 Determine if contingency plans exist to cover the accounting and servicing functions performed by ISOs to ensure data continuity.

## **FRAUD DETECTION**

- 34 Review the bank's fraud detection system. The primary tool of a bank's fraud detection system is the exception report, which is generated from parameters based on expected merchant activities.

A good fraud report should tailor exception parameters for each merchant (usually based on dollar volume of sales and customer chargebacks) and screen variances in the following items:

- 34 A Average ticket size.
  - 34 B Daily volume.
  - 34 C Multiple same dollar amount of tickets.
  - 34 D Keyed versus swiped transactions.
  - 34 E Multiple use of same cardholder number.
- 35 Determine if the scope and frequency of the fraud review is adequate.
- 36 Determine if management takes appropriate action if suspicious activity is detected. Assess the adequacy of corrective actions.

### **AGENT BANKS**

**Acquiring (clearing) banks often process credit card transactions for other banks known as agent banks. Only review this section if agent bank relationships exist.**

- 37 Determine if the bank has an agent bank policy that addresses the following items: (If the agent bank relationship involves only one or two agent banks with minimal activities, formal written policies may not be necessary as long as sound controls exist.)
- 37 A Agent bank agreements (should outline the agent bank's financial liability for merchant losses).
  - 37 B Agent bank merchant underwriting standards (should be similar to subject bank).
  - 37 C Approval of policy exceptions.
  - 37 D Agent bank liability and responsibilities regarding merchant fraud.
  - 37 E Early termination of the agent bank relationship.
  - 37 F Approval authorities for each agent bank.
- 38 Review reports that show agent bank merchant volume by agent bank. Review agent banks that have significant merchant volume in comparison to the size of their banks. (Small banks with large merchant volume may have difficulty fulfilling their responsibilities regarding chargebacks.)
- 39 Review a sample of agent bank files, if necessary. Evaluate information and check for compliance with policy (including periodic financial information).

### **PROFITABILITY**

- 40 Review the department's operating statements. Compare the statement to the budget and investigate significant variances.
- 41 Evaluate the bank's pricing system.
- 41 A Pricing policies should set minimum discount rates for merchants based on the following criteria:



Core Analysis

- 41 A1 1. The merchant's volume of sales activity.
- 2. Inherent risk in operations.
- 3. Overall financial condition.

41 B Management should consider the following issues when determining appropriate pricing:

- 41 B1 1. Employee and equipment costs.
- 2. Cost of providing float in the clearing process.
- 3. Insurance and bonding needs.
- 4. Loss history and the risk of future loss.
- 5. Annual budget and strategic plans.
- 6. Competition.

42 Review a sample of merchant financial statements.

## Credit Card Related Merchant Activities

### REPORT OF EXAMINATION PRESENTATION:

1 Discuss the findings, conclusions, and recommendations, with the EIC and management prior to completing the following pages as needed:

- 1 A Appropriate items on the Risk Management Page (FDIC).
- 1 B Earnings Analysis.
- 1 C Management/Administration.

## Credit Card Related Merchant Activities

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. Expanded procedures associated with Core Analysis and Decision Factors of no concern need not be used. The flexible guidelines specified for the Core Analysis also apply here.

1 Investigate why the policy deficiencies identified in the Core Analysis exist. Discuss recommendations with management. (Note: The Core Analysis reveals what the deficiencies are, whereas the Expanded Analysis is focused on the circumstances causing the deficiencies and management's ability to implement corrective action.) Possible reasons for policy deficiencies may include the following circumstances:

1 A Management overlooked these issues.

1 B Management is unfamiliar with prudent credit card related merchant activity guidelines and procedures.

1 C Management is unwilling to create or enhance policies and procedures.

2 If poor compliance with policies and procedures exist, determine the reasons. Possible reasons are detailed below:

2 A Lack of awareness of policy's existence.

2 B Disregard for established policies.

2 C Misunderstanding the intent of policy guidelines.

2 D Poor internal communication of subsequent revisions to policy and procedures.

3 Determine why management and board reports are deficient. Seek management's responses to and corrective actions taken for these deficiencies. The cause(s) of deficient reports may stem from the following circumstances:

3 A Inaccurate information is contained in reports and input and output has not been tested.

3 B Management information system is not able to generate necessary reports.

3 C Management is unfamiliar with the information system's capabilities.

3 D Management is unfamiliar with important monitoring reports.

4 Determine if management supports proper controls and monitoring to ensure policy guidelines are followed in the future.

5 Research the reasons for weak controls and evaluate management's plan to correct these weaknesses. Perform additional internal control evaluations as necessary:

5 A Determine if access to merchant and ISO reserve accounts are restricted to only bank personnel.

5 B Review exception reports on merchants experiencing unusual activities. Determine the reasons for the exceptions.

## Expanded Analysis

- 6 Investigate the causes of operating losses in the merchant credit card operations and evaluate the prospects for profitability.
- 7 Determine the reasons for inadequate chargeback reserves.
- 8 If the bank suffered significant losses on chargebacks from a particular merchant or group of merchants over the past several years, complete the following items:
  - 8 A Determine why certain merchants are generating significant chargebacks.
  - 8 B Ascertain what actions management takes to reduce losses (implementing additional controls or terminating an arrangement with a merchant).
- 9 Investigate reasons for merchants with low profitability or actual losses. Only review those that are significant.
  - 9 A Review a sample of written onsite inspections.
  - 9 B Review a sample of merchant profitability accounts and compare actual pricing against the pricing policy.
  - 9 C Review the most recent financial statement and assess financial capacity of the merchant.
  - 9 D Determine if the bank is giving the merchant a favorable discount rate because of an existing commercial loan or deposit relationship. (Although this is an acceptable practice for noninsiders, the bank should be able to measure the overall profitability of the merchant account to ensure the other banking relationship offsets the favorable discount rate.)
  - 9 E Review any courses of action management intends on implementing.

## Credit Card Related Merchant Activities

### REPORT OF EXAMINATION PRESENTATION:

1 Discuss analysis and conclusions with management and the EIC prior to completing the following pages as needed:

- 1 A Those pages listed in the Core Analysis Decision Factors section.
- 1 B Internal Routines and Control comments.
- 1 C Examination Comments and Conclusions.
- 1 D Matters Requiring Board Attention.

## Credit Card Related Merchant Activities

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition. Impact Analysis also directs the examiner to consider possible supervisory options.

- 1 Determine the impact merchant processing deficiencies have on the bank's earnings and capital. Consider potential losses due to inadequate reserves and any other contingent liability.
- 2 Consider whether an informal or formal enforcement action is warranted, such as an MOU, a Cease and Desist Order, or a recommendation for removal action.
- 3 Discuss the possibility of administrative and enforcement actions with executive management and the board of directors.
- 4 Prepare appropriate recommendations for administrative and enforcement actions and associated memorandums.

## Credit Card Related Merchant Activities

### REPORT OF EXAMINATION PRESENTATION:

1 Discuss analysis, conclusions, and recommendations with the EIC and management prior to completing the following pages as needed:

- 1 A Those pages included in the Expanded Analysis Decision Factors section.

## **Credit Card Related Merchant Activities**

### **Core Analysis Decision Factors**

Examiners should evaluate Core Analysis in this section for significance and to determine if an Expanded Analysis is necessary. Negative responses to Core Analysis Decision Factors may not require proceeding to the Expanded Analysis. Conversely, positive responses to Core Analysis Decision factors do not preclude examiners from proceeding to the Expanded Analysis if deemed appropriate.

**Do Core Analysis and Decision Factors indicate that risks are adequately managed?**

**General Comment:(If any)**

#### **Core Analysis Decision Factors**

- C.1. Are policies and procedures adequate for merchant credit card activities?
- C.2. Does management adhere to policies and procedures?
- C.3. Is the management information system adequate and accurate?
- C.4. Are management and board reports sufficient to relay all necessary information?
- C.5. Is the audit function adequate?
- C.6. Are controls over merchants, agent banks, and ISO's adequate?
- C.7. Does management properly monitor and control chargebacks?
- C.8. Are reserves for chargebacks adequate?
- C.9. Is the department profitable?



## **Credit Card Related Merchant Activities**

### **Expanded Analysis Decision Factors**

This section evaluates the significance and materiality of deficiencies or other specific concerns identified in the Core and Expanded Analyses.

**Do Expanded Analysis and Decision Factors indicate that risks are adequately managed?**

**General Comment:(If any)**

#### **Expanded Analysis Decision Factors**

E.1. Are deficiencies immaterial to management's supervision of credit card merchant activities?

E.2. Are deficiencies immaterial to the bank's financial condition?