

October 24, 2013

The Honorable Benjamin Bernanke, Chairman  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Ave., NW  
Washington DC 20551

The Honorable Richard Cordray, Director  
Consumer Financial Protection Bureau  
1700 G Street NW  
Washington, DC 20552

The Honorable Tom Curry, Comptroller  
Office of the Comptroller of the Currency  
250 E Street SW  
Washington, DC 20219

The Honorable Martin Gruenberg, Chairman  
Federal Deposit Insurance Corporation  
550 17th Street Northwest  
Washington, DC 20429

The Honorable Eric Holder  
Attorney General of the United States  
Department of Justice  
950 Pennsylvania Ave  
Washington, DC 20530

The Honorable Debbie Matz, Chairman  
National Credit Union Administration  
1775 Duke Street  
Alexandria, VA 22314-3428

The Honorable Edith Ramirez, Chairwoman  
Federal Trade Commission  
600 Pennsylvania Ave NW  
Washington, DC 20530

Dear Chairman Bernanke, Director Cordray, Comptroller Curry, Chairman Gruenberg, Attorney General Holder, Chairman Matz and Chairwoman Ramirez,

The undersigned organizations write to thank you for your efforts to date and to urge you to take further strong action to protect consumers and the integrity of the payment system by stopping depository institutions and payment processors from facilitating electronic payments for illegal transactions, including illegal payday loans. Numerous regulatory and court actions have highlighted the crucial role that banks and payment processors play, intentionally or unintentionally, in processing illegal payments for internet and telemarketing scammers, debt settlement companies, payday lenders and others. We appreciate the efforts of your agencies. We encourage you to continue to closely monitor payments networks in order to identify those merchants that operate outside of the law and rely on access to consumers' bank accounts to extract payments. Regulatory scrutiny of those who process payments for higher-risk merchants is necessary, not only to address the direct harm imposed upon consumers by the

illegal transaction, but also to reduce the legal and reputational risks to insured depository financial institutions, consistent with longstanding supervisory expectations.

### **The payment system is crucial to a wide variety of unscrupulous, higher-risk merchants**

Higher-risk merchants that extract unauthorized, abusive or illegal payments raise numerous consumer protection concerns. As many of these high-risk merchants expand to the internet, they increasingly rely on payment processors and originating depository financial institutions (ODFIs) to access consumers' bank accounts. The payment processor and the ODFI enable a payment to be debited from a consumer's account through the automated clearinghouse (ACH) system, a remotely created check (RCCs) or remotely created payment order (RCPOs).

High-risk merchants perpetrating fraud are subject to legal action. But the responsibility does not stop there. Recognizing that fraudsters need help in accessing the payment system, over the last several years regulators have held that payment processors and ODFIs are responsible for managing legal and reputational risk by closely monitoring the activities of their clients. In extreme cases, when the payment processor or ODFI is reckless or even complicit, they may themselves be subject to legal action. Enforcement actions against payment processors or ODFIs by financial services regulators in recent years have involved abuse of the payment system to perpetrate fraud involving vulnerable seniors,<sup>1</sup> telemarketing scams,<sup>2</sup> internet schemes to extract payments for unwanted goods and services,<sup>3</sup> illegal debt settlement fees,<sup>4</sup> and other fraudulent activity. While many high-risk merchants may evade enforcement of consumer protections or be judgment proof, cracking down on those who abet illegal conduct is essential to protecting consumers, preventing abuse of the payment system and shielding financial institutions from legal and reputational risk.

### **Payment processors and depository financial institutions should not facilitate illegal loans**

Online payday lenders are particularly high-risk merchants. These lenders typically market and originate loans to borrowers that reside in another state. Non-depository entities such as payday lenders must follow the law of the state where the consumer is located. Payday loans and other forms of high-cost lending are illegal in many states, and are legal in other states only if the lender is licensed and the loan complies with state consumer protection and other laws.<sup>5</sup>

Online payday lenders present different legal and consumer protection challenges than storefront high-cost lenders. These online lenders routinely market and originate loans with terms and conditions that violate the law of the state where the borrower resides. These lenders are regularly subject to investigation by state and federal officials and have been subject to numerous cease and desist orders and other enforcement actions.<sup>6</sup> Financial institutions that process payments for lenders operating illegally or subject to ongoing litigation are exposed to significant legal and reputational risk.

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<sup>1</sup> See OCC Consent Order for a Civil Penalty, In re Wachovia Bank, 2008-027 (Apr. 24, 2008).

<sup>2</sup> Reyes v. Zion Nat'l Bank, 2012 WL 947139 (E.D. Pa. Mar. 21, 2012).

<sup>3</sup> See Complaint for Injunctive and Other Equitable Relief, FTC v. Landmark Clearing, Inc., et al., No. 4:11-cv-00826 (E.D. Tex. Dec. 15, 2011), available at [www.ftc.gov/os/caselist/1123117/index.shtm](http://www.ftc.gov/os/caselist/1123117/index.shtm)

<sup>4</sup> See CFPB, Press Release, CFPB Takes Action Against Meracord for Processing Illegal Debt-Settlement Fee (Oct. 3, 2013), available at <http://www.consumerfinance.gov/newsroom/cfpb-takes-action-against-meracord-for-processing-illegal-debt-settlement-fees/>.

<sup>5</sup> See Consumer Federation of America, Legal Status of Payday Loans by State, available at <http://paydayloaninfo.org/state-information>; National Consumer Law Center, CONSUMER CREDIT REGULATION § 9.3 (2012).

<sup>6</sup> See Center for Responsible Lending, *CRL Issue Brief: Effective State and Federal Payday Lending Enforcement*:

Nonetheless, high-cost lenders have used choice of law provisions, purported tribal sovereign immunity, preemption claims and other arguments in efforts to circumvent state consumer protection laws such as interest rate caps or restrictions on intensity of use. Courts have rejected efforts of lenders to locate offshore or otherwise claim exemption from state laws through choice of law provisions.<sup>7</sup>

Tribal affiliation also does not insulate payday lenders from state laws. The Supreme Court has made clear that, “[a]bsent express federal law to the contrary, Indians going beyond reservation boundaries have generally been held subject to non-discriminatory state law otherwise applicable to all citizens of the State.”<sup>8</sup> Similarly, tribal lenders cannot, by contract, subject borrowers to the laws and jurisdiction of the tribe for transactions outside of and unrelated to the reservation. While tribes have authority over their own members, “exercise of tribal power beyond what is necessary to protect tribal self-government or to control internal relations is inconsistent with the dependent statutes of the tribes, and so cannot survive without express congressional delegation.”<sup>9</sup> Tribal laws and not state laws apply on a reservation, but once a payday lender begins lending to nontribal members, off reservation state laws apply.

Tribal sovereign immunity, where it applies, does not allow tribally-affiliated lenders to ignore state law. Sovereign immunity is immunity from being sued, not an exemption from compliance with state consumer protection and other laws. “There is a difference between the right to demand compliance with state laws and the means available to enforce them.”<sup>10</sup> If a payday lender is truly an arm of the tribe and has a claim to tribal sovereign immunity, states may have difficulty bringing an enforcement action. The tribe, however, is still bound to comply with state law. Of course, many of the payday lenders who claim tribal sovereign immunity have a spurious claim to sovereign immunity or no claim at all.

Even in circumstances where a lender has claim to sovereign immunity, a payday loan or other transaction is illegal if made by an unlicensed lender in a state that requires a license to legally operate, or if the loan violates state consumer protection law in the state where the borrower resides. Tribal affiliation does not change the legality of the loan.

Payment processors and depository institutions, who have no claim of tribal sovereign immunity, are complicit in this illegal transaction if they permit themselves be used to facilitate payments for illegal loans. As with any other higher-risk activity, financial institutions have a duty to scrutinize their customers and their customer’s customers to ensure that the institution is not being used to process illegal payments.

### **Scrutiny of payment processing for higher-risk merchants is consistent with longstanding supervisory expectations and warnings about relationships with third parties**

Despite recent criticism of financial regulators scrutinizing the role of financial institutions in facilitating illegal transactions, these actions are consistent with long-standing supervisory expectations. Some of these criticisms have stemmed from actions by depository financial institutions that process payments for

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*Paving the Way for Broader, Stronger Protections* (Oct. 4, 2013), available at <http://www.responsiblelending.org/payday-lending/research-analysis/State-Enforcement-Issue-Brief-10-4-FINAL.pdf>.

<sup>7</sup> See Consumer Federation of America, “States Have Jurisdiction over Online Payday Lenders” (May 2010) (discussing cases), available at <http://www.consumerfed.org/pdfs/IPDL-States-Have-Jurisdiction.pdf>.

<sup>8</sup> Mescalero Apache Tribe v. Jones, 411 U.S. 145, 149 (1973).

<sup>9</sup> Montana v. United States, 450 U.S. 544, 564 (citations omitted); *accord* Brief of the Federal Trade Comm’n as Amicus Curiae, Jackson et al. v. Payday Financial LLC, et al., No. 12-2617 (7<sup>th</sup> Cir. Sept. 13, 2013).

<sup>10</sup> Kiowa Tribe of Okla., v. Mfg. Technologies, Inc., 523 U.S. 751, 755 (1998).

high-risk merchants and have taken steps to ensure that they are not processing payments for illegal transactions.

Financial institutions have an obligation to know their customers, to conduct due diligence in their relationships with third parties, and to take actions to minimize risks presented by the processing of illegal transactions. ODFIs are the “gatekeepers of the ACH system.”<sup>11</sup> They “undertake critical responsibilities under the NACHA rules that reflect the reliance of the ACH Network on appropriate underwriting and monitoring of Originators by ODFIs and the third parties with whom ODFIs have ACH origination arrangements.”<sup>12</sup> Similarly, in the banking and payment processing industries, the monitoring of return rates is a well-established component of risk management practices.<sup>13</sup>

On March 30, 2013, Michael J. Bresnick, Executive Director of the U.S. Department of Justice Financial Fraud Enforcement Task Force, warned when discussing actions to clamp down on banks facilitating payday loan transactions in violation of laws such as the Bank Secrecy Act:

“We are aware, for instance, that some payday lending businesses operating on the Internet have been making loans to consumers in violation of the state laws where the borrowers reside. And, as discussed earlier, these payday lending companies are able to take the consumers’ money primarily because banks are originating debit transactions against consumers’ bank accounts.”

Depository institutions whose customers claim exemption from state law through aggressive interpretations of choice of law, preemption, or sovereign immunity doctrines expose financial institutions to legal and reputational risk.

Regulator scrutiny of bank relationships with online payday lenders and their payment processors is consistent with longstanding scrutiny of other higher risk third party relationships. To assist in this effort, NACHA regularly publishes two lists, one of high-risk operators,<sup>14</sup> and another of operators who have been terminated from the ACH system.<sup>15</sup>

Years ago, regulators warned financial institutions that they faced increased legal and reputation risks when they assisted payday lenders in offering loans on terms that the lenders could not offer directly.<sup>16</sup> This increased risk also applies in cases where the financial institution processes payments for payday lenders who claim exemption from state laws based on choice of law, preemption, or sovereign immunity doctrines.

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<sup>11</sup> NACHA, ACH Operations Bulletin #2-2013, *High-Risk Originators and Questionable Debit Activity* (Mar. 14, 2013), available at [www.nacha.org/OpsBulletins](http://www.nacha.org/OpsBulletins); 2013 NACHA Operating Rules § 2.1 at OR4.

<sup>12</sup> *Id.*

<sup>13</sup> See, e.g., Complaint for Injunctive and Other Equitable Relief, FTC v. Landmark Clearing, Inc., et al., No. 4:11-cv-00826 (E.D. Tex. Dec. 15, 2011), available at [www.ftc.gov/os/caselist/1123117/index.shtm](http://www.ftc.gov/os/caselist/1123117/index.shtm); OCC Consent Order for a Civil Penalty, In re Wachovia Bank, 2008-027 (Apr. 24, 2008); Reyes v. Zion Nat'l Bank, 2012 WL 947139 (E.D. Pa. Mar. 21, 2012). However, return rates do not tell the entire story. Some unscrupulous players are adept at manipulating how they submit payments in order to avoid excessive returns in any one place. See, e.g., FTC v. Automated Electronic Checking, Inc., et al., <http://ftc.gov/os/caselist/1223102/130313aecmpt.pdf>; FinCEN Advisory, FIN-2012-A010, “Risk Associated with Third-Party Payment Processors” (Oct. 22, 2012), [http://www.fincen.gov/statutes\\_regs/guidance/html/FIN-2012-A010.html](http://www.fincen.gov/statutes_regs/guidance/html/FIN-2012-A010.html). Also, monitoring only of returns coded as unauthorized will not catch high rates of returns for reasons of stop payment or insufficient funds, which can also be indications that consumers did not expect or authorize the payment or were defrauded.

<sup>14</sup> See [www.nacha.org/originator\\_watch\\_list](http://www.nacha.org/originator_watch_list).

<sup>15</sup> See [www.nacha.org/terminated\\_originator\\_database](http://www.nacha.org/terminated_originator_database).

<sup>16</sup> See, e.g., *Payday Lending*, OCC, OCC Advisory Letter (Nov. 27, 2000); FDIC, *Guidelines for Payday Lending*, Financial Institution Letter (March 1, 2005).

In 2008, the OCC issued a risk management guidance outlining the need for effective monitoring of certain higher risk merchants, including but not limited to telemarketers. The guidance addressed the need for careful monitoring of consumer complaints, returned items and potential unfair or deceptive practices to limit legal, reputation, and other risks.<sup>17</sup> The FDIC issued a similar warning last year, and updated it in September of this year.<sup>18</sup>

### **Regulators must ensure that illegal operators do not turn to remotely created checks**

The ACH system has a well-established system for monitoring fraud and high risk activity. But the check system is subject to far fewer systemic controls. Regulators must take actions to ensure that merchants who wish to process illegal payments do not turn use of remotely created checks and related electronic payments processed through the check system in order to evade scrutiny or impediments to using the ACH system.

The FTC recently proposed to ban use of remotely created checks (RCCs) and remotely created payment orders (RCPOs) in transactions governed by the Telemarketing Sales Rule. The FTC's well-documented proposal describes the way in which telemarketing scammers have turned to RCCs and RCPOs to escape the scrutiny and strong consumer protections for electronic payments. Our groups supported the FTC's proposal and have urged regulators to prohibit use of RCCs and RCPOs in consumer transactions.<sup>19</sup> We recognize, however, that a complete prohibition is a long term goal and cannot be accomplished immediately.

In the interim, we urge your agencies to consider other measures to ensure that illegal activity does not simply move from the electronic payment system to the check system, where it is subject to far fewer controls. Possible actions could include stronger monitoring requirements of merchants who use RCCs and RCPOs by depository institutions and payment processors and a prohibition on use of RCCs or RCPOs by operators who have been banned from the ACH system. Similarly, merchants should be banned from using RCCs or RCPOs after a consumer has stopped payment on or revoked authorization for an ACH payment, just as they may not process an ACH payment after a consumer has stopped payment on a check that was converted to an ACH payment.<sup>20</sup>

### **Conclusion**

We encourage your agencies to continue to closely monitor the payment processing procedures and compliance safeguards in place at the payment processors and financial institutions that you supervise. Where you find indications that the institution has insufficient safeguards to avoid processing illegal

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<sup>17</sup> *Risk Management Guidance: Payment Processors*. Office of the Comptroller of the Currency, April 24, 2008.

<sup>18</sup> See FDIC, FIL-3-2012, Payment Processor Relationships Revised Guidance (Jan. 31, 2012), available at [www.fdic.gov/news/news/financial2012/fil12003.html](http://www.fdic.gov/news/news/financial2012/fil12003.html); FDIC, FIL-43-2013, FDIC Supervisory Approach to Payment Processing Relationships with Merchant Customers that Engage in High-Risk Activities (Sept. 27, 2013).

<sup>19</sup> See Letter to the Federal Reserve Board and Consumer Financial Protection Bureau, "Supplemental Comments, 12 CFR Part 229, Regulation CC: Docket No. R-1409, 76 Fed. Reg. 16862 (Mar. 25, 2011), Remotely Created Items, Funds Availability Schedule for Prepaid Cards and Mobile Deposits," from the National Consumer Law Center (on behalf of its low income clients), Consumer Action, Consumer Federation of America, Consumers Union, National Association of Consumer Advocates, and National Consumers League (Sept. 18, 2013), available at [http://www.nclc.org/images/pdf/rulemaking/comments-regulation\\_cc\\_rcc\\_efaa\\_9-18-2013.pdf](http://www.nclc.org/images/pdf/rulemaking/comments-regulation_cc_rcc_efaa_9-18-2013.pdf).

<sup>20</sup> See NACHA, ACH Operations Bulletin #3-2013, Reinitiation of Returned Debit Entries (July 15, 2013), available at <https://www.nacha.org/OpsBulletins>.

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payments, or is exposed to excessive legal, compliance, reputation or other risks through arrangements with third parties, we urge you to take swift action.

We thank you for protecting the integrity of the payment system, financial institutions, and consumers and look forward to your efforts to strengthen this important role going forward.

Respectfully submitted,

Americans for Financial Reform  
Arkansans against Abusive Payday Lending  
California Reinvestment Coalition  
Center for Responsible Lending  
Coalition of Religious Communities (UT)  
Consumer Action  
Consumer Federation of America  
Consumers for Auto Reliability and Safety  
Consumers Union  
Economic Fairness Oregon  
Georgia Watch  
GRO Missouri  
Jacksonville Area Legal Aid (FL)  
Jesuit Social Research Institute at Loyola University  
The Leadership Conference on Civil and Human Rights  
Maryland Consumer Rights Coalition  
NAACP  
National Association of Consumer Advocates  
National Community Reinvestment Coalition  
National Consumer Law Center (on behalf of its low income clients)  
New Economy Project (NY)  
Policy Matters Ohio  
Rhode Island State Council of Churches  
Rhode Island Payday Lending Reform  
South Carolina Appleseed Legal Justice Center  
Southwest Center for Economic Integrity (AZ)  
Texas Appleseed  
US Public Interest Research Group  
Virginia Poverty Law Center  
Woodstock Institute (IL)