ELECTRONIC TRANSACTIONS ASSOCIATION

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October 27, 2016

VIA ELECTRONIC TRANSMISSION

Rae-Ann Miller
Associate Director
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C., 20429-9990

Re: Comments on the FDIC's Proposed Guidance for Third-Party Lending

Dear Ms. Miller:

The Electronic Transaction Association submits this comment letter in response to the FDIC's proposed Examination Guidance for Third-Party Lending, released July 29, 2016. Thank you for your attention to this matter, and please let us know if you have any questions.

Respectfully submitted,

Scott Talbott
Senior Vice President of Government Affairs
Electronic Transactions Association

Comments Enclosed

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COMMENTS OF THE ELECTRONIC TRANSACTIONS ASSOCIATION

Federal Deposit Insurance Corporation

Examination Guidance for Third-Party Lending

Financial Institution Letter FIL-50-2016

October 27, 2016

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I. Introduction

The Electronic Transactions Association ("ETA") appreciates this opportunity to comment on the Federal Deposit Insurance Corporation's ("FDIC") proposed Examination Guidance on Third-Party Lending (the "Guidance").[1] ETA is the leading trade association for the payments industry, representing nearly 550 companies worldwide involved in electronic transaction processing products and services. In addition to its work with companies in the payments space, ETA represents members in the small business finance industry. Many of these members offer financing opportunities to small businesses through partnerships with depository institutions, including those regulated by the FDIC. Because nonbank entities frequently employ online platforms and systems that are more efficient and cost-effective for processing and underwriting smaller commercial loans, these companies are able to provide a valuable service to banks and expand the scope of eligible small business borrowers.

While ETA supports the FDIC's goal of promoting safe and sound banking practices, we suggest that the FDIC further tailor the Guidance to reflect important differences between consumer and small business lending, and also to avoid language that suggests third-party lending relationships should be viewed with heightened scrutiny or suspicion. The Guidance should foster innovation in a market that is benefiting small businesses seeking capital to grow. Adopting a one-size-fits-all Guidance that treats all third-party relationships the same may have the unintended consequence of encouraging "de-risking" by banks with existing or potential third-party lending relationships. Such an outcome would harm small businesses by restricting their access to much needed credit.

II. Small Business Loan Market

As the FDIC is likely aware, small businesses are an incredibly important part of the U.S. economy. Small businesses employ half of the nation's private sector workers and in recent decades have created two-thirds of net new jobs.[2] Many of these small businesses struggle to grow,[3] with access to growth capital and cash flow management cited as key challenges.[4] Many companies look to debt financing to resolve these issues and 47% of respondents in a 2015 Federal Reserve study on small business credit stated they had applied for credit in the past 12 months.[5] Of those small businesses that applied, 18% were not approved for any financing, while another 50% stated they were not approved for the full amount of credit they sought.[6] In addition, 16% of all respondents stated they did not apply for financing because they believed they would be turned down. Although traditional bank lending remains the primary source of financing for small businesses, banks alone are not meeting the demand.

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[1] Examination Guidance for Third-Party Lending, FDIC (July 29, 2016), [hereinafter the "Guidance"] available at https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf.

[2] Federal Reserve Banks of New York, Atlanta, Cleveland and Philadelphia, Joint Small Business Credit Survey Report, 2014 at 4 (released February 2015) ("Joint Small Business Credit Survey Report"); Karen Gordon Mills, Brayden McCarthy, The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game, Harvard Business School Working Paper 15-004 (July 22, 2014) at 3 ("State of Small Business Lending")

[3] In the second quarter of 2014, 220,000 businesses started-up and 205,000 exited (went from having at least one employee to having none for at least a year). The Small Business Advocate - Small Business Profile, U.S. Small Businesses Administration (March – April 2016), available at https://www.sba.gov/sites/default/files/March_April_2016_FINAL_508_compliant.pdf.

[4] 2015 Small Business Credit Survey, Federal Reserve, pg. iii (Mar. 2016), available at https://www.newyorkfed.org/medialibrary/media/smallbusiness/2015/Report-SBCS-2015.pdf.

[5] *Id*. at iv.

[6] *Id*.

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Third-party lending relationships between banks and non-bank companies represent an important alternative to traditional bank lending that is helping to fill the gap in small business demand for financing. The FDIC Guidance recognizes that these relationships take multiple forms, with the common theme being that the bank relies on the non-bank entity to perform certain aspects of the lending process, including marketing, borrower solicitation, loan origination and processing, and underwriting, among others.[7] As noted by the Treasury Department in its white paper on online lending, small business lending has historically involved high search, transaction, and underwriting costs for banks relative to earnings potential.[8] The Treasury found that partnership arrangements between banks and non-banks allow financial institutions to improve efficiencies and to offer new products.[9] What was once a process that could take up to one month for approval now is entirely digital and takes on average just one day. This reduction in processing time is a valuable benefit for customers who need quick and affordable access to capital to grow their small businesses.[10] ETA encourages the FDIC to keep these many benefits in mind when finalizing the Guidance, and to recognize that it is sound public policy to incentive and foster the bank and non-bank partnerships that exist within current bank regulatory frameworks.

III. The FDIC's Guidance Needs to Account for the Important Differences in Types of Third-Party Lending Arrangements

A. Small Business versus Consumer Lending

As drafted, the Guidance appears to take a one-size-fits-all approach to third party lending arrangements. The focus of the Guidance, for example, is to set forth "safety and soundness and consumer compliance measures FDIC-supervised institutions should follow when lending through a business relationship with a third party."[11] The Guidance also states that "Institutions that engage in new or significant lending activities through third parties will generally receive increased supervisory attention."[12]

Although the Guidance advises institutions to develop risk-based compliance programs, the Guidance does not sufficiently recognize the important and well-established differences between consumer and small business lending (*i.e.*, commercial lending). Small business borrowers have different needs and objectives in obtaining credit than consumers, and small business lenders have developed credit products specifically designed to answer those needs and objectives. These needs include capital to pursue growth opportunities, hire new workers, or secure stable working capital funding. These small business use cases differ materially from traditional consumer loans.

Unlike consumers, businesses take out loans for the following reasons:

- Purchase or upgrade equipment, sales inventory, furniture, and supplies
- Hire staff
- Secure stable working capital
- Invest in marketing

[7] Guidance, at 2.

[8] Opportunities and Challenges in Online Marketplace Lending, U.S. Treasury Department (May 2016), available at https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf.

[9] *Id*. at 15

[10] There are also numerous responses to Treasury's request for information confirmed that such partnerships provide opportunities to expand access to credit for small businesses. *Id*. at 22.

[11] Guidance at 1.

[12] *Id*.

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- Purchase land, buildings, or rent office space
- Finance seasonal operating needs
- Pay off accounts payable
- Invest in research

In this regard, regulation cannot and should not treat consumer and small business lending the same – such an approach would have a detrimental effect for both small business lenders and the small business community. The Guidance should tailor examination and regulatory requirements and priorities according to applicable laws based on whether the third-party lending arrangement involves consumer or business lending.

While ETA supports transparency in small business credit, a regulatory approach that fails to recognize the important and significant distinctions between consumer and small business lending would inhibit small business access to capital for the use cases noted above. We therefore encourage the FDIC to develop Guidance and examination principles that are sensitive to the prospect that enhanced regulation and scrutiny may limit lenders' ability to answer the needs of small businesses by stifling creativity and innovation.

B. Role of Payment Networks

The Guidance defines "third-party lending" to be "a lending arrangement that relies on a third party to perform a significant aspect of the lending process, such as some or all of the following: marketing; borrower solicitation; credit underwriting; loan pricing; loan origination; retail installment sales contract issuance; customer service; customer disclosures; regulatory compliance; loan servicing; debt collection; and data collection, aggregation, or reporting."[13]

As currently drafted, the definition could be interpreted to cover credit card payment networks. ETA suggests that the definition include an exclusion for payment networks. These networks are technology companies that link together the various participants in consumer credit transactions. The networks are not lenders and do not have any direct relationships with borrowers. Note that the FDIC's Guidance for Managing Third-Party Risk already covers services provided by payment networks, which are also subject to examination by the federal banking agencies under the Bank Service Company Act.

Specifically, we suggest the FDIC revise the definition of "third-party lending" such that it (i) is limited to the specifically enumerated activities described in the proposed definition or (ii) includes a final sentence after the proposed definition as follows: "Third-party lending" does not include, by itself, the act of originating credit card loans that are processed through a payment network."

IV. Small Business Lending is Already Subject to Significant Federal and State Regulatory Scrutiny

The Guidance treats third-party lending arrangements as high-risk and deserving of increased scrutiny without appreciating that many of these arrangements are already subject to other federal and state regulatory requirements. Online small business lending, at a basic level, involves many of the same steps as traditional commercial lending – the marketing, underwriting, closing, servicing, securitization (in some cases), and collection of loans. In this regard, commercial online lending is subject to various federal and state laws and regulations. Given this regulatory framework, ETA questions the Guidance's characterization of third-party lending arrangements as inherently high-risk.

[13] *Id*. at 2.

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V. The FDIC Should Consider the Threat of "De-Risking" Before Increasing Regulatory Pressure on Third-Party Lending Arrangements

Although ETA appreciates the FDIC's consideration of the risks that banks may face in partnering with nonbank entities to originate loans, the FDIC should avoid sending the message that third-party lending arrangements are inherently risky or require the same degree of scrutiny during examinations. To the contrary, the "tone" established by bank regulators should incentivize and foster these partnerships that yield significant financial benefits and opportunities for small businesses.

In the past, federal regulators have released guidance indicating that certain bank customers or relationships are "high-risk" and would receive increased scrutiny. The result of such guidance was to discourage banks from forming relationships with merchants or other businesses deemed high-risk, leading to the "de-risking" of entire industries.[14] For example, the FDIC previously published guidance that deemed third-party payment processors ("TPPP") to be high risk, particularly those servicing certain merchant classes.[15] This guidance, issued against the backdrop of the Department of Justice's Operation Choke Point,[16] caused widespread de-risking of TPPPs and other industries marked as "high-risk" by the government. Eventually, the issue became serious enough that the FDIC released new guidance qualifying its prior guidance and encouraging banks to assess risk on an individual customer basis rather than declining to provide services to entire categories of customers.[17]

In the Guidance, the FDIC states that it will apply "increased supervisory attention" to any institution engaging in new or significant lending activities through third parties."[18] In addition, institutions significantly engaged in third-party lending arrangements will be expected to maintain "well-above average" capital levels and are subject to a reduced twelve-month examination schedule instead of the eighteen-month schedule for which the bank may qualify.[19] The Guidance, however, does not provide a rationale to support these enhanced requirements, or explain how additional scrutiny will reduce risk in the bank partnership model. In most partnerships with small business lenders, banks originate the loans and then sell them wholesale to the lender partner, thereby significantly decreasing the need for above-average capital. This

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[14] De-risking refers to the bank industry practice of refusing to enter into deposit account or other relationships with customers in industries determined by regulators to be "high-risk." De-risking can undermine financial inclusion, financial transparency, and financial activity. Remarks of Under Secretary of the Treasury David Cohen at the BA/ABA Money Laundering Enforcement Conference (Nov. 10, 2014), available at https://www.treasury.gov/press-center/press-releases/Pages/jl2692.aspx.

[15] FIL 127-2008, "Guidance on Payment Processor Relationships," http://www.fdic.gov/news/news/financial/2008/fil08127.html; FIL-3-2012, "Payment Processor Relationships, Revised Guidance," http://www.fdic.gov/news/news/financial/2012/fil12003.html; FIL-43-2013, "FDIC Supervisory Approach to Payment Processing Relationships with Merchant Customers That Engage in Higher-Risk Activities," http://www.fdic.gov/news/news/financial/2013/fil13043.html; FDIC *Supervisory Insights*, Summer 2011, "Managing Risks in Third-Party Payment Processor Relationships," http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum11/managing.html.

[16] Operation Choke Point is a controversial initiative of the Department of Justice, in coordination with Financial Fraud Enforcement Task Force, to investigate banks and the services they provide to payment processors and certain merchant categories the government views as higher risk for potential fraud or money laundering. The initiative has received criticism from the public and Congress for causing widespread de-risking.

[17] FIL-41-2014, FDIC Clarifying Supervisory Approach to Institutions Establishing Account Relationships with Third-Party Payment Processors (July 2014), available at https://www.fdic.gov/news/news/financial/2014/fil14041a.html; FIL-5-2015, Statement on Providing Banking Services (Jan. 2015), available at https://www.fdic.gov/news/news/financial/2015/fil15005.html#continuation.

[18] Guidance at 1.

[19] *Id*. at 13.

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process is nearly automatic, and the risk to a bank during the short period the loans remain on the bank's books is greatly reduced through collateral accounts that are standard in the partnership agreement.

Moreover, the Guidance fails to recognize the differences between various types of lending (consumer versus commercial), as well as the many different business models in the market. The implication of the Guidance is that banks engaged in third-party lending arrangements – whether consumer or commercial – are participating in high-risk activities deserving of increased scrutiny. ETA is concerned that such statements will cause banks currently engaged in third-party lending arrangements to shed some or all of their partnerships, or increase their fees to cover the risk of this increased scrutiny, which, in turn, will increase the cost of credit for small businesses.[20] Worse, by suggesting it will apply increased scrutiny to new lending activities through third parties, the FDIC is discouraging banks that have not already formed such arrangements from partnering with nonbanks in the future. This will have the perverse effect of limiting the FDIC's ability to monitor this market, and steer financial services activity out of the FDIC's existing regulatory framework.

Given the benefits of bank-nonbank partnerships described above, de-risking in response to the Guidance would reduce small businesses' access to credit and would stifle innovation and efficiency in loan underwriting and origination.

VI. Conclusion

Third-party lending arrangements between banks and nonbanks have created increased opportunities for small businesses to obtain much-needed credit. Such partnerships increase efficiencies and reduce the cost to make small business loans for banks, including institutions supervised by the FDIC. As drafted, we are concerned that the FDIC's Guidance will prompt its supervised institutions to reduce their third-party lending partnerships, steer activity outside of bank regulatory frameworks, and discourage banks from exploring how such arrangements can improve their loan origination processes – essentially driving the opposite outcomes that sound public policy would dictate.

While ETA and its members respect the FDIC's need to examine third-party lending partnerships for risk to supervised institutions, we recommend the Guidance clarify that third party lending arrangements (particularly commercial ones) are not inherently suspicious or high-risk. Further, we recommend removing reference to "increased supervisory attention," particularly as it pertains to new lending through third parties. Otherwise, the Guidance suggests that banks not already engaged in third-party lending arrangements will be scrutinized merely for testing the benefits that such arrangements can offer. Finally, the FDIC should emphasize that the risk of entering into any third-party lending arrangement should be assessed on an individual basis and not as an entire class of bank customers or relationships, consistent with the FDIC's prior statements clarifying its guidance on TPPPs. We believe such statements would avoid a widespread de-risking response to the Guidance and provide comfort to banks that currently engage in third-party lending arrangements.

* * * * *

[20] Similarly, the suggestion in the proposed Guidance that banks "[e]stablish limits as a percent of total capital for each third-party arrangement and for the program overall, relative to origination volumes, credit exposures (including pipeline risk), growth, loan types, and levels of credit quality (such as delinquency, losses, and charge-offs)," has the potential to discourage robust lending activities. Further, this policy does not clearly define whether the capital limits should be for the bank or for each third-party lending partner. If for the bank, the policy fails to recognize that under most partnerships the bank is at risk for only a few days (usually two, at the most) before the nonbank partner purchases the loans.

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ETA appreciates the opportunity to comment on the FDIC's proposed guidance. We look forward to working with the FDIC to find solutions that encourage responsible, affordable, and convenient small business lending.

Respectfully submitted,

Scott Talbott
Senior Vice President of Government Affairs
Electronic Transactions Association