PaymentsFirst
Service • Education • Support

Risk Management / Compliance
Module 4

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NACHA DIRECT MEMBER
Regional Payments Associations℠

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Types of Risk

- Credit Risk
- Exposure Risk
- Operational Risk
- Fraud Risk
- Systemic Risk
- Compliance Risk

Security Requirements

- Non-Consumer Originators, Participating DFIs and Third-Party Service Providers must
  - Protect confidentiality and integrity of Protected Information until destruction
  - Protect against anticipated threats
  - Protect against unauthorized use

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Data Breach

- NACHA Board of Directors Interim Policy Statement on ACH Data Breach Requirements
  - Loss, theft or unauthorized access of consumer data by or from any ODFI or Originator or Third-Party Service Providers using the ACH Network

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Credit Risk

- Occurs when a party to a transaction cannot provide the necessary funds, as contracted, in order for settlement to occur

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ODFI Credit/Exposure Risk

- ODFI Credit origination
  - Risk is the Originator will fail to fund the ODFI for credits
  - ODFI is exposed from the time the ACH File is transmitted until the ODFI receives funding from the Originator/Third-Party Sender
- ODFI Debit origination
  - ODFI is exposed to risk from the time the funds from the debit entries are released to the Originator/Third-Party Sender until the statute of limitations expires under applicable state law
  - NACHA Operating Rules allow for ease of return via the Network within the 60-day timeframe

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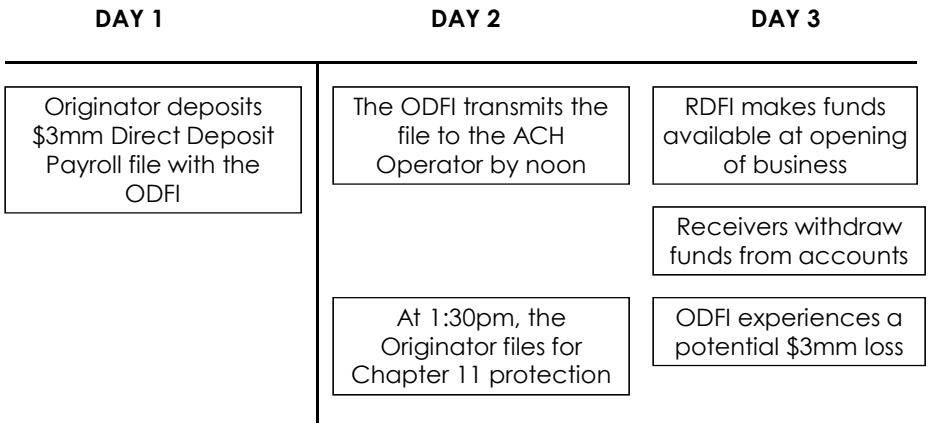
Exposure Risk – Next-Day Credit File



Same Day ACH Credit File

- Credit File of Same Day ACH Entries
  - Effective Entry Date of October 18
  - Submitted to the ACH Operator within Same Day ACH processing window
  - File contains four Entries
    - 2,000.00
    - 20,000.00
    - 1,000.00
    - 6,000.00
- Settlement of the Credit Entries will occur on October 18

Same Day ACH Credit File

- Effective entry date stays the 18th, the settlement date will be the 18th. Suggested changes:
- Offset Debit File
  - Settlement Date is October 18 right? Wait!
    - Although debits are eligible for processing, the total offset debit exceeds the per entry limit of $25,000
  - Settlement for the debit will occur after October 18 regardless of when the Debit File is sent on October 18
    - The Settlement Date for the debit will be pushed to the next eligible settlement window
- Risk alert
  - Credits will settle before the funding Debit File
  - Funds may not be available for debits despite final settlement of credits

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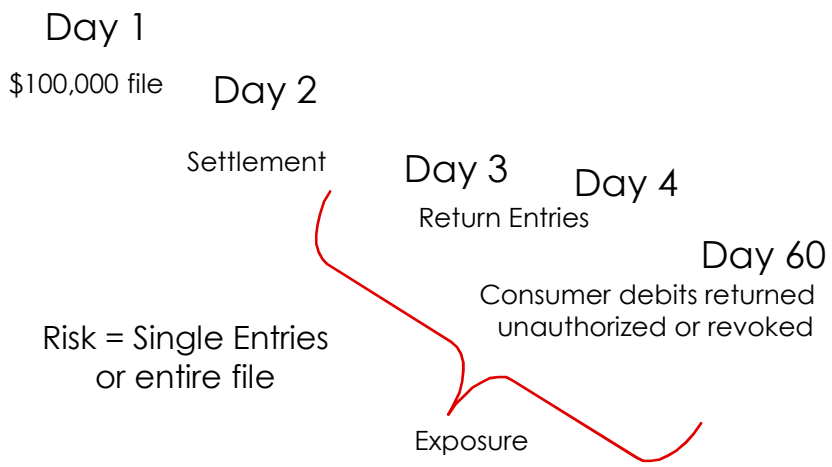
Exposure Risk - Debit File



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ODFI Credit/Exposure Controls

- Determine creditworthiness and exposure limits for Originators and Third-Party Senders and review periodically
- Assess the nature of the Originator's and Third-Party Sender's activity and the risk it represents
  - Through prefunding, ODFI may significantly reduce credit risk
- Monitor the Originator's and Third-Party Sender's origination and returns across multiple settlement dates

ODFI Credit/Exposure Controls

- Establish clear policies and procedures to deal with "over limit" transactions
- Perform ACH Rules Compliance Audit annually
- Address in Originator and/or Third-Party Sender agreement
  - Restrictions on the types of ACH transaction that may be originated
  - Right to terminate or suspend
  - Right to audit

RDFI Credit/Exposure Risk

- RDFI credit receipt
  - Risk is related to the time of settlement finality granted by the ACH Operator
  - Reduced by Same Day ACH
- RDFI debit Return
  - Failure to meet return time frames may result in a loss for the RDFI

Operational Risk

- Occurs when a transaction is altered or delayed due to an unintentional error
  - Hardware failure
  - Software failure
  - Telecommunications failure
  - Power failure
  - Human error
  - Staffing problems
  - Disaster or civil unrest

Operational Risk Controls

- Maintain systems
  - Hardware
  - Software (update software versions and patches as needed)
- Personnel
  - Employ skilled staff
  - Continuous training
  - Cross-train

Operational Risk Controls

- Processing
  - Account for Files
    - Balance Files after each step of processing
  - Authenticate Originator or Third-Party Sender
  - Establish and comply with processing schedules
  - Use positive acknowledgements for transmitted Files
  - Monitor key dates
  - Reconcile dollar amounts and item counts
  - Maintain audit trails

Operational Risk Controls

- Contingency
  - Alternative telecommunications; protect operations with uninterruptible power supply
  - Develop and test disaster recovery plan
    - Protect data
    - Restrict access
    - Back up copies
    - Provide offsite storage

Fraud Risk

- Occurs when a payment transaction is initiated or altered in an attempt to misdirect or misappropriate funds by any party to the transaction
  - Outside parties
  - Intruders
  - Combination of both

Who Commits Fraud?

- Employees
  - Dissatisfied, disgruntled, desperate or dishonest
- Interlopers
- Originators/Receivers
  - Dishonest or unscrupulous

Fraud Risk Controls

- Physical security
- Data security
- Application security
- You tell me…provide some examples of each of these three

Fraud Risk Controls

- Operational controls
  - File and dollar controls for each processing step
  - Ability to reconstruct series of events to analyze the transaction
  - Out of band transaction verification
  - Out of band alerts for unusual activity
  - Require dual control

Fraud Risk Controls

- Educate Originators
  - Initiate ACH payments under dual control
  - Restrict functions for computer workstations and laptops used for online banking and payments
  - Monitor and reconcile accounts daily
  - Install commercial, up-to-date anti-virus and firewalls on all computers
  - Never access bank accounts at Wi-Fi hotspots (airports, Internet cafes, etc.)

Systemic Risk

- Occurs when one funds transfer system participant is unable to settle their commitments causing others to fail
- ACH Operators have established risk management procedures which help minimize the possibility of systemic financial institution failures due to ACH settlement

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Systemic Risk Controls

- ACH Operators monitor
  - File controls and dollar controls
  - ACH activity according to funding capabilities of ODFI
  - Finality
    - Reserve Bank next-day settlement is final for ACH credits and debits as of 8:30 a.m. ET
    - Two Same Day settlement windows added at 1:00 p.m. ET and 5:00 p.m. ET

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Compliance Risk

- Occurs when a party to a transaction fails to comply, either knowingly or inadvertently, with *NACHA Operating Rules*, applicable regulations, U.S. law and state law

Compliance Risk Controls

- Compliance constitutes the actions necessary for a financial institution to meet the requirements imposed
- ACH participants must be familiar with rules and regulations, including but not limited to
  - *NACHA Operating Rules*
  - EFTA and Regulation E
  - Regulation CC
  - Regulation D
  - 31 Code of Federal Regulations (CFR) Parts 203, 208, 210, 370
  - Uniform Commercial Code Articles 3, 4 and 4A
  - Bank Secrecy Act/Anti-Money Laundering
  - Right to Financial Privacy Act
  - OFAC
  - Federal Reserve Bank Operating Circulars

Additional Risk Considerations

- Ancillary Risk - Consequence of not managing previously discussed risks
  - Reputation Risk
  - Cross-Channel Risk
  - Counterparty Risk
  - Third-Party Relationships
  - Direct Access
  - High return rates
  - Remotely-Created Checks
  - Certain business types

Reputation risk

- The risk of adverse publicity and the possible resulting litigation or loss of business from an incident, event, or problem.

Cross-Channel Risk and Controls

- Cross-channel risk should be monitored to watch for fraud and credit exposure across various payment systems used by a single entity
- Exposure may occur as a result of
  - Individuals perpetrating fraud from external sources (e.g. corporate account takeover)
  - Internal fraud or intentional misuse of multiple payments system by the entity itself
- To reduce these risks, organizations should be aware of activity on payment systems beyond ACH to identify anomalies

Counterparty Risk

- Counterparty Risk is reduced by more frequent settlement
  - Financial institutions will have less exposure to potential settlement failure by another financial institution

Direct Access

- Originator, Third-Party Sender, or a Third-Party Service Provider transmits credit or debit Entries directly to an ACH Operator using an ODFI's routing number and settlement account
- ODFI warrants all transactions that enter the Network under its routing number
  - Transactions bypass ODFI monitoring & review

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Direct Access Controls

- Direct Access approval required by FI's Board or Board-level committee for new debit participant customers
  - Although not required by the *NACHA Operating Rules*, it is highly recommended that Direct Access credit relationships be approved by Board or Board-level committee

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Direct Access Registration

- Each ODFI must register its Direct Access Debit Participant status with NACHA
  - Acknowledge no Direct Access Debit Participants
  - Provide information about each Direct Access Debit Participant
    - Must report volume and return rate activity on a quarterly basis
- Must report any change in status, including terminations, to NACHA

Return Rate Levels

- Administrative Return Rate
  - The rate at which an Originator's or Third-Party Sender's debit Entries are returned for administrative reasons as calculated in accordance with the Rules
    - R02
    - R03
    - R04
- Administrative Return Rate Level
  - 3%

Return Rate Levels

- Overall Return Rate
  - The rate at which an Originator's or Third-Party Sender's debit Entries, excluding RCK Entries, are returned, regardless of reason, as calculated in accordance with the Rules
- Overall Return Rate Level
  - 15%

Return Rate Levels

- Unauthorized Entry Return Rate
  - The rate at which an Originator's or Third-Party Sender's debit Entries are returned on the basis that they were unauthorized as calculated in accordance with the Rules
    - R05
    - R07
    - R10
    - R29
    - R51
- Unauthorized Entry Return Rate Threshold
  - 0.5%

Return Rate Levels - Definition

- Calculation processes are the same two options that exist currently in 2.17.2

Method One

$$\frac{\text{\# of debits returned for 60 days or two months}}{\text{Total \# of debit Entries within the File(s) the original Entries were sent}}$$

Method Two

$$\frac{\text{\# of debits returned for 60 days or two months}}{\text{Total \# of debit Entries originated for the proceeding 60 days or two months}}$$

Calculations are computed for each Originator or Third-Party Sender

Return Rate Levels - Definition

- All rates apply to debits only, calculated over a 60-day or two month period
  - RCKs are exempt from the overall return rate level
- Threshold vs. levels will be handled differently by the Rules Enforcement Panel

Thresholds vs. Levels

Violation of the Unauthorized Entry Return Rate Threshold

- NACHA will notify the ODFI of a potential threshold violation at which time the ODFI will be required to provide requested information within 10 Banking Days
- If the ODFI determines the threshold was exceeded, a plan and timeline to reduce this activity within 30 days must be provided
- Once reduced, unauthorized Return activity must remain below the threshold for 180 days
- Failure to respond to, reduce or maintain the unauthorized Return activity may constitute a Class 2 Rules Violation

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Thresholds vs. Levels

Violation of the Administrative or Overall Return Rate Levels do not follow the same pattern of activity

- Levels are designed to be more forgiving and exceeding a level may not require action to reduce the level or other steps as exist with the threshold process
- Instead, exceeding a level will result in a brand new inquiry process overseen by an industry review panel appointed by NACHA

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Inquiry Process

- Requests for return rate information related to the Administrative or Overall Rates require a response within 10 Banking Days
  - ODFIs have the ability to respond and explain why the rate is above the 3% or 15% respectively
  - The industry review panel may determine the activity is acceptable and close the case or it may direct the ODFI to reduce the return rate(s)

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Inquiry Process

- Responses to a request for return rate information on a Return Rate Level do not state how much or what type of supplemental information should be included to justify activity
- The industry review panel will evaluate information across certain review criteria
  - Length of time in business, time as customer of FI
  - Total Originator/TPS volume and Return volume
  - Rules Violations, RDFI complaints, UDAAP complaints
  - Regulatory or legal investigation or actions
  - Third-Party Sender audit completion, if applicable

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Inquiry Process

- Additional considerations may be given to the type of industry and trends displayed by similar Originators
- Remember
  - An inquiry doesn't automatically mean a Rules violation, but you have to make your case!

High Return Rate

- Occurs when the rate of unauthorized returns rises above reasonable ratio
- Risk to confidence in ACH Network and loss to ODFI
- *NACHA Operating Rules* contain reporting requirement
  - Written request from NACHA when suspect that unauthorized return rate threshold exceeds .5%
  - Requires mitigation plan if exceeds .5%

Return Rate Levels

- Returns that exceed the rates will not automatically be a Rules violation
- Should be a trigger to review the Originator's or TPS's origination activity

High Return Rate Controls

- Know Your Customer (KYC)
- Know Your Customer's Customer (KYCC)
- Verify company following proper authorization policy
- Monitor return volume and ratio by company
- Originator training/education

Remotely-Created Check (RCC)

- Regulation CC defines RCC as a check that is not created by the paying bank and does not bear a signature
- FIs should note that a shift from ACH to RCC could indicate a potential problem with Originator

Risk Specific to Products

- Internet-Initiated/Mobile Entries (WEB)
  - Unique risk issues inherent to Debit Entries
    - Open, fast, anonymous
- Telephone-Initiated Entries (TEL)
  - Potential for misuse through origination of unauthorized payments
    - May be originated as a result of deceptive practices
    - Anonymity when no prior existing relationship

Internet-Initiated/Mobile Debit Entry Risk Controls

- Authentication
  - Used to verify Receiver identity
  - Must be commercially reasonable
  - Varies based on relationship with Receiver (new, existing, single, recurring)
- Verification of routing number
  - Minimize exceptions
  - Verify RDFI routing number validity using commercially reasonable method

Internet-Initiated/Mobile Debit Entry Risk Controls

- Fraudulent Detection System
  - Screening reduces potential for fraudulent Entries
  - Factors vary based on Entry value, type, relationship
  - Must be deployed regardless of payment size or type
- Annual security audit
  - Originator/Third-Party Sender must conduct annually
  - Ensure Entry & Receiver information security
    - Physical security – theft, tampering and damage
    - Personnel security – unauthorized access and use
    - Network security – secure capture, storage and distribution

Telephone-Initiated Entries Risk Controls

- Verification of identity of Receiver
  - Utilize commercially reasonable method
    - Database, directory, etc.
    - For example: name, address, phone number, account profile information
- Verification of routing number
  - Minimize exceptions
  - Verify RDFI routing number validity using commercially reasonable method

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Questions?

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