

NACHA Risk Management News

Volume 5, Issue 2



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Winning the War

By Roy DeCicco, CCM, J.P.Morgan and Risk Management Advisory Group Chair



As we meet in Orlando for PAYMENTS 2009, the NACHA community has every right to be proud of the ACH infrastructure that has been developed over the years. The ACH Network is processing a record number of transactions and the industry focus on safety and soundness has helped ensure the overall integrity and quality of the Network. As good as things are, we must keep our focus on safety and soundness for one very basic reason – there are those that have every intention of taking advantage of all payments channels. They have many different faces - individual hackers,

unscrupulous telemarketers, or sophisticated criminal enterprises located anywhere in the world. Whatever they are and wherever they are – they have a common goal – to breach financial institution clients by gaining unauthorized access to accounts. Or put another way – they want to invade our territory...and to me that means war!

NACHA's and Regulators' Strategies

There have been many positive steps taken by NACHA and the regulatory communities that have helped raise the bar on safety and soundness. The industry has experienced a steady stream of new rules, regulatory guidance and process improvements which, when viewed collectively, have had a significant positive impact on ACH Network quality.

In 2003, NACHA began ODFI risk counseling and by 2007, this was supplemented by the Network Enforcement Rule, which provided both an enforcement mechanism to ensure that Originator return rates for unauthorized entries are below 1 percent and an enhanced fine structure. In 2006 and 2008, the OCC issued two important bulletins. The first provided guidance on managing the risks of ACH activity, and the second focused on due diligence for third parties who process payments for telemarketers and other merchant clients.

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NACHA—The Electronic Payments Association
13450 Sunrise Valley Drive
Suite 100
Herndon, VA 20171
Phone: 703/561-1100
Fax:703/787-0996

Editor
Jeanette A. Fox, AAP

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Winning the War

Largely as a result of these enhanced educational and due diligence initiatives, the ACH Network has seen a decline in problematic Originators. And if you believe that enforcement is a potential risk mitigant – more good news – under the National System of Fines, more cases are being escalated from risk counseling to enforcement.

Financial Institutions' Strategies

Financial institutions are employing best practices to stay on top of trends. One key theme is the importance of customer vigilance.

It is no secret, corporate clients must review statements in a timely fashion to comply with the rules for returning unauthorized transactions and avoid potential losses. Financial institutions have enhanced their processing models to assist corporate clients in this account monitoring. ACH debit block, which ensures transactions never hit the corporate client's account, has been around for a long time. More recently, financial institutions have started to provide additional functionality with an ACH positive pay service, allowing clients to review and make decisions on posted transactions within the 24 hour return window.

The frequency of communication between financial institutions is increasing, and this is helping to reduce the instances of unauthorized entries. For example, some large ODFIs have noticed an increase in requests for original authorizations, and these financial institutions are educating, or reminding, clients that the retention period for original authorizations is two years from termination of the authorization. Adherence to a rule as basic as this will save clients money and help manage the return rates for unauthorized reasons in the Network.

Another example illustrating how communications have been effective is that RDFIs are increasingly aware of unusual traffic patterns from an ODFI. Communications with the ODFI often leads to the conclusion that the traffic pattern is more than unusual, it is in fact not authorized. The results could not be better – grateful ODFIs and Originators and frustrated fraudsters.

How to Win the War

There are many in the ACH community who will say that education is a full-time job. So be it – the value of ongoing educational initiatives pays big dividends in mitigating losses for participants in the ACH Network. An educational program and updates on sound business practices – which several financial institutions offer through web sites – are good examples on how the industry is winning this particular battle.

By keeping the focus of the industry on the big picture – a safe, secure and sound ACH Network and by executing on initiatives, both large and small, which collectively have a positive impact on reducing risk and maintaining quality in the ACH Network, NACHA and financial institutions will win. ■

Roy C. DeCicco, CCM, with J.P.Morgan was appointed Risk Management Advisory Group (RMAG) Chair in September 2007. DeCicco also serves on the NACHA Board of Directors. At J.P.Morgan, Roy is a Managing Director and an Industry Issues Executive with the Treasury & Securities Services Global Markets Infrastructure Team.

Also see [*A Conversation with RMAG's Chair Roy DeCicco*](#) beginning on Page 3 of this newsletter.

A Conversation with RMAG's Chair Roy DeCicco

By Ann-Marie Bartels, AAP, President & CEO, Mid-America Payment Exchange and RMAG Communications & Education Project Team Chair

While I serve on RMAG with Roy, it was interesting to spend some time talking with him about his perspective on RMAG initiatives and ACH Network risk. **-AMB**

RMAG was established in 2005 to address risk in the ACH Network. How would you assess the impact of RMAG to date?

DeCicco – “I’m very positive about what RMAG has accomplished. We knew that risk was a strategic priority for ACH Network participants. The Two Sparrows Consulting report prepared in 2005 helped RMAG develop an implementation plan for risk strategy. We engaged industry subject matter experts interested in focusing on risk and were able to focus on very specific initiatives around onboarding, underwriting, ongoing requirements, enforcement, and transaction quality improvements. RMAG proposed several rule changes that were implemented through NACHA’s rule-making process. This includes enhancements to the System of Fines, establishing return reporting thresholds, enhancements to the audit requirements, and the Company Name field requirements, as well as working with the ACH Operators to improve incident reporting and investigations. We have seen the rate of unauthorized returns decline. The Network continues to be safe, secure, and reliable.”

As Chair of RMAG, what do you see as the most pressing risks facing DFIs?

DeCicco – “I see the most pressing risks as those related to technology, phishing, and identity theft. Protecting the Network from these types of attacks is an obvious target of our attention. There are very sophisticated organizations around the world, not just an occasional hacker, that develop plans and methodology to identify weak spots and cause as much financial damage as they can. If they are this focused, we must be also.”

What is RMAG doing to address these risks?

DeCicco – “As basic as it sounds education is key. Through articles in the *Risk Management Newsletter*, we are educating the community on the latest types of attacks. We are also focused on identifying poor behavior and low quality origination in the Network. This is not an easy fix; we have to take many small steps, do them well, and we will continue to improve the Network. We’ve already taken many steps and our current focus is on the concept of a Terminated Originator Database.

The Terminated Originator Database concept is one of our biggest objectives to explore this year. The RMAG Data Sharing Project Team is currently preparing a business case that would outline the need to create a source (or sources) that collects information on terminated Originators in the ACH channel. We need to address the issues, answer the questions, and determine a solution. If we can accomplish this it will benefit everyone in the industry.”

The Two Sparrows report identified increasing numbers of third party participants as one area of potential risk to the ACH Network. What are your thoughts about third parties?

DeCicco – “Third parties play an important role in the ACH Network; however, ODFIs have important responsibilities when onboarding third parties and aggregators. ODFIs have to practice ‘Know Your Customer’ and ‘Know Your Customer’s Customer’ principles and be confident that they have the right processes in place to monitor the transactions these third parties introduce into the Network. The ODFI always owns the responsibility and liability for the activity. ODFIs must conduct appropriate due diligence, monitor these relationships,

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A Conversation with RMAG's Chair Roy DeCicco

and be prepared to make difficult decisions. The environment can change quickly, and if negative changes take place, the ODFI must be sophisticated and nimble enough to recognize the change and react, and if necessary, terminate the relationship."

As RMAG worked on the NACHA Board Policy on Direct Access Registration, can you elaborate on the concerns associated with direct access?

DeCicco – "The issue is focused on what transactions get introduced into the Network directly from Originators and Third Party Senders. Again, it is the ODFI's responsibility to know what gets introduced into the Network. Potentially, there are increased levels of risk with direct access relationships. If the ODFI doesn't review files, for example, the transactions will settle without this review. 'Know Your Customer' is very important, as is vetting these transactions through risk tools.

"In its white paper, the RMAG Direct Access Project Team focused on debit origination as unauthorized debit activity can have the broadest negative impact within the Network."

IAT has been a primary focus for the ACH Network for the past several years. Do you see any risks associated with IAT?

DeCicco – "IAT risk is not on RMAG's radar screen. The focus right now is on educating the market place on implementation, working through processing issues and meeting the objectives of OFAC. As an industry we are focused on the processing risks to meet OFAC requirements. NACHA has taken the lead on education. I give kudos to NACHA for their interaction with OFAC, their frequent calls with the community and their extensive education efforts. NACHA staff has done the heavy lifting. The next thing will be compliance risk; this may be a potential play for RMAG."

Mobile payments are another hot topic right now. Are there risk concerns with mobile?

DeCicco – "Yes, newer payment channels such as mobile, P2P or A2A have the potential to introduce new risks to the environment. We are at the forefront of these newer channels as they are still being defined. There is a lot of work being done by the NACHA councils. The RMAG Rules, Regulations & New Risk Project Team is doing a really good job at looking at industry impacts, what it means to the ACH Network, what SEC Codes should be used, and if new rules are necessary. We have an ACH infrastructure that serves us well; with these new channels we need to make sure that we can keep the Network safe and secure."

Looking to the future, what is RMAG's role in mitigating ACH Network risk?

DeCicco – "We have to keep an eye on how the ACH Network compares to other channels related to risks. We need to improve our metrics, looking at underlying data points and re-measure them from time-to-time, and ask ourselves 'Are we winning the fight'? The indicative number we point to right now is return rates for unauthorized entries. We saw a period when TEL return rates for unauthorized entries were high. The community addressed that and overall the Network's unauthorized trend rates are holding steady at .04 percent. While this is a viable indicator, other data points would be helpful. We need to look at ACH loss rates which can be tricky because there is reluctance for DFIs to share this information. We need to figure out how we can identify and measure this, and then create tools to help address it. We want to raise the bar, look at leading indicators, and try to get more texture. RMAG is just now launching an initiative to benchmark losses in the ACH Network.

The ACH Network is safe, secure and reliable; we want to do everything we can to make sure it remains that way." ■

Risk Management and Assessment Rule Proposal

By Michelle Sledge, AAP, Fifth Third Bank

The Risk Management and Assessment Rule Proposal is a component of NACHA's Risk Management Strategy. The goal of the strategy is to ensure high-quality ACH transactions and reduce risk for financial institutions, businesses, and consumers. The strategy addresses risk throughout the lifecycle of ACH payments, and this proposal addresses network entry requirements and ongoing requirements within that lifecycle.

The proposal is consistent with the OCC Guidance (2006-39) which states "Each bank should...use this guidance to develop an ACH risk management program that reflects the nature and complexity of the bank's activities."

A Request For Comment was issued on the proposal in 2008.

Background

Currently, the requirements of the *NACHA Operating Rules (Rules)* related to ODFI's risk management is limited to establishing, reviewing, and monitoring exposure limits for an Originator's ACH activity. This proposal would codify within the *Rules* additional risk management practices that are common in the industry that would improve risk management in the ACH Network when utilized by all DFIs.

Risk Assessments

The rule would require all participating DFIs to conduct a risk assessment of their ACH activities and to implement risk management programs based on the results of such assessments in accordance with the requirements of their regulators.

Agreements with Originators and Third Party Senders

The proposal provides that each ODFI has the right to terminate or suspend an Originator, or any Originator of a Third Party Sender for breach of the *Rules*; and the right to audit an Originator's, or Third Party Sender's and its Originator's, compliance with the agreements and the *Rules*.

The ODFI would be required to address each of these requirements as it renews or enters into new agreement with an Originator or Third Party Sender.

ODFI Risk Management Practices

The proposal would require ODFIs to perform comprehensive risk management practices in addition to the current rule requirements on exposure limits. Specifically, the ODFI would be required to:

- Perform due diligence with respect to Originators and Third Party Senders sufficient to form a belief that the party has the capacity to perform its obligation in conformance with the *Rules*:
- Assess the nature of the Originator's or Third Party Sender's ACH activity and the risks it presents; and
- Establish procedures to (1) monitor the Originator's or Third Party Sender's origination and return activity, relative to its exposure limit, across multiple settlement dates; (2) enforce the exposure limit; and (3) enforce restrictions on the types of ACH transactions that may be originated.

These requirements reflect ACH industry best practices to ensure that all ODFIs perform appropriate 'Know Your Customer' due diligence and establish appropriate procedures, systems and controls to manage the risks of Originators' or Third Party Senders' ACH activities.

NACHA anticipates distributing the proposal for ballot to the Voting Membership in the 2nd quarter of 2009. ■

Audit Enhancement Rule Approved

By Steve Helgen, Vice President, US Bank

The Rules Audit Enhancement Rule was sponsored by the Risk Management Advisory Group as part of a comprehensive risk management strategy for the ACH Network. The Request For Comment was initially distributed in January 2008. Extensive commentary resulted in a revised rule proposal, which was balloted and approved in January 2009 and will become effective December 18, 2009.

Currently, the *NACHA Operating Rules (Rules)* require all Participating Depository Financial Institutions to audit their compliance with the *Rules*, and requirements for such an audit are defined in Appendix Eight.

This rule is intended to reduce ACH Network risk and improve quality by ensuring that Depository Financial Institutions (DFIs) perform a broader assessment of their compliance with the *Rules*, helping them to identify key areas of ACH processing where improvement may be necessary.

New Provisions & Reorganized Structure

This rule incorporates audit areas related to many recent *Rules* changes and provides additional specific guidance on key audit points. In addition, the audit requirements are reorganized to include a distinct section on provisions that apply generally to all DFIs, which is intended to facilitate use of the material and eliminate redundant information. In addition, this rule clarifies that the failure of a DFI to provide NACHA with proof of completion a rules compliance audit upon NACHA's request may be considered a Class 2 rule violation.

Since all DFIs are currently required to conduct a rules compliance audit on an annual basis, no DFI or organization would be required to conduct a rules compliance audit that does not already do so. However, implementation of the rule could result in situations where the scope of the audit may need to be expanded if shortcomings are identified in their current audit practices.

Extensive Changes Made in Response to 2008 RFC

Respondents to the Request For Comment released in January 2008 requested that consistent terms be used throughout the language in Appendix Eight. Previous language in the original proposal referencing the verification of various policies and/or procedures has been removed, because the *Rules* do not mandate the establishment of such policies/procedures but instead obligate the DFI to verify its compliance with the substantive processing requirements of the *Rules*. Language has been made consistent by using "audit" in place of "examination," and "verify" in place of "ensure."

Handling of Best Practices

The original proposal included several best practices as components of an ACH audit. While not mandated by the *Rules*, the following issues were viewed as important to successful ACH processing. Under the proposal, the introduction to Appendix Eight provides references to some practices to provide DFIs with additional context for their ACH Operations. These include:

- OFAC compliance;
- ACH business continuity plans;
- ACH risk management policies; and
- Compliance with 31 C.F.R. Part 210 and the Green Book for processing Federal Government ACH transactions.

Audit Requirements for RDFIs

The Rule expands the scope of audit coverage for RDFIs by incorporating additional rules within the RDFIs' compliance review. These include:

- appropriate handling of XCK entries and entries received to non-transaction accounts;

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Audit Enhancement Rule Approved

- compliance with rules governing the return of unauthorized debits to corporate accounts;
- proper utilization of return reason codes;
- timely return of un-posted credit entries and credit entries returned by the Receiver;
- handling of ODFI requests for return or adjustments of erroneous entries; and
- compliance with notice requirements for credit entries subject to UCC Article 4A.

Audit Requirements for ODFIs

In addition to the existing ODFI audit requirements, this Rule incorporates a review of the ODFI's compliance with:

- its obligation to accept and inform the Originator of return entries transmitted by the RDFI;
- rules governing dishonored return entries and handling of contested dishonored returns, including proper use of related return reason codes;
- rules governing the refused NOC process;
- its obligation to obtain and provide the RDFI with copies of authorizations when requested to do so;
- notice requirements for credit entries subject to UCC Article 4A;
- proper use of the reversal process; and
- its obligation to report information on each Originator or Third-Party Sender as requested by the National Association.

Effective Date

The Rule will become effective on December 18, 2009, with rules compliance audits conducted under the revised requirements to be completed no later than December 1, 2010. Although not mandatory until the 2010 audit year, earlier compliance with these expanded audit provisions is encouraged. ■



Join us June 14-18, 2009 in Scottsdale, Az. or July 19-23, 2009 in Atlanta, Ga. for The Payments Institute (TPI)!

The Payments Institute continues to be the best value in payments system education. Students are introduced to key concepts in all aspects of the payments cycle – from ACH to cards to checks to the risks associated with these payment mechanisms – in a fun, interactive learning environment.

The Payments Institute is an intensive 5-day course aimed at helping you achieve a higher understanding of the payments system. The Payments Institute's powerful curriculum is meticulously designed to accommodate both the novice and the experienced payments system professional. Whether you are starting from square one or have years of experience under your belt, this unique environment allows you to custom-design your learning experience to your current learning level.

The Payments Institute is not a conference. It is a unique adult learning experience that gives you the opportunity to focus on key applications, implementation approaches and experiences, best practices, and case studies. Additionally, The Payments Institute's environment allows for substantive and fun networking opportunities with other payments system professionals from a wide range of industries and backgrounds.

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Are you thinking of becoming an AAP? TPI is a great place to start or enhance your studies for the exam.

For more information about TPI please visit http://www.nacha.org/conferences/TPI_2009/default.htm or contact Stephanie Prebish at sprebish@nacha.org.

New Research on Customer Service Telephone Number

Summarized by Ann-Marie Bartels, AAP, President & CEO, Mid-America Payment Exchange and RMAG Communications & Education Project Team Chair

Inclusion of a customer service telephone number in the ACH record has been under consideration for quite some time; new research conducted by NACHA may suggest that the time is right to revisit this proposal.

The NACHA Customer Service Telephone Number Rules Work Group has twice proposed specific amendments to the *NACHA Operating Rules* to implement a provision requiring an Originator to include a telephone number in the ACH record. The objectives of these rules proposals were to:

- make the telephone number available to Receivers;
- reduce the customer service impact on RDFIs; and
- reduce the incidence of debits returned as unauthorized because of customer confusion.

In June 2006, the first Request For Comment was issued proposing that the telephone number be included in the Company Discretionary Data Field of the Company/Batch Header Record. Eighty-two responses were received:

- 94% supported the concept of the Originator maintaining a telephone number for Receiver inquiries.
- 88% supported the concept of the Originator including a telephone number in the ACH record.
- 80% supported the concept of the RDFI providing the number to the Receiver on a periodic statement.
- 69% supported the telephone number being placed within positions 21-30 of the Company/Batch Header Record.

While there was significant support for the proposal, many ODFIs reported that they use the Company Discretionary Data Field to identify information to their customers, and that changing the field would result in major software and procedural changes.

In June 2007, a second Request For Comment was issued proposing new data fields in the Company/Batch Control Record to carry the telephone number.

Of the 116 responses:

- 92% supported the concept of the Originator maintaining a telephone number for Receiver inquiries.
- 88% supported the concept of the Originator including the telephone number in the ACH record.
- 81% supported the telephone number being placed within the Company/Batch Control Record.

New Research Findings

To attempt to resolve this impasse, the RWG suggested that research be conducted on the use of the Company Discretionary Data Field. The Company Discretionary Data Field is 20 positions in length; if the contents of the field use 10 positions or less, then the use of the field would not be impacted by re-allocating 10 positions of the field for the telephone number.

Based on the analysis of a sample of ACH transactions, the following conclusions were drawn:

- 32% of the transactions in the sample contain 11 or more characters in the Company Discretionary Data field. This means there would be no impact on 68% of ACH transactions if 10 positions of the Company Discretionary Data field are used to carry a telephone number.
 - Of the 32% that do contain 11 or more characters in the field, it is most commonly used for POP entries, with 96% using 11 or more positions; however, the field is used primarily to carry a telephone number.
- 43% of CCD credits use 11 or more characters of the field; the impact on CCD entries could be mitigated by only requiring the telephone number for consumer entries.

These findings suggest that it may be appropriate to include a telephone number in the Company Discretionary Data Field for consumer entries.

The Rules Work Group will issue a Request For Information in the near future seeking input on this potential approach. ■

NACHA's Risk Management Advisory Group

Roy DeCicco, CCM
J.P.Morgan
RMAG Chairperson

Ann-Marie Bartels, AAP
Mid-America Payment Exchange

Joseph Caputo
State Street Bank and Trust Company, N.A.

Keith Crockett
BBVA Compass

Joseph Flannery, AAP
BB&T

Mary Gilmeister, AAP
WACHA – The Premier Payments Resource

Steven J. Helgen
U.S. Bank

Daniel J. Heller
Wells Fargo

Peter C. Hohenstein, CCM
Bank of America

John King
MACHA – The Mid-Atlantic Payments Association

Fred Laing II, AAP, CCM
Upper Midwest ACH Association

Devon Marsh
Wachovia Bank, N.A.

James McKee
Federal Reserve Bank of Atlanta

Sara Pinkus, AAP
TD Bank

Sharon Roberts
KeyBank

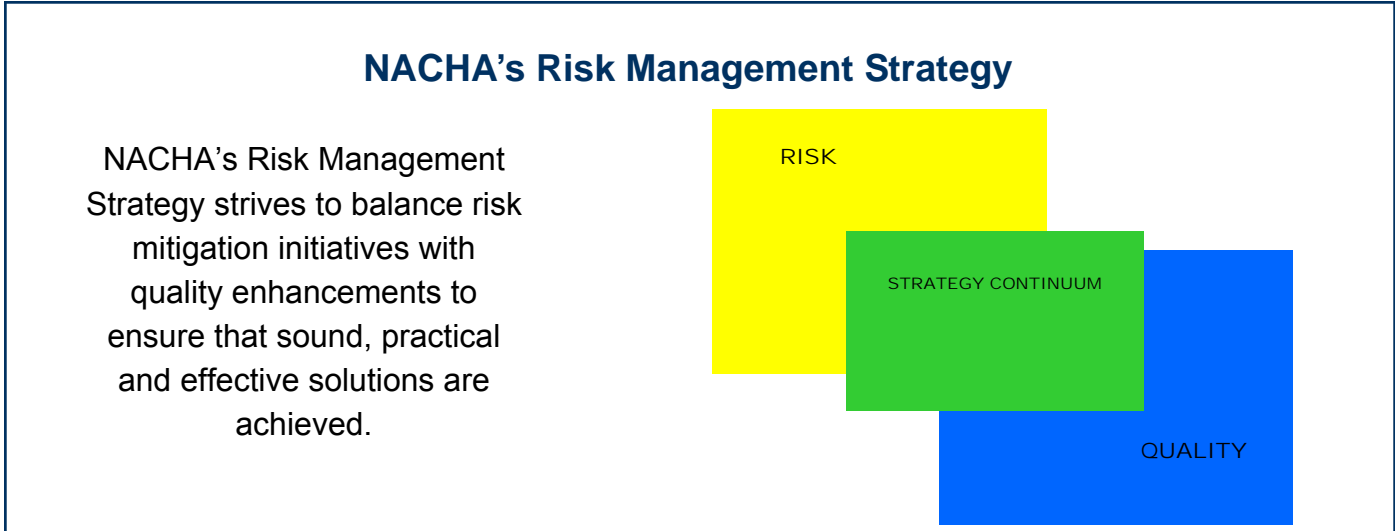
Alex Romeo
The Clearing House Payments Company

Dennis Simmons, AAP
SWACHA - The Electronic Payments Resource

Michelle Sledge, AAP
Fifth Third Bank

Samuel A. Vallandingham
The First State Bank

Steve Whitney
Norway Savings Bank



ARC, TEL and WEB: Impacting the ACH Network

Nancy Grant, AAP, Senior Director, Research and Standards, NACHA

Three major drivers of ACH growth over the past few years – ARC, TEL and WEB transactions – are used overwhelmingly to pay routine household bills, from credit card and telephone bills to auto loan payments and utility bills. More than nine out of ten – 91.6% – of ARC, TEL and WEB transactions are for paying routine household bills.

ARC, TEL and WEB were introduced within a 12 month period in 2001 and 2002 – and they did not take long to establish their presence. While 2002 data shows that the three SEC codes, still in their infancy, accounted for only 1.4% of ACH transactions, by year-end 2003 they accounted for more than one in ten – 10.4%. At the close of 2008, they accounted for an impressive 34.1% – more than one in three – of ACH transactions. Indeed, the compound annual growth rate (CAGR) for the three SEC codes combined was a striking 80% over the time period 2002-2008.

Overall Usage of These SEC Codes

The number one use is payments for bank credit cards, with more than one in four – 25.4% – of transactions. (See Figure 1.) The second highest is for payment of telecommunications bills (15.4%); third is bills for all non-bank credit cards (12.7%), which include other general purpose cards, retailer and store cards, and oil company cards. These three uses account for more than half – 53.4% – of ARC, TEL and WEB transactions.

Uses other than bill payments include routine purchases (1.7%), transfers, A2A, and investments. A small percentage of transactions (0.9%) cannot be identified, and a smaller percentage (0.3%) appear to be B2B transactions.

There are, as might be expected, some differences by SEC Code explained in the following sections.

ARC Usage

ARC's original purpose – to convert consumer bill payment checks to ACH entries – has been met. Nearly all – 96.3% – of ARC transactions are payments

for routine bills. ARC has long been dominated by payments for credit cards. Bank credit card and other credit card payments account for more than one in three (35.7%) of ARC transactions. Rounding out the top five uses of ARC are payments for telecommunications bills at 20.9%, utility bill payments at 13.2%, and insurance at 5.5%. These four uses account for more than three quarters (75.2%) of ARC payments.

A small percentage of ARC transactions, 2.8%, is for purchases, typically for reading material and photography. Small percentages either cannot be identified (0.6%), or appear to be B2B transactions. (0.2%).

TEL Usage

More than nine in ten (91.2%) of TEL transactions are for household bill payments. TEL usage is topped by – perhaps ironically – telecommunications bill payments, which account for nearly one in five (19.1%) TEL transactions. Auto loans and leases, and mortgage and HELOC payments, come in second (12.4%) and third (11.4%) respectively. Rounding out the top five uses are loans (10.5%) and utility payments (9.4%). These five uses account for nearly two thirds of TEL payments (63.0%).

Only 1.8% of TEL transactions are for purchases of a variety of items – from alumni directories and music to prepaid phone cards and household goods. A slightly higher percentage of TEL transactions than the other two SEC codes can not be identified (2.7%), but the percentage of transactions that are apparently B2B remains low at 0.4%.

WEB Usage

The percentage of WEB transactions that are routine bill payments is slightly below that of TEL and ARC at 85.8%. Making up the difference are A2A

**What are
ARC, TEL and WEB?**

ARC – Identifies consumer and some small business payments initiated by check, delivered by mail or drop box to biller and converted to an ACH entry

TEL – Consumer telephone-initiated ACH entry

WEB – Consumer Internet-initiated ACH entry

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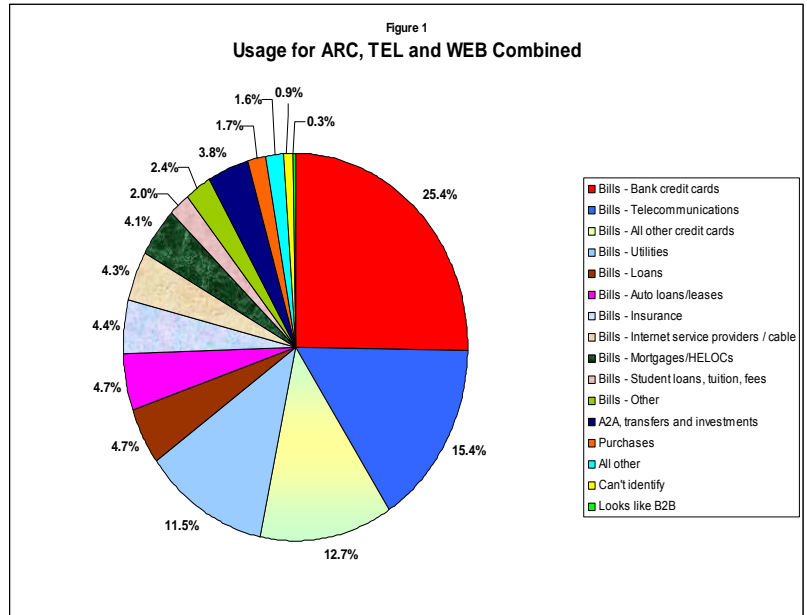
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ARC, TEL and WEB

transactions, which account for nearly one in ten (9.5%) WEB transactions.

WEB has an even higher percentage of transactions that are for credit card payments than ARC. All credit card payments combined accounted for 46.1% of WEB payments. The top five WEB bill payment uses also include utility bills at 9.8%, telecommunications at 7.5%, and Internet service providers and cable companies at 4.1%. These five uses account for two thirds (67.6%) of WEB transactions.

Routine purchases account for 1.7% of WEB transactions, with – truly ironically – the purchase of paper checks accounting for the largest share of WEB purchases. Other items purchased using WEB range from movie rentals and tax services to household items and event tickets. Under one percent (0.9%) of WEB transactions could not be identified, and 0.3% appear to be B2B payments. ■



Questions?

Questions about the data in this article are welcome and should be directed to the author at 703-561-3911 or ngrant@nacha.org.

Attention ODFIs:

RMAG Requests Your Participation in a New Survey

ODFI Best Practices for Originating ACH Transactions in Challenging Economic Times

At PAYMENTS 2009: Stop by the NACHA Booth in the Exhibit Hall and complete the survey onsite!

On the Web: Go to

http://www.surveymonkey.com/s.aspx?sm=m4IJZq9xci1P7cb_2fJ9RvPQ_3d_3d

and complete the survey by April 30, 2009.

This survey was designed by NACHA's Risk Management Advisory Group (RMAG) to gather information from Originating Depository Financial Institutions (ODFIs) on their best practices for origination of ACH transactions. It is particularly important to gather this information to help develop best practices in order to assist ODFIs in today's challenging economic climate. RMAG will utilize the summary of survey results to develop a best practices document for financial institutions.