

10 Ways to Minimize Risk in the ACH Payment Space

Speaker: Steven Bernstein – January 2011

The following podcast is brought to you by J.P. Morgan.

My name is Steve Bernstein. I'm the Senior ACH Product Manager for J.P. Morgan. Today we're going to discuss 10 ways to minimize risk in the ACH payment space. With the advent of several amendments in 2010, we see a quicker advent of increasing ACH volume. Two of those examples of those are the Durbin amendment, which is going to limit debit card fees and which may well constitute a resurgence and growth in the ACH which has been flat between the 2009 and 2010.

In addition, the Obama administration has made it clear that healthcare and electronifying payments within the healthcare space is a high priority. We see an increased influx of volume that will occur, specifically due to healthcare amendments with regard to electronifying disbursements and claims that are made to doctors, as well as patients for payments and receipt of the same. All this means is that there's an increased impudence to ensure that you mitigate and minimize any type of risk in the ACH industry.

Throughout the last few years there's been studies that have reflected that ACH continues to be the least risk laden payment type in the industry. But there has been an influx of incidents where fraud has occurred. Today we're going to discuss 10 ways that a corporate practitioner can minimize fraud and risk to their space. And some of these are quite common sense in nature, but as I can cite examples for, even the smallest type of deviation from these practices can lead to potential fraud and risk. So we're going to count down from 10 to 1 what these different options are.

The first is Number 10: Dual security administrators for electronic payments. This seems like it's common sense, but there are many cases in which the security administrator is the same person that approves as well as releases payments in a treasury area. We strongly recommend that there be a minimum dual security for administering electronic payments. That way you've got a separation of duties, and as such, a separation of duties is one that is well known to be a risk mitigant.

There have been several examples in the last year where there have been issues and fraud that has occurred because there wasn't the utilization of dual security administrators specifically for electronic payments that enabled the party to go unchallenged to initiate these payments to another known party and create several million dollars of fraud. So again, we highly recommend that this be administered.

Number 9 is separate accounts for ACH debits and ACH credits. And this is a reconciliation item where if you keep your sheets for reconciliation clean, you can separate the ACH debits and ACH credits, because for any ACH debit or ACH credit you can have a return. And because of the provisional nature of an ACH transaction, and the fact that you can have a return, it would follow that if you minimized your potential exposure by separating your accounts between the two, you can keep separate accounts and minimize the utilization of same, but yet have a cleaner reconciliation process internally. So we highly recommend that if you can deploy a separate account for ACH debits and ACH credits that you go ahead and do so.

Number 8 is UPIC. An administering UPIC, which is the Universal Payment Identification Code. And this is where if a corporate practitioner decides that they want to utilize a UPIC, this is where a corporate administrator would provide to their counterparty, not their actual account number but a UPIC, which is known as a pseudo account that is used by the counterparty to pay that corporate practitioner. UPICs, or the Universal Payment Identification Code, is strictly for corporate credits. So in the sense that another party from a corporate standpoint pays a corporation, it can be used to initiate an ACH corporate credit and only an ACH corporate credit. The benefit is that the corporation neither has to list their account number on their website, which is another no-no, nor provide it to their corporate practitioner. So the idea

is to minimize the communication of an actual DDA, and instead utilizing Universal Payment Identification Code for the purpose of rendering an ACH credit. We know of several Fortune 500 companies that have deployed UPICs extensively, and are utilizing in all of their payment processes instead of an in lieu of an actual DDA. And they're doing this with all of their banks. And by doing so they are helping minimize the potential transference of that DDA to others that may use it for purposes other than for what it's intended. So utilization of a UPIC is something that we view to be a positive mitigant to ACH risk.

Number 7: Daily reconciliation of electronic and check payments. And this again sounds like it's common sense, but again we can cite examples in the last year where not reconciling on a daily basis has directly led to taking your eye off the ball, and not detecting in those cases where there was risk and there was fraud that did occur. So we can't underline enough how important it is to reconcile on a daily basis. Not only from a practical standpoint, but also one that it will enable you to identify any potential risk or fraud as they occur rather than letting it build. So again, daily reconciliation of electronic and check payments is viewed as a significant risk mitigant.

Number 6 is an ACH mirror or companion file. And this is utilized when a party originates an ACH payment file. In many cases clients are using PeopleSoft or SAP for example. And the type of reconciliation that is used in these systems calls for something like a mirror or companion file. The definition of a mirror or companion file is that for every transaction that is remitted for processing, another transaction that mirrors that transaction is sent back to the corporate practitioner or to their system of record. This not only enables the corporation to know that the party, in this case the bank, has received the payment file, but has also provided that file back to that company so that they know there was no manipulation of the data that has occurred when the file was initiated. So this is significant in many respects, because in most cases ACH provides batch level payment data and information. With regard to an ACH mirror companion file, that data as it was sent is then mirrored back or sent as a companion file back to the party that initiated it so that, that party knows that not only did the bank receive all of the data that it sent, but that it received the data exactly how it did send it to the bank and that it was not manipulated. So we can cite several examples of corporations in the last year that have used this to their benefit so that they'd be insured that although they still have a settlement of the aggregate total of the transactions, they also have a mirror companion file which reflects each and every item that was remitted. So again, ACH mirror companion file is utilized as a risk mitigant as a positive benefit.

Number 5: ACH Positive Pay. And this is one that has been used extensively by our client base in the last several years. ACH Positive Pay enables a client to identify any ACH debit or credit that is posted to their account. That corporation has 24-hours to go through a Web portal to identify any items that they view to be not theirs, or one that they want returned. If there are such items, they denote those within that 24-hour period, and then request that the bank return them systemically on their behalf. ACH Positive Pay is used very often in conjunction with other things like ACH Debit Block. The difference is that ACH Positive Pay requires much more action on behalf of the corporate practitioner. In other words, there's an action that is required within that 24-hour period to either allow the item to post, or to return them. And unless that action is taken, then the payment will not be returned. So it's intrinsic to the ACH Positive Pay transaction that the item be identified if it does not want to retain the item, in most cases an ACH debit. An ACH credit can also be returned and there are some instances where accounts cannot receive corporate credit, so they cannot retain them. So they will have to have them returned. So again, Number 5, ACH Positive Pay is used extensively, and it is a product that J.P. Morgan utilizes with its client base extensively as well.

Number 4: Late ACH return block. And this is where a corporate practitioner can identify an ACH return or that any return that is received after a certain amount of time can be returned systemically by J.P. Morgan. And this is a moving filter. For example, we can have returns that are received beyond two business days that will be automatically rejected and returned to the receiving financial institution. Or you can pick another type of time frame, such as five days, or seven days. The key is that there be a comfort level with regard to acceptance of returns, with stipulation that you do not want to have the receiving bank contest the fact that it was returned and rejected and that they met the time frame. So we feel confident that the minimum of three business days where the items can be received, or anything past two business days in this case that can be automatically rejected, is still utilizing the parameters of the ACH rules and enabling the corporate practitioner to limit their exposure for any types of ACH returns. The stipulation here is that the return block does not hold true for Reg E based returns. So if they are consumer-based transactions, we are under the statute of federal Regulation E where we must accept returns for up to 60 days. In those cases we have to accept those types of transactions as we do for any ACH reversals, which we have to presume the originator utilized the reversal based on the NACHA parameter of five business days from settlement date. So the use of the late ACH return block is extremely helpful where those transactions that are non Reg E based are received by J.P. Morgan, and the stipulation is made by the corporate practitioner to have J.P. Morgan return those transactions back to the receiving financial institution. So it limits the exposure of the corporation to those items that are either Reg E based, or that are returned within the time frame that is stipulated by the ACH.

As time goes on it is extremely important to manage the types of returns that may be initiated through the ACH process, as well as important to understand the levels and parameters that are acceptable for certain types of transactions. For example, Web transactions and Tel transactions have a parameter that are built within the NACHA rules, not only where the receiving bank initiates the return on a timely basis, but also one where J.P. Morgan has to identify whether or not there are those practitioners that are exceeding those parameters for the types and levels of returns that occur on those Web and Tel transactions. Further, because ACH is a provisional instrument, it behooves a corporation to limit their exposure wherever possible. And this is one that is quite utilized. In many cases there's no fee for it, and it also helps a corporate practitioner manage their balancing their books. We recommend a return block wherever possible, which is based on an origin level return block. So whatever parameter is chosen, whether it be three days, five days, seven days, et cetera, that it applies for each origin level on behalf of that company. So again, Number 4, late ACH return block is extremely helpful.

Number 3: The file total validation process. And this is one where clients originate payment files to the bank, but those ACH files are held in suspense until an authorized individual is able to validate the item counts and total debit and credit amounts for file release. And what this does, it enables the bank to hold the file and enables the originator to detect if there was a fraud or if there was an issue that occurred between when the file was sent and when the file was received. Because the files are held in suspense, if there's anything that's untoward that occurred between when the file was initiated and when it was received, there is the ability to have that file deleted and erased. And this is also sometimes used in conjunction with a product that we have called ACH File Warehouse. Where a file is held in a warehouse or is in suspense, and enables a client who forward dates their file for a period of two business days or more, to enable themselves to delete transaction before that file is released into the network. Once the file is released to the network, it becomes that much more difficult to return or reverse that transaction, as well as potentially delete it. So wherever possible we always recommend that the transactions be either deleted or validated before the file leaves the bank, because you are then in control of initiating any deletion or if you need to delete the entire file then it can be done so as well. So again, the file total validation process is Number 3. We feel it is a very strong risk mitigant.

Number 2: ACH Debit Filters. ACH Debit Filters is worked and utilized in conjunction with debit blocks where you allow for greater flexibility to authorize a single, multiple, or recurring ACH debit for the exact or maximum amount of a transaction. In this case, each party that has the ability to debit the counterparty that has an account at J.P. Morgan, in other words, their receiving an ACH debit from an outside party. An ACH Debit Filter allows for flexibility to authorize by a dollar limit what they will allow that entity to originate an ACH debit to their account for. For example, the U.S. Government may have the ability to authorize a payment for up to \$1 million dollars, but another trading partner may only have the ability to initiate an ACH debit for up to \$50,000, because you know that in no way, shape, or form should they ever initiate an ACH debit for greater than that amount. So the utilization of an ACH Debit Filter allows you to be very specific with whom you allow to debit your account for a single type of transaction for an ACH debit.

So again, ACH Debit Filters as a risk mitigant is a strong recommendation, and that's used in conjunction with ACH Debit Blocks, which is Number 1. And this is where an ACH debit is rejected before posting to your account and returned to the originator. We strongly recommend the use of ACH Debit Blocks for all types of transactions and for all accounts. We have many examples of where corporations only initiated or originated ACH Debit Blocks for certain of their accounts, because they felt that if they utilized ACH Debit Block for the most frequently used account, then none would occur for the ones that were not frequently utilized. Well, that doesn't always happen. As long as there is an account out there, then the counterparty has the ability, if they do have access to it, where they would try to penetrate the weakest link. And in this case, if it was an infrequently used account, perhaps it's not reconciled on a regular basis, so it enables a would-be fraudster to initiate an ACH debit, and if there is not a debit block on that account, then they have access to that account if their balance is in it. So again, we strongly recommend that ACH Debit Blocks be initiated on every single account that you retain, because we view it as a low cost insurance policy for you to prevent your accounts from untoward initiation of ACH debits to your account. And we see three types of functions with regard to maintaining these types of blocks. For example, using ACH Debit Block in conjunction with ACH Debit Filters and ACH Positive Pay. We think the three together really forms a framework for a strong resistant point toward any would be interlopers for initiating a potential ACH fraud on that account.

Those are the 10 top ways to prevent risk to your corporate account. Thanks for listening and have a great day.

J.P. Morgan is pleased to have brought you the proceeding podcast. For more information on J.P. Morgan Treasury services and products visit our website at www.jpmorgan.com/ts.

This presentation was prepared exclusively for the benefit and internal use of the J.P. Morgan client to whom it is directly addressed and delivered (including such client's subsidiaries, the "Company") in order to assist the Company in evaluating, on a preliminary basis, certain products or services that may be provided by J.P. Morgan. This presentation contains information which is confidential and proprietary to J.P. Morgan, which may only be used in order to evaluate the products and services described herein and may not be disclosed to any other person. In preparing this presentation, we

have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources or which was provided to us by or on behalf of the Company or which was otherwise reviewed by us. This presentation is for discussion purposes only and is incomplete without reference to, and should be viewed solely in conjunction with, the oral briefing provided by J.P. Morgan. Neither this presentation nor any of its contents may be used for any other purpose without the prior written consent of J.P. Morgan. J.P. Morgan makes no representations as to the legal, regulatory, tax or accounting implications of the matters referred to in this presentation.

Notwithstanding anything in this presentation to the contrary, the statements in this presentation are not intended to be legally binding. Any products, services, terms or other matters described in this presentation (other than in respect of confidentiality) are subject to the terms of separate legally binding documentation and/or are subject to change without notice. Neither J.P. Morgan nor any of its directors, officers, employees or agents shall incur any responsibility or liability whatsoever to the Company or any other party in respect of the contents of this presentation or any matters referred to in, or discussed as a result of, this document.

All services are subject to applicable laws and regulations and service terms. Not all products and services are available in all geographic areas. Eligibility for particular products and services is subject to final determination by J.P. Morgan and or its affiliates/subsidiaries.

J.P. Morgan is a marketing name for the treasury services businesses of JPMorgan Chase Bank, N.A. and its subsidiaries worldwide.

J.P. Morgan is licensed under U.S. Pat Nos. 5,910,988 and 6,032,137.

© JPMorgan Chase & Co. All rights reserved. JPMorgan Chase Bank, N.A. Member FDIC.