Erica El Hilali, MBA, AAP
Director of Client Services

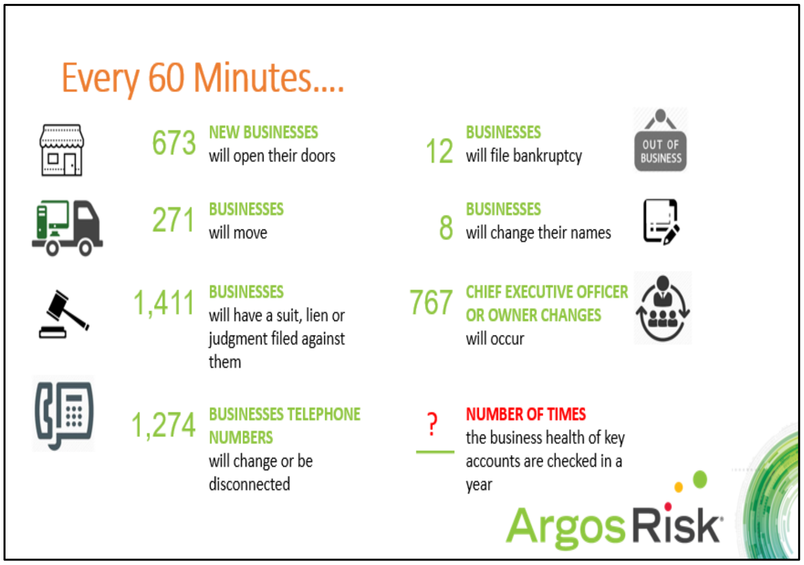
08.01.2017

Risk Management and Real-Time Payments

With Real-Time Payments (RTP), the speed of payments is being brought into the 21st century and the long-held goal of having modern payment options outside traditional banking hours has arrived. The advantages for financial institutions (FIs) using RTP are vast, including being able to directly compete with FinTech disruptors, and retake ownership of the payments marketplace.

Originators, receivers, consumers and businesses will all benefit by removing the uncertainty of the delay of payments and settlements from the process, while having the ability to have transactions settled 24 hours a day, 7 days a week.

As financial institutions embrace bringing faster payments to the marketplace and giving end users what they are demanding, there are several components of the process that will have to change to keep up with the evolving technology and to mitigate risk. Conducting initial onboarding and quarterly reviews of originators is no longer enough.



Depending on the financial institution, many originators are subject to quarterly or semi-annual reviews to stay in compliance with Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) bulletins. Not only are these reviews time consuming and labor intensive, they often leave the institution making financial decisions based on outdated information. Putting the FI at significant risk for missing out on pertinent changes that can impact the risk profile of an originator. In an environment with same-day settlement, how valuable are months-old financials from an originator?

With disruptive forces impacting nearly every major industry, and shrinking business cycles, the financial, operational, and reputational risks are ever increasing. Every 60 minutes there are twelve (12) new bankruptcies filed in America. Conversely the number of new business openings has been constantly accelerating with 673 occurring every hour in the United States.

As The Clearing House (TCH) introduces Real-Time Payments, financial institutions will need to update and automate many of their risk management practices to align with the faster pace of their commercial and consumer customers to protect against the associated origination risks. This will require FI's to incorporate more technology and automation into their risk management processes and practices for contemporary risk management to fit a modern payments program.

The Acceleration of Technology Advancements

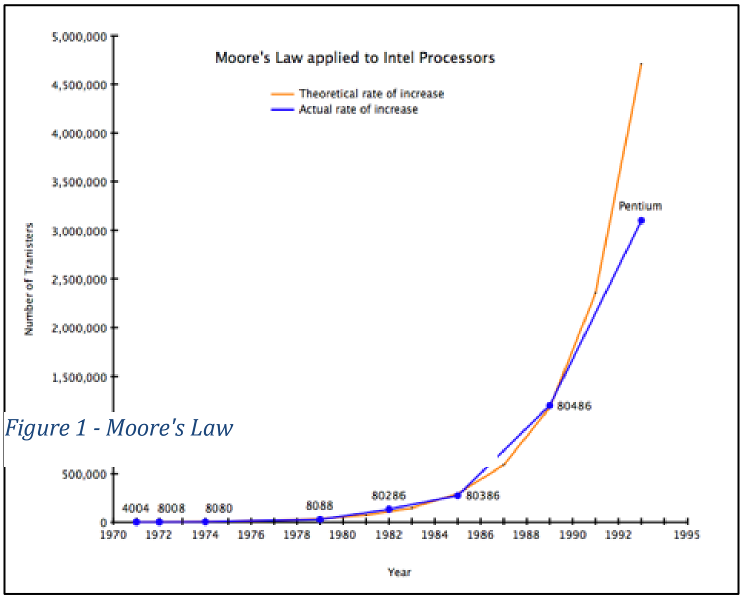


Figure 1 - Moore's Law

For years, the pace of technological improvement has been following Moore's Law. Moore's law is based on Intel's co-founder, Gordon Moore's observation from 1965 which observed that since they were invented, transistors per square inch on integrated circuits doubled exponentially every two years. Due to the speed of this rapid advancement, computers and other electronic devices have become extremely powerful, inexpensive, and small. As a result, the amount of computing power we carry in our phones today far exceeds the capacity of every ship in the Space Shuttle fleet.

The impact advancements in technology have had on the speed of e-commerce and consumer expectations does not go unnoticed. However, for many financial institutions their risk management policies and practices were originally designed for a world in which “check float” existed.

Today’s risk management must be more proactive, real-time, and on-going, mirroring the technological advancement in the payments sector. Static snapshots of an originator’s credit and business health representing stale or irrelevant data will not reveal current potential risk.

When ACH was first conceived in the 1970’s it was a very manual process and involved transporting ACH files physically on disk or mag tape hundreds of miles from originating depository financial institutions (ODFIs) to the Federal Reserve operator and then physically transporting them to the receiving depository financial institution.

As the technology became more efficient and cost-effective, ACH volume exploded which subsequently lead to increased scrutiny and responsibility for the role financial institutions play as gatekeepers to capital markets and payment networks.

In the 1990s, as more banks became active in ACH origination, payments-centric risk management practices, such as temporal risk tracking, an originator-specific focus became more common. Many institutions turned to their credit analysts who review lending for businesses to also review ACH Originator risk. Even though they may not fully understand the unique risks posed from payments versus traditional commercial lending.

Today a Bank's board of directors (or a board committee) and senior management are responsible for overseeing all the banks risk management processes and can be held accountable by regulators. This puts significant pressure on all staff to ensure the practices and process are enhanced and updated as the payments landscape changes.

However, many teams are being overwhelmed by the amount of monitoring required for regulatory compliance. Requirements for the Bank Secrecy Act, Patriot Act, and even internal vendor management requirements have forced FI's to spend a great deal of time searching for the latest information on originators, vendors, and clients. This process is often manual and subject to inconsistent standards, leaving wide gaps in knowledge and the potential for human error, leaving many financial institutions exposed to exponential risks.

Role of Financial Institutions as Gatekeepers of the Payment Network

Financial institutions play a vital role in any payment network as gatekeepers. Through proper screening, they can ensure criminal, fraudulent and non-credit worthy originators are kept out of the networks. This not only protects financial institutions from regulatory action, lowering credit and reputational risks, it also ensures that the overall health of the payment system is protected and maintained.

To address systemic risks within the RTP network, financial institutions will be under ever increasing obligation to know who they are originating for and have solutions in place to ensure 24x7 compliance.

Real-Time Payments will include foreign transaction processing, on parity with multiple international real-time payments processing platforms. These platforms, like The Clearing House's RTP network are in compliant with ISO 20022 electronic data exchange standard.

With the ISO 20022 standard being adopted, it created universal standards that allow for quicker adoption and rapid growth of Real-Time Payments internationally. With this framework in place, financial institutions need to act as a gatekeeper to the payments network.

First, through automated OFAC (Office of Foreign Assets Control) screenings. These screenings check a business name, individual name, and address to verify there is no match, individuals can also be scanned against the Specially Designated Nationals list. Should there be a match, the financial institution would be required to stop the transaction before transmitting to the payment operator.

The companies matched on these lists are banned from doing business within the United States by the US Treasury Department. By performing these scans automatically and frequently as the lists are updated, it ensures regulatory compliance, preventing regulatory actions and reputational risks.

The second gatekeeper role the originating financial institutions play is to check the FinCEN database of Money-Service Businesses (MSBs). The MSBs carry higher risks in the network for being susceptible to money laundering activity since they are offering money based services. As such, they require stricter monitoring and more conservative risk limits. This database is updated approximately twice a month and it is crucial that each time it is updated your originators are rescanned.

Just checking the MSB list when a business first begins origination with a financial institution and not continuously checking it against the list, puts the financial institution at risk of on-boarding an originator who is at one time not registered as an MSB and then later registers, being at risk for not knowing they are originating for an MSB.

For example, at Argos Risk, our financial institution clients have seen cases where an originator will be on-boarded with their primary business and NAICS code as "Retail Shop." This over time can change as that retail establishment starts processing money orders and over time the financial institutions witnessed their volume and transactions to eventually include transactions from an undeclared subsidiary check cashing business. Having on-going monitoring of transactions, as well as on-going due diligence checks against the FinCEN database can help protect the FI from this risk.

Third, financial institutions act as a gatekeeper by verifying the identity of their originators in the network. Financial institutions can verify the registered names of originators on file with the Secretary of State office in the state of operation as well as verify the DBA.

In addition to verifying the identification documents and registration, financial institutions should be verifying the address and reviewing all business which are registered at the same location. This is best done by using technology that is specifically designed to perform this type of analysis. This includes verifying that the address fits the description for the business type, is a business location versus a residential address. It can also help screen out other businesses located at the address and FI's can ensure no restricted NAICS businesses reside at the same location.

For example, if a business says they are an accounting firm, but when using visual technology, the images show a check cashing location, the financial institution can properly identify and prevent that entity from entering the payment network. This protects the network and the financial institution itself from a myriad of risks.

One of the signs of a fraudulent company is that they will register dozens of businesses at a single address. For example, if you retrieved a mapped image of the reported "World Headquarters" of a new originator, and they share an address with fifty other businesses, then there is obviously a need for further due diligence.

Fourth, the way a financial institution can act as a gatekeeper is by constantly monitoring the business health of originators by monitoring for bankruptcies and other indicators of credit and business health deterioration. This can result in preventing unhealthy originators from entering the network and setting commercially reasonable and justifiable limits.

The retail sector is the epitome of why persistent monitoring of the health of originators is extremely important. Stalwart, household brands are now on the brink of collapse. The size of a company should not be equated with safety from a risk perspective. In just a few years there have been numerous examples of companies growing rapidly, reaching a multi-billion-dollar valuation, only to be liquidated and disappear shortly after.

In addition, if an originator sells B2B, risk management needs to be aware of the trend in commercial payment terms. For example, if the originator signs an agreement to provide "widgets" to a larger organization, the payment terms in that relationship can cause a working capital strain. Many larger organizations have implemented policies for payment terms ranging from NET 60 to NET 120. When mapped out on a calendar, it is easily seen how an originator, depending on industry, could have to invest a great deal of capital to fulfill an order, but then must wait a quarter or more before receiving payment. This can burden cash flow causing a business to become unhealthy very quickly. An automated credit risk update can identify this and provide early warnings.

Finally, financial institutions should act as a gatekeeper by monitoring how business originators treat their customers. If there are actions taken by the Consumer Financial Protection Bureau (CFPB) against an originator, not only is this a financial risk, it also is a reputational risk. Therefore, monitoring CFPB complaints would be an even more proactive way to determine if originators are treating their consumer customers unfairly.

Furthermore, financial institutions can monitor business originators by using Better Business Bureau ratings and complaints and services such as Rip-Off reports.

Operational Challenges with Manual Processes

There are several operational challenges when considering processing and posting of Real-Time Payments. One challenge is documentation, including ensuring disclosures and other account agreements are updated to include RTP for consumer and business accounts and determining how RTP will affect transaction posting order disclosures.

In addition, there are several regulatory considerations for operations with Real-Time Payments. Ensuring that the financial institution's Bank Secrecy Act (BSA) compliance program is accounting for Real-Time Payments and has a 24x7 capabilities either through adequate staffing, implemented automated solutions, or both. Financial institutions are also required to establish proper Anti-Money Laundering (AML) controls. The impact of RTP on AML activities, both from an operations and compliance perspective must be evaluated.

Other operational concerns to consider involve exception processing. With RTP's 24x7 processing, having staffing in place to process exceptions and ensure exception processing will no longer be done in ACH-like batch cycles. With ACH, there were processing deadlines and clear timeframes for exceptions to be processed before a batch was sent to the ACH Operator.

With RTP, exceptions will need to be addressed in real time and through a combination of staffing changes and automation, financial institutions can process these exceptions real-time. A review and redesign of payment exception processing will require reviewing current controls, determining if additional functionality is needed, and securing proper automated solutions wherever possible.

Leverage Technology for Real-Time Payments (RTP) Risk Management

There are three ways technological advancements can be used to help improve risk management in a Real-Time Payments era.

1. **Automation:** First, automation of processes is paramount. Since real-time payments will be operating effectively 24x7, automation will allow bankers to continue to enjoy traditional operation hours, reduce staffing costs, and ensure that no matter when a real-time payment is released, the risks will be properly considered and weighed before execution.

   Considerations to include are if a payment is over a pre-set payment limit. For example, if an originator has a $5,000 limit and they are trying to process a transaction for $6,000 will there be a human handling the exception processing? Will the transaction be suspended or will an officer with override authority be notified of the transaction?

   Maintaining transaction limits which stay current with a growing a business' needs is also going to be more important than ever. When a business is first on-boarded, then begins originating, it may only qualify for a limit of $5,000 but as revenues increase, and the business grows, they may need the limit increased to $10,000. Having automated ways of evaluating adjusting limits will be needed to ensure smooth daily processes.

2. **Data Analytics:** Financial institutions can incorporate and leverage more data analytics in risk management practices and policies. Getting an originator's financial data is an appropriate way to analyze how risky a business was in the previous year.

   To understand the risks of doing business with a company today it is important to leverage data analytics and incorporate more current data into the risk evaluation and review. If you review an originator annually but they have filed bankruptcy, had a major lawsuit, started making untimely payments, or any number of changes, a financial institution only doing yearly reviews would have to wait until their next review to identify the changes.

The gap between when an originator is on-boarded and the next review can expose financial institutions to several potential risks. For example, a financial institution on-boarded a new originator who came back with a low risk profile. They were an 80 plus year old publicly traded company who had strong financials and so were given high origination limits. Over the course of six months however, there were 26 alerts letting them know of the deteriorating business and credit health, including multiple downward score trends, several senior level personnel changes, negative earnings reports, and negative legal actions being taken. Luckily, because this financial institution had an automated solution based in strong data analytics, they could proactively manage the risks posed by this originator and prevent potential losses.

If financial institutions are only looking at prepared financials they will miss out on the on-going changes happening with the originator over time. Having data analytics inform the decision-making process, especially if done in an automated way, will also ensure a fair and consistent standard is applied. This will help ensure compliance with regulations, and help organizations make more informed decisions.

3. **On-going Monitoring**: On-going originator monitoring ensures any changes that happen are identified and addressed when they happen and not months and months later during an annual review. By having on-going monitoring, financial institutions ensure the limits for originators are current and defensible and are responsive to the needs of an originator.

   As an originator's financial situation improves, limits can be increased which can help increase revenue and provide a better customer experience for originators. On-going monitoring also allows for more informed relationships between originators and financial institutions.

As financial institutions embark into the 21st Century of Real-Time Payments, they will need advanced technologies to mitigate and manage risks more proactively and effectively. Products such as Argos Risk Surveillance and Argos Risk Scan are examples of products that allow financial institutions to better manage the risks of Real-Time Payments. Both products can be used separately or in tandem to provide ease of information, automation and leverage data analytics for faster, smarter and more modern management.

About Argos Risk

FOR MORE INFORMATION CONTACT:

Erica El Hilali, MBA, AAP
Director of Client Services
Argos Risk, LLC
eelhilali@argosrisk.com
952-314-2095

Biography: Erica El Hilali has over a decade of banking experience including in ACH, Treasury Management, Corporate and Commercial Banking. In 2017, she earned her Masters of Business Administration with a concentration in Information Systems Management from the University of Minnesota's Carlson School of Management. Ms. El Hilali is also an Accredited ACH Professional (AAP). As the Director of Client Services, she strives to ensure the that Argos Risk continues to be a consumer centric origination with best in class product offerings and services.

Argos Risk specializes in the development of web-based technology solutions that enable companies to proactively manage credit and financial risks, perform due diligence, and ensure regulatory compliance. Argos Risk leverages its proprietary data analytics process- Argonomics™- and its custom-built web portal to deliver up-to-the-minute credit risk information and financial health scores to subscribers. Both Argos Risk products- Argos Risk Surveillance and Argos Risk Scan- allow companies to better manage their credit, due diligence, and compliance risks associated with doing business in today's economic climate.

Argos Risk's flagship product, Argos Risk Surveillance, works in tandem with Argos Risk Scan to provide cost-effective financial and business health credit risk information to businesses and financial institutions of all sizes. With access to information on over 28 million business entities, Argos Risk allows subscribers to continuously monitor a list of their customers, originators, vendors, supplies, prospects, and competitors for changes in their business and financial health. This information can be supplied through API or through a web-based platform that provides credit updates and daily alerts. The solution's visual dashboard makes it quick and easy for a company of any size to proactively spot upward or downward trends.

In today's fast-paced economy, Argos Risk enables businesses and financial institutions to find all the pertinent information they need to evaluate both old and new relationship and stay on top of rapidly changing credit and business health.
organization can interpret the results.

Visit us at www.argosrisk.com