

The ACH payments mechanism was developed in the early 1970s as an electronic substitute for paper based payments. Today, the ACH is a nationwide electronic payments system used by a large number of depository institutions and corporations. ACH rules and regulations are established by the National Automated Clearing House Association (NACHA) and the local ACH associations, and are incorporated by reference in the Federal Reserve Bank's ACH operating circulars.

ACH is a value-dated system that supports both credit and debit transactions. In ACH credit transactions, funds flow from the depository institution originating the transaction to the institutions receiving the transactions. Examples of credit payments include direct deposit of payroll, dividend and interest payments, Social Security payments, and corporate payments to contractors and vendors. In a debit transaction, funds flow from the depository institution receiving the transaction to the institution originating the transaction. Examples of ACH debit transactions include collection of insurance premiums, mortgage and loan payments, consumer bill payments, and corporate cash concentration transactions. ACH transactions are deposited in batches at Federal Reserve Banks (or private-sector ACH operators) for processing one or two business days before the settlement date. These transactions are processed and delivered to the receiving institutions through the night processing cycle for a given day.

### **GROWTH**

Over the last seven years the volume and dollar value of ACH credit transactions have increased 23 percent and 30 percent per year, respectively. Additional uses of the ACH, such as bill paying services, continue to be developed as depository institutions, corporations, and consumers realize its efficiency and low cost compared to large dollar payments systems and check payments. Another area of growth is the use of debit transactions for the collection of large payments due the originator, such as cash concentration of a

company's nationwide branch or subsidiary accounts into one central account and other contractual payments of a recurring nature.

### **OPERATORS**

The Federal Reserve is the principal ACH operator. In addition, there are several private sector ACH operators including the New York Automated Clearing House Association (NYACH), VISA, and the Arizona Automated Clearing House Association (ACHA). VISA and ACHA use the Federal Reserve to process transactions which are delivered to depository institutions that are not members of VISA or ACHA. NYACH serves as the ACH processor in the Second Federal Reserve District and uses the Federal Reserve Bank of New York as a communications facility for interregional transactions originated and received by NYACH members.

For the Federal Reserve ACH system, depository institutions send ACH transactions to and receive ACH transactions from the Federal Reserve by direct computer interface connection or by personal computer connection. Third-party processors also may send ACH files to a Reserve Bank on behalf of a depository institution.

### **RISKS AND EXAMINATION CONCERNS**

As with any funds transfer system, there are inherent risks in using the ACH, including error, credit risk and fraud. When reviewing ACH activities, examiners should evaluate the following:

- Agreements maintained by the depository institution as an originator and/or receiver of ACH transactions covering delivery and settlement arrangements.
- Balancing procedures for ACH transactions sent to and/or received from an ACH operator.
- Monitoring of institution's and customers' intraday and interday positions.

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- The credit policy and effectiveness of procedures to control intraday and overnight overdrafts, resulting from extensions of credit to ACH customers, to cover the value of credit transfers originated. (Note: Since the ACH is a value-dated mechanism and transactions may be originated one or two days before the settlement date, the originating institution is exposed to risk from the time it submits ACH credit transfers to the ACH processor until the time its customer funds those transfers.)
  - Credit assessments of customers originating large dollar volumes of ACH credit transactions. Ensure that these credit assessments are reviewed periodically to ensure that recent economic conditions having a possible impact on customers' financial position are taken into consideration.
  - Uncollected funds controls and related credit policy for deposits created through ACH debit transactions. (Note: Although the Federal Reserve makes funds available on the settlement date, these are provisional funds because ACH debits

may be returned for insufficient funds or other reasons (e.g., court order)).

- Exception reports, i.e., large item and new account reports.
- Control procedures for terminals through which additions, deletions, and other forms of maintenance could be made to customer databases.
- The retention of all entries, return entries, and adjustment entries transmitted to and received from the ACH for a period of six years after the date of the transmittal. (This is a NACHA requirement.)

Reference should also be made to Chapter 18, Wholesale EFT for additional consideration of ACH related concerns in the areas of input/output controls, encryption, backup, insurance, and disaster recovery. For additional guidance also refer to the Federal Reserve's *Guide to the Federal Reserve's Payments System Risk Policy*.