

Automated clearing house payment system



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Automated Clearing House payment system is a nationwide mechanism that electronically processes originated batches of high-volume, low-value credit and debit transfers. For transmission during a predetermined time period, ACH transactions are accumulated and sorted by destination rather than sending separately each payment.

As compared to paper checks, ACH transactions provide significant economies of scale and faster processing. Moreover, the ACH network is used in converting check payments into ACH debit transfers, which consequently provides faster processing and reduces costs in payment processing (as cited in FHFB 2007).

Analysis of specific features/characteristics of ACH.

An ACH is a paperless-entry facility that acts on behalf of local, regional, or national associations of commercial banks to make direct deposits and preauthorized payments. ACH is used for preauthorized payments of recurring bills, including car payments, utility bills, and mortgages. Also, ACH is used to make direct deposits of payroll and Social Security payments into recipients' accounts.

ACH can replace checks and check-clearing facilities by transferring and processing the same information via tapes, discs, or e-messages between financial institutions. ACH was especially designed to replace checks as a means for making mortgage, insurance, utility, and other recurrent payments by consumers as well as wage, dividend, and other recurring payments to consumers (Gup 2003, p. 61).

It was in 1972 when the first ACH was established in California. As local ACH associations expanded in number and size, the National Automated Clearing House Association (NACHA) was formed in 1974 with 18 charter member regional associations representing population centers in all 12 Federal Reserve Districts with the purpose of facilitating the interregional exchange of ACH transactions on a national scale.

Even though there are varying views on the development of ACH, many observers were hopeful that local and regional ACHs would eventually expand into an efficient, accessible, and widely used nationwide electronic payments clearing system. Nevertheless, until banks faced and passed along to their customers more of the total costs of their check and currency processing services, incentives for customers to switch to the ACH remained muted.

Analysis of benefits.

A couple of studies suggest that the processing of the unit social cost of automated clearing house (ACH) is lower when compared to the unit social cost of paper check processing (Humphrey and Berger 1990; Wells 1996). Humphrey and Berger (1990) estimated the social cost of a check transaction to be \$0.79 and the social cost of an ACH transaction to be \$0.29.

On the other, Wells (1996) utilized data from 1993 to estimate the social cost of a check transaction at \$2.78 to \$3.09 and the social cost of an ACH transaction at \$1.15 to \$1.47. Both studies (Humphrey and Berger 1990; and Wells 1996) consistently found that an ACH transaction costs about one-

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third to one-half as much as a paper check transaction. While the general result shows uniformity across the two studies, the discrepancies in the results show that the estimates of the social costs of each payments method are sensitive to specific assumptions.

Advantages and disadvantages of ACH.

In today's banking, the ACH relationship is considered to be one of the strongest loyalty indicators. The ACH data provides a very rich source of transaction data. For financial institutions, the combination of ACH data, MCIF data and demographic data collectively produce a more complete picture for its banking customer consequently allowing a chance for a more effective cross-selling of services.

ACH transactions are admittedly considered to be low-cost allowing financial institutions in positioning its ACH customers in more profitable products, with lesser risk of losing the customer. For instance, if a customer is a single-service Direct Deposit Account (DDA) customer with no ACH relationships the risk that the customer will leave the bank is great as a result of a fee increase.

On the other hand, the DDA customer with an ACH relationship, along with the perception that changing ACH transactions to another bank is difficult to accomplish, may be more willing to tolerate slight changes to pricing.

An actual case in point from a major bank's customer profitability profile proves this claim. After evaluating the profile, it was found that in general retail customers with a DDA relationship had an average annual profit of

\$22. 61. Segmenting these retail customers into two categories will come up with (1) customers without an ACH relationship and (2) customers with ACH relationship.

The first category of retail customers represented an annual loss of \$45. 07 each, while the second category produced an average profit of \$104. 01. In addition, the average deposit balances for the two groups were \$3, 663 and \$4, 695 respectively. Moreover, the average number of years that retail ACH customers were with the bank was 27 percent longer than non-ACH customers (as cited in Coffey 2002).

The results from the commercial sector are even more amazing. Taken as a whole, businesses with DDA relationship had an average annual profit of \$403. 13. Segmenting these commercial customers into two categories will produce (1) businesses without an ACH relationship and (2) businesses with an ACH relationship.

Accordingly, the non-ACH customers represented an average loss of \$9. 89, whereas the ACH customers represented a profit of \$1, 230. Additionally, the average deposit balances for the two groups were \$21, 730 and \$29, 494 respectively (as cited in Coffey 2002).

Disadvantages

Drawbacks of the ACH payment system can be traced through a comparison with check processing. For a check processing application, checks can be returned if funds are not available at posting. Contrastingly, electronic payments through the ACH or wire transfers do not have the same

alternative for outgoing transactions because of the finality of the settlement. Consequently, the bank will be left holding the bag if the customer is unable to fund the resulting overdraft.

Furthermore, the fear of fraud also contributes to the concern over transaction risk on ACH. A vice president of risk management illustrates how this could possibly happen. “ For instance, a certain customer wires out all the funds in its account.

In the meantime, it funds an ACH payroll using the same funds because corporate cash managers know that ACH and wire do not talk to each other. Beverly Kennedy explains that if the company has some financial problems, the exposure that the bank is taking could lead to a loss (as cited in McClure 1994, p. 23+).

Worth mentioning is the fact that ACH is considered the most unregulated application of the bank and subsequently presents increasing dangers. There is even a possibility that customers can create a \$10 million transaction as easily as a \$10, 000 transaction if no one is reviewing it before it leaves the bank. Even if the bank has set predefined ACH limits, they are static and do not take into consideration current balance or other intraday transactions.

While payroll files of ACH do not conjure up images of bank exposure, the risk is actually very real. The ACH payroll file is typically a file of credits that leaves the bank approximately two days prior to settlement date.

By the time the bank discovers that funds are not available on the settlement date, the ACH transaction is too late to be recovered since the funds have already been deposited into the consumer's accounts. And, as ACH cash concentration grows in volume, it also opened the door to kiting (fraudulent increase of amount).

Usually, the intraday fluctuation in the balances of small, retail accounts does not dramatically affect the bank's exposure level. Nevertheless, a certain corporate customer that has numerous accounts across banks and across states have the tendency of bringing up a tremendous impact on the bank's cash position.

At a relationship level, these corporate accounts are often managed by officers. An officer can determine, by viewing all the accounts together, which problems are isolated overdrafts and which are occurring across all accounts. This consequently indicates deterioration in the company's financial position.

On the other hand, when a corporate customer's accounts, during the day, have experienced a high level of activity, it becomes difficult to obtain an accurate balance. If officers release the funds without confirming their availability, this case can be especially dangerous. In order to cover large transactions, corporate customers usually move money from one account to another. Nevertheless, sometimes another application may already have committed those same funds without the knowledge of the officer.

It is a commonplace that banks loan on daylight overdraft or intraday funds to 'good risks' customers relying on the hope that those customers will cover their overdrafts by the end of the processing day.

The problem arises by the time this 'good customer' experiences financial difficulty and additionally failed to communicate the problem to the bank, consequently leaving the bank open to exposure. As a result, the bank must cover the shortfall if it has released more funds than it received during the processing day and funds do not come in to cover the overdraft.

Analysis of cost on ACH payment system

The cost of transaction on ACH payment system can be analyzed through obtaining accurate statistics on its cost of transaction risk. However, obtaining this precise statistics is quite difficult because banks are particularly tight-lipped about their losses and points of vulnerability in their determination to project a solid and stable front to the public.

It becomes even more difficult to find out what types of controls that financial institutions are implementing in addressing the problem by the time the details of a major mishap do not surface until long after an event has occurred. Accordingly, many banks are appointing risk managers and risk committees in order to identify potential weak links and immediately make recommendations.

Risk committees that address transaction risk seriously usually are progressive banks. The last thing that a bank would want is to police their customer's accounts and possibly create any bad feelings consequently

sending these customers to a competitor. Nonetheless, progressive banks established risk committees in order to address these issues.

Owing to this transaction risk, banks are subsequently finding a way to charge the customers that cause the daylight overdraft. No system, at present, can help the bank tie back accurately the charge to a certain customer. If a significant transaction goes wrong, financial risks are intimidating knowing that such a technology is an extremely complicated and expensive task to develop.

Banks already have a tremendous investment in existing software applications that are often purchased from different vendors. This additionally becomes another major aspect of the problem of developing a technology of daylight overdraft charging.

Unfortunately, no vendor has ever been able to develop an entire bank's transaction processing system, therefore creating serious interfacing issues. While banks do not want to lose their investment for such technology, they run into difficulty when vendors are unwilling to interface their products with those of their competitors.

Banks, as a result, oftentimes build the interfaces between their applications themselves, thus creating another set of new problems to handle. As cited in McClure (1994) " if the ACH application, for instance, builds interfaces to the other applications in the bank in order to obtain current balance information, the bank ends up with numerous, intricately entwined webs that can become costly to maintain and difficult to keep track of" (p. 23+).

Counteracting Transaction Risk Cost

On a contractual basis, banks theoretically loan money only after establishing terms and approving the borrower's creditworthiness. Financial institutions, in reality, have the tendency of extending credit to customers inadvertently with no terms and no guarantee that the funds will be repaid. The bank's inability to monitor the intraday transaction balances is the cause of this risky business. Easier said than done, this necessitates an immediate solution – through transaction risk control.

In response to the perceived transaction risk cost, vendors and banks alike are putting risk management on the top of their list from a variety of angles. Some vendors are developing the so-called RMAC or the Risk Management and Control System in order to monitor an intraday, bank-wide transaction.

This system is a DB2-based intraday transaction monitoring system that is designed around a central repository that have the ability of providing accurate intraday balances to all interfacing applications.

To the executives at the top having enough of a perspective of understanding its magnitude, addressing the transaction risk problem goes beyond individual application areas, especially on ACH payment system.

A customer would certainly want to be assured of account security and find bank executives with the ability of actually implementing a solution to transaction risk. This is especially true, knowing that transaction risk is a serious bank-wide issue and unsurprisingly does not get supported in any single area of the bank.

Transaction risk management is currently considering little more than an insurance policy. A loss of significant proportions will certainly put banks difficulty in justifying the cost of a solution. The climate is nevertheless changing while banks are painstakingly looking for ways of limiting opportunities for potential fraud and implementing technologies that accordingly helps them manage the bank's funds as well as the funds of their customers.

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