COLLEEN: Welcome. This is Colleen Morrison on behalf of NEACH’s Pacing Payments, your trusted resource for faster payments news and information.

In this episode, we’re touching on a major topic for financial institutions, credit risk. Because credit risk is individualized, it morphs depending on your unique circumstances, and it creates a number of complicated if/then scenarios. Then, just when you think you’ve got your arms around it, that slippery sucker glides just beyond your grasp, and you’re reassessing risk tolerance once again.

It’s challenging enough with traditional ACH. Just think about the additional issues that arise when you add Same Day ACH to the mix. Because credit risk centers on the availability or collectability of funds versus the settlement date of the transaction, if any part of that equation changes, like settlement time, credit risk models change, too.
So we’re here today with Sean Carter, senior vice president of payment strategies at NEACH, to delve into credit risk in the Same Day ACH environment and what to do about it. Sean, thanks for joining us.

SEAN: Hey. Thanks for having me.

COLLEEN: So, I think let’s start with the basics. Why in the world is credit risk so complicated to begin with?

SEAN: I think that there’s two pieces to that answer. So first of all, credit risk itself, right, because it’s not an exact science so each institution as you mentioned in the open has to almost have their own standards or appetite for risk. And the folks that are responsible, usually the developing credit risk policies and things of that nature, they’re used to looking at loans where there’s a much longer payback period.

When you talk about credit risk within a payment system, you go down from, you know, expecting somebody to pay you back over 15 or 30 years down to
a day or every two days. So I think credit risk gets complicated because it’s really about the risk of settlement. So people have taken settlement risk and they use the model of credit risk because that’s the thing that it’s so closely associated with, but it’s not exactly like everything else you do in credit risk. So I think that’s the first thing that makes it complicated.

Secondly, I think a big issue is just the way that technology is used or not available to use as it relates to monitoring. So it’s one thing to establish your risk profile and how you’re going to underwrite. It’s a whole other thing to implement it. So I think what makes it complicated in the ACH environment is just the way that in some places you can prefund to eliminate your risk and others don’t have that same capability because of the requirement to a balanced file or, you know, things that are limited through the software or through some of the tools people are using.
So I think it’s two pieces. It’s just the general concept of bringing credit risk and scoring into a payment system in which the ability for somebody to have to fund you is much more rapid than it would be in a traditional loan environment.

COLLEEN: And to that point, adding Same Day to this list of variables clearly further complicates things. So how does that impact how an FI looks at risk?

SEAN: So you really -- an FI, once they truly understand the settlement component of this, as you said in the open, you finally get your hands around it and now the settlement time gets sped up, right. So there’s a number of different ways that impacts an institution because, A, if you’re going full throttle and you’re going to originate, the risk model may be very different on a Same Day item, not necessarily the customer and how you assess a customer, but just the way that you’re going to manage it on a day-to-day basis, right.
So you may ultimately because of shortcomings in technology or the ability to do certain things you would like to do to manage the risk, you may then impact who you offer the service to because again if you can’t satisfy your requirements on the monitoring side, then you have to beef it up on the onboarding side.

So this really complicates that issue because you may be totally comfortable what you’re monitoring today so that maybe your onboarding — I’m not going to use the word lacks, but maybe your onboarding is better supported by your technology today. You add a change to that equation and you may have to not only rethink your entire way of monitoring, that may require you to change the way you do customer or member selection.

So it is a big change for institutions, and we deal with FIs all the time that are just kind of getting the hint around lenders being trained on the, you
know, the settlement issues in a payment system and now we’re changing that model on them.

COLLEEN: And I’m trying to visualize how this all plays out. I think sometimes a concrete example can help, you know, really solidify the topic. Is there a situation you can talk about where you’d have to be really mindful of the credit risk impact of Same Day ACH?

SEAN: Yeah. So I want to stick to -- we’ll stick to Phase 1 in the institution originating a credit transaction out the door. So, the big emphasis here is collectible funds. So when you look at a typical file, right, so we’ll use a customer is uploading a file to online banking, the effective entry date has today’s date, the, you know, the files, total file is 18,000 individual transactions, total 18,000. In today’s environment that transaction will settle the next day. So the financial institution basically has all day to collect the funds, you know, and up until 8:30 a.m. the next day to truly be covered against settlement risk.
When you look at after September 23rd because that file would meet the criteria of a Same Day entry, that file, let’s say it went out at 10 a.m. settlement, they’re going to come calling at 1 p.m. So the financial institution now has to get that $18,000 back starting at 1:00 or they’re basically in chase mode.

So when you look at how files are processed, if you are not able to collect that debt for whatever reason -- I don’t want to pick on balanced files. Let’s just say you don’t have the ability to do -- for a number of reasons you can’t collect until the next day. Well, that 18,000 during the day is uncollected. So if anything happens to that account, whether it be as a subpoena mid-day or some teller, you know, not recognizing that there’s a batch to collect on, allows somebody to close an account or other obligations of the business customer just keep
flooding in after 1:00, when do you collect on that 18,000?

So, Same Day by speeding up the clock, you know, really underscores, you know, how you have to look at, A, the monitoring event because normal monitoring using a lot of the tools that are provided today, a lot of this stuff is captured the next morning, which in this case is too late or it’s not as -- nor it’s not as real-time as it needs to be. So you may get an end-of-day summary that says oh, these five customers were over their limit or have breached their monthly limit or exceeded a weekly limit, it’s too late. One o’clock has come and the funds have settled.

So I think Same Day by speeding it up just changes the way you need to think about it, and that’s the easiest scenario to pick on is a credit transaction going out that may have been an inadvertent Same Day so there might not have been, you know, further
underwriting of that customer, you know, that causes some additional concern.

COLLEEN: Yeah. And it’s kind of a little bit of a race against time to get everything handled and taken care of so that your risk is contained, and I think that is a good example, but it’s just one example. So I’m betting there are other scenarios out there that financial institutions should be considering. Can you kind of at a high level address some of those? What should we be thinking about?

SEAN: Yeah. So, from a risk standpoint there’s a lot of things that need to be addressed in the faster payments environment. And one of the things that I’m struck by as we work with financial institutions both credit unions and banks, when you look at just the retail, let’s think of the retail environment for a second, you have people giving availability on remotely deposited items. Then you have ACH transactions coming in, P2P payments that may be getting sped up. Well, all those payments that are coming in might also be able to go out, right. So as
we speed up availability, how are your risk models looking at okay, the funds are available and now somebody’s sending it out, right.

So looking at retail alone in a faster payments environment, you know, not to say you can delay availability, but what you can do is ensure that, you know, when the person’s taking those available funds to use for a bill pay or to use for another A2A or another P2P or even a wire transfer, there needs to be some cross-channel risk models put in place that allow an institution to make decisions to say okay, you know, we have this customer, he’s a new customer or new member, you know, maybe we don’t want to give that type of access right away. Maybe we need some more history in that account before we turn all these bells and whistles on for online banking or with the mobile technology.

So I think as we get into a faster payments environment, you know, people talk commercial and
credit risk and it’s a bigger deal with larger transactions, but, you know, I could easily envision a scenario at some institutions where as a consumer I open it up -- I can open up an account with bad funds and get access to transfer services, use that for some, you know, nefarious purposes. I think people are going to really need to think about how all of this fits in, right. We push everybody to electronics and now the electronic settlement piece of it is speeding up. And has the security become good enough or has the reporting or the monitoring kept up with what you would call the need for speed?

So I think it’s a very interesting time, and I think things like, you know, retail offerings need to be looked at just like you would look at how we’re going to offer ACH origination to corporates in a faster environment. I think people need to think about these things when we talk about how fast checks are collected and availabilities happening. These are things that people need to plan for. And right now
we can -- from a NEACH membership standpoint we get a lot of calls today without the faster environment where people are taking hits on these retail applications because somebody used a bogus transaction to open a new account online and they give them access to bill pay and it’s very easy to get the funds out the door.

Just think about when all of this stuff accelerates even faster, the need for better risk scoring, better monitoring, you know, better reporting, all of these things are going to need to be amped up in a faster environment. And I don’t want people to forget about the retail piece of this.

COLLEEN: Right. It’s enough to make your head spin for sure, and I think if we look at the broad landscape and all of the components that you outlined, it’s a little daunting. So if we really funneled down and just focused in on one core piece of advice about managing credit risk with Same Day ACH, what would you say to financial institutions?
SEAN: So, this is really a great question, and because it’s so individualized, what people really I think need to understand is what is their risk appetite. If as a financial institution you don’t have that as an understanding, then I think it’s going to be hard to put in the right onboarding practices because you get three chances for risk management, right. You get it at onboarding, you get it for your periodic day-to-day transaction reviews, and then whenever the periodic review for a client or service comes up. You really only get three chances to get it right.

So if there’s any lack of understanding or clarity around what the acceptable risk standards are at the institution, then I think it’s very difficult to implement a proper risk management program. And what the regulators expect from institutions is a layered program which includes customer or member selection, ongoing monitoring, and periodic review. So within
those three buckets there really needs to be clarity around what is going to happen.

Not to say that you can’t take advantage or people need to be scared of faster payments because there’s great opportunity with this and we don’t want that to get -- to ever get lost. But when, you know, you certainly want to make sure that whatever opportunity you’re looking at, that you’ve properly put a good foundation in place so that it doesn’t come around to say hey, the institution took a chance that they weren’t prepared for because that’s what the regulators don’t want you doing. So I do think it’s important to be very -- to have that clarity within the institution because once you have that, then I don’t think credit risk is overly complicated from a payment standpoint because then you will be able to develop solid onboarding, monitoring, and review processes.

COLLEEN: That’s a good way to look at it I think, right, with risk comes opportunity, and if you get
your house in order, that opportunity can outweigh the risks and I think that’s good guidance for financial institutions for sure.

SEAN: We don’t want to lose that because there is great opportunity in all of this. So we want people to understand that. We want our members to flourish and grow and take advantage of it, but at the same time you don’t want this to become a negative thing where the regulators, you know, pile up and the Board gets mad and management and all of that stuff and then it becomes a sour thing. So, with the right clarity and focus, I think members will do fine in managing the risks.

COLLEEN: I think that’s sound guidance that your members are certain to take to heart and to consider as they move forward with planning for Same Day ACH. For more information on credit risk, you also can take a look at Sean’s Pacing Payments blog post, “Credit Risk and the Impact of Same Day ACH Transactions” at engage.neach.org.
Sean, thanks again for joining us today. I think this was really helpful, and it’s going to give some good information to NEACH members.

SEAN: Thank you for having me.

COLLEEN: Until next time, this is Colleen Morrison for NEACH’s Pacing Payments.

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