OCC Payment System Membership Rule (12 CFR § 7.1026) for National Banks and Federal Savings Associations

Information Regarding Safety and Soundness Considerations (EPN)

I. OCC Payment System Membership Rule

The OCC's Payment System Membership Rule (12 C.F.R. § 7.1026(f)) codifies requirements for national banks and federal savings associations regarding membership in payment systems, which were previously set out in OCC Interpretative Letters.[1] These requirements include notice obligations,[2] as well as safety and soundness procedures that include a risk evaluation prior to joining a payment system[3] and ongoing risk management after joining.[4] Under the rule, the risk evaluation and ongoing risk management should consider seventeen specified payment system characteristics.[5] The OCC indicates that not all seventeen characteristics are applicable in all instances, and the applicability and relative importance of each characteristic may depend on, among other things, the nature and characteristics of a payment system and the risk tolerance of the financial institution.[6]

The Clearing House has prepared the following information that national banks and federal savings associations may wish to consider as they conduct the risk assessment and ongoing risk management in relation to the Electronic Payments Network (EPN).

II. Background Regarding The Clearing House

The Clearing House Payments Company L.L.C. (TCH) is a bank-owned[7] industry utility and operates four interbank payments systems: a high-value funds transfer system (CHIPS); an ACH system (EPN); a check image exchange (Image Exchange Network); and a real-time payment system (RTP®).[8]

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[1] *See* OCC Interpretive Letter 1157 (December 2017), available at: https://www.occ.gov/topics/licensing/interpretations-and-actions/2017/int1157.pdf; and OCC Interpretative Letter 1140 (January 13, 2014), available at https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2014/int1140.pdf.

[2] 12 C.F.R. § 7.1026(c)-(d).

[3] 12 C.F.R. § 7.1026(e)(1).

[4] 12 C.F.R. § 7.1026(e)(2).

[5] 12 C.F.R. § 7.1026(f).

[6] Specifically, the OCC explains that "national banks and Federal savings associations are best positioned to evaluate the applicability and importance of each factor given the wide variety of global payment systems as well as the varied complexity of and risk tolerances at individual banks and savings associations. The OCC expects banks and savings associations to review the standards and identify the components that are applicable to the payment system and financial institution at issue." Activities and Operations of National Banks and Federal Savings Associations, 85 Fed. Reg. 83686, 83701-02 (December 22, 2020).

[7] Additional information about The Clearing House is available here: www.theclearinghouse.org.

[8] RTP® is a registered service mark of The Clearing House Payments Company L.L.C.

TCH is highly-regulated, falling under the FFIEC's Significant Service Provider (SSP) program with respect to its operation of EPN, Image Exchange Network, and the RTP System.[9] Under the FFIEC's framework, TCH is examined each year by a multi-agency team. SSP exams include a broad range of activities including governance, risk management, internal controls, information security, and financial condition. Additionally, TCH, as the operator of CHIPS, has been designated under Title VIII of the Dodd Frank Act as a systemically important financial market utility (SIFMU). Under this designation TCH is subject to continuous supervision by full-time, dedicated Federal Reserve examiners and CHIPS must meet Regulation HH's[10] enhanced requirements for SIFMUs. As TCH payment services generally utilize a common infrastructure and fall under a common governance structure, TCH's Title VIII supervision and standards benefits all TCH services.

III. Characteristics for Payment Systems

The seventeen payment system characteristics set forth in 12 C.F.R. § 7.1026(f) appear below, along with relevant information regarding EPN. Capitalized terms that are not defined herein have the meaning ascribed to them in the EPN Rules.[11]

Characteristic #1 ***Does the processing occur on a real-time gross settlement basis or provide reasonable assurance (e.g., prefunding, etc.) that members will meet settlement obligations?***
EPN settles intra-EPN ACH entries (i.e., between an EPN ODFI and an EPN RDFI) on a net settlement basis using the Federal Reserve's National Settlement Service (NSS).[12] For this arrangement, The Clearing House acts as the settlement agent for EPN Settlers. Use of NSS is governed by the Federal Reserve's Operating Circular 12. The process TCH uses to calculate settlement totals and submit NSS settlement files to the Federal Reserve Bank of New York (FRBNY) to complete EPN settlement is defined in the EPN Rules.[13] For each Business Day, there are four Scheduled Settlements: a primary (or "next day") ACH settlement (at 8:30am ET), and three same-day ACH settlements (at 1:00pm ET, 5:00pm ET, and 6:00pm ET). For

[9] The SSP program was previously known as the Multi-Regional Data Processing Servicers (MDPS) program, and is described here: https://ithandbook.ffiec.gov/it-booklets/supervision-of-technology-service-providers/supervisory-programs/mdps-program.aspx.
[10] 12 C.F.R. Part 234.
[11] The EPN Rules are available from The Clearing House upon request.
[12] In addition to intra-EPN entries, ACH entries may be originated through EPN for a FedACH RDFI, or vice versa. These "inter-operator" ACH entries settle through FedACH settlement subject to the terms of Federal Reserve Operating Circular 4.
[13] *See* EPN Operating Rules 7.3 and 7.9A, and Appendix 1-A.

each settlement window, EPN calculates a Participant's Net Balance, which is either a Net Credit Balance or a Net Debit Balance. TCH provides each Settler Participant (and each Settler for a non-settling Participant) a report showing the Settler's Net Balance. TCH then submits an NSS settlement file to the FRBNY, which debits the Reserve Bank Accounts of Settlers that have a Net Debit Balance, then credits the Reserve Bank Accounts of Settlers that have a Net Credit Balance. The NSS process for debiting and crediting Settlers' Reserve Bank Accounts is governed by Operating Circular 12 and the debits and credits to those Reserve Bank Accounts are final and irrevocable when made.[14] EPN settlement is complete when all Aggregate Net Credit Balances have been credited to the Federal Reserve Accounts of the corresponding Creditor Settlers.[15]

As a risk control regarding Participants' settlement obligations, the EPN Rules provide TCH the authority to establish origination limits as well as a Net Debit Cap (i.e., a limit on the net debit position that a Participant is permitted to incur on EPN for any Effective Entry Date) that is monitored on an ex-post basis.[16]

The EPN Rules also include provisions related to a delayed or abnormal settlement.[17]

Characteristic #2

How does the payment system's rules limit its liability to members?

The EPN Rules limit TCH's liability to EPN Participants. Specifically, the EPN Rules provide that in carrying out its responsibilities as an ACH operator, TCH shall only be liable to a Participant for TCH's failure to comply with the EPN Rules or its gross negligence or intentional misconduct.[18] TCH's liability in such instances shall be limited to actual damages attributable to its failure to comply with the EPN Rules, gross negligence, or intentional misconduct and shall not include consequential damages, even if such damages were foreseeable.[19]

Characteristic #3

Does the payment system have insurance coverage and/or self-insurance arrangements to cover operational losses?

[14] *See* sections 5.4 (Posting Debit Balances) and 5.6 of Federal Reserve Operating Circular 12, https://www.frbservices.org/binaries/content/assets/crsocms/resources/rules-regulations/030821-operating-circular-12.pdf.
[15] EPN Operating Rule 7.9A.2.
[16] EPN Operating Rule 2.2A.3.
[17] EPN Operating Rules 7.9A.4 and 7.9A.5.
[18] EPN Membership Rule 11(a).
[19] *Id.*

TCH has a financial institution bond and computer crime policy with a $50 million aggregate limit and a $25 million single loss limit.[20] TCH's insurance coverage is reviewed on a regular basis by a committee of its Managing Board and can be adjusted at the direction of the Board.

Characteristic #4

Do the payment system's rules provide an unambiguous pro-rata loss allocation methodology under its indemnity provisions and does the methodology provides members the opportunity to reduce or eliminate liability exposure by decreasing or ceasing use of the payment system?

In relation to EPN settlement, EPN Participants that are Settlers are required to indemnify the Federal Reserve Bank of New York (FRBNY) under Federal Reserve Operating Circular 12, which requirement is incorporated into the EPN Rules.[21] EPN provides an unambiguous pro-rata loss allocation methodology for any indemnity claim brought by FRBNY and the methodology provides Participants the opportunity to reduce or eliminate liability exposure by decreasing or ceasing use of EPN. Specifically, the EPN Operating Rules provide that each Participant's pro rata responsibility for a claim under this indemnity equals the ratio of EPN Usage over the total EPN Usage of all Participants during the three months preceding the date on which a loss occurred.[22] If applicable, each Settler shall pay FRBNY an amount equal to its proportionate share plus the proportionate share of each Non-Settling Participant for which it settles. While an EPN Participant may eliminate future liability exposure by ceasing its use of EPN or terminating its participation, the Participant will remain liable for obligations that accrued based on its EPN usage prior to such cessation or termination.[23]

Characteristic #5

Do the payment system's rules provide for unambiguous membership withdrawal procedures that do not require the prior approval of the system?

EPN Participants may unilaterally resign from EPN upon not less than 30 days prior written notice to TCH.[24] The EPN Rules also contemplate that TCH may accept shorter notice.

[20] *See* EPN Membership Rule 11(b).
[21] Rule 7.10A.7.
[22] EPN Operating Rule 7.10A.
[23] EPN Membership Rule 13.
[24] EPN Membership Rule 10.

Characteristic #6

Does the payment system have appropriate admission and continuing participation requirements for system participants? Such requirements should address, among other things:

(a) the participants' access to sufficient financial resources to meet obligations arising from participation;

(b) the adequacy of participants' operational capacities to meet obligations arising from participation; and

(c) the adequacy of the participants' own risk management processes.

The EPN Membership Rules set forth general eligibility requirements and procedures for approval of Participants and state that TCH's review of a prospective Participant may include considerations of the institution's business practices and those of its customers.[25] TCH's procedures for approval include confirmation of the prospective Participant's eligibility under the EPN Rules, and an evaluation of the prospect against due diligence requirements relating to financial resources and relevant enforcement actions.

(a) Financial Resources. As part of the evaluation of a prospective Participant, TCH reviews the prospect to confirm it has an adequate capital ratio, liquidity, and credit quality to meet its obligations arising from participation in EPN; and evaluates Participants on an ongoing basis to ensure they continue to meet required standards. Based on the financial review, TCH may establish a Net Debit Cap, which is a limit on the net debit position that the Participant is permitted to incur on EPN on any Effective Entry Date, and which is set against the net of all debit and credit entries that the Participant has sent or received.[26] Any Participant with a high-risk rating that exceeds its Net Debit Cap frequently may be subject to suspension or termination.[27]

(b) Operational Capacities. TCH's onboarding procedures for EPN require Participants to test and confirm their ability to send and receive files to and from EPN before they are permitted to "go live" on EPN. A Participant's operational failures that negatively impact TCH or other EPN Participants may be addressed under TCH's risk management framework and TCH's authority under the EPN Rules to suspend or terminate a Participant.[28] In addition, the EPN Rules incorporate the Nacha Rules, which require all ACH Participants to perform an annual audit for compliance with the Nacha Rules, including operational aspects of the rules.[29]

[25] *See* Rules 1 and 2 of the EPN Membership Rules.
[26] *See* Rule 2.2A.3 of the EPN Operating Rules.
[27] *Id.*
[28] EPN Membership Rule 12.
[29] Nacha is a non-profit organization that writes rules and establishes standards for use of the ACH network. The Nacha Rules are incorporated into the rulesets of both ACH Operators (The Clearing House, which operates EPN and the Federal Reserve Banks, which operate FedACH). The Clearing House and the Reserve Banks also modify

(c) Risk Management Processes. TCH requires all EPN Participants to be supervised depository institutions.[30] TCH relies upon the risk management standards that are applied to supervised depository institutions through applicable laws, regulations, and supervisory guidance. In its initial due diligence and ongoing monitoring of Participants, TCH reviews public enforcement actions and would consider risk management failings documented in such actions as a basis for not allowing a depository institution to become or remain a Participant. In addition, the Nacha Rules, which are incorporated into the EPN Rules, require all ACH Participants to conduct an assessment of the risk of ACH activities, and federal financial regulators have issued guidance and examination procedures regarding expectations for financial institutions with respect to managing the risks associated with ACH.[31]

TCH has broad discretion to terminate a Participant if its continued participation in EPN is not in the best interest of TCH, EPN, or other Participants, including if the Participant is not being operated in a safe and sound manner.[32]

Characteristic #7

Does the payment system have processes and controls in place to verify and monitor on an ongoing basis the compliance of each participant with admission and participation requirements?

As noted in response to Criteria #6, TCH uses initial onboarding procedures and ongoing monitoring to verify and monitor the compliance of each Participant with EPN admission and participation requirements. Non-compliance with admission or participation requirements may be addressed under TCH's risk management framework and TCH's authority under the EPN Rules to suspend or terminate a Participant.

In addition, the Nacha Rules, which are incorporated into the EPN Rules, require every ACH participant to conduct an annual audit of compliance with the Nacha Rules. EPN Participants that do not comply with the Nacha Rules may also be subject to penalties under the Nacha Rules enforcement process.

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and supplement the Nacha Rules in certain respects, such as through additional terms specific to the relationship between the payment system operator and its customer, or regarding topics not covered in the Nacha Rules. While Nacha is a separate organization from The Clearing House, Nacha rule obligations and Nacha's authority to enforce those rules, serve as controls regarding certain risks related to use of EPN (and the overall ACH network comprised of both EPN and FedACH).

[30] EPN Membership Rule 1(a).

[31] *See* FFIEC IT Examination Handbook, Retail Payment Systems, available at: https://ithandbook.ffiec.gov/it-booklets/retail-payment-systems/retail-payment-systems-risk-management/retail-payment-instrument-specific-risk-management-controls/ach.aspx.

[32] EPN Membership Rule 12.

Characteristic #8 ***Does the payment system have written policies and procedures for addressing participant failures to meet ongoing participation requirements?***
See responses to Criteria #6 and #7. TCH also has a written Risk Management Framework (internal policy) that may inform decisions to suspend or terminate an EPN Participant for risk-related reasons.
Characteristic #9 ***Are the payment system's rules relating to the system's emergency authorities unambiguous and may they be amended or otherwise altered without prior notification to all members and an opportunity to withdraw?***
In the event of an emergency, including, but not limited to, severance of communications between TCH and one or more Participating DFIs, failure or disruption of EPN's operations, or any other emergency, EPN services are handled in accordance with decisions by TCH's CEO or his/her designee, and TCH notifies the EPN Business Committee and EPN Participants as soon as reasonably practicable.[33]
Characteristic #10 ***Is the payment system governed by uniform, comprehensive and clear legal standards in its operating jurisdiction that address payment and/or settlement activities?***
The EPN Rules set forth uniform, comprehensive and clear legal standards for EPN Participants that address payment and settlement activities. The EPN Operating Rules incorporate the Nacha Rules, which establish a uniform set of general requirements and standards for use of the overall ACH Network, comprised of both EPN and FedACH. Each EPN Participant must agree by contract (governed by New York law) to the EPN Rules.

[33] EPN Operating Rule 1.3A.

Characteristic #11

Is the payment system subject to and in compliance (or observance) with the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (CPSS-IOSCO) Principles for Financial Market Infrastructures?

CPMI-IOSCO's Principles for Financial Market Infrastructures (PFMI) is an international standard designed for systemically important financial market utilities. In the U.S., the PFMI has been adopted into Regulation HH, which is applicable to payment and clearing systems that have been designated as systemically important under Title VIII of the Dodd Frank Act. CHIPS has been designated as systemically important and follows the requirements of Regulation HH. In the U.S., neither Regulation HH nor the PFMI have been applied to low-value systems like ACH, card networks, or check image exchanges.

As EPN is a low-value system, the PFMI does not apply and TCH has not undertaken to be fully in observance with it. However, EPN satisfies many of the PFMI principles, such as with respect to legal basis, comprehensive risk management, and governance.

The Federal Reserve's Policy on Payment System Risk (PSR), which sets forth the Federal Reserve's expectations for payment system operators, including those that are not subject to the PFMI, is the applicable framework for EPN.[34] The PSR establishes expectations with respect to credit risk, liquidity risk, operational risk, and legal risk with respect to the operation of a payment, clearing, settlement, or recording system. EPN is in compliance with PSR expectations.

Characteristic #12

Is the payment system designated as a systemically important financial market utility (SIFMU) by the Financial Stability Oversight Counsel (FSOC) or the international or foreign equivalent?

EPN is a low-value system and has not been designated as systemically important by the FSOC. It should be noted, however, that TCH, as the operator of CHIPS, has been designated a SIFMU by the FSOC and TCH's infrastructure and governance is largely shared with TCH's other payment systems, including EPN.

[34] *See* Part I(C) of Federal Reserve Policy on Payment System Risk (March 19, 2021), *available at* https://www.federalreserve.gov/paymentsystems/files/psr_policy.pdf.

Characteristic #13 ***Does the payment system provide members with information relevant to governance, risk management practices, and operations in a timely manner and with sufficient transparency and particularity for the bank to ascertain with reasonable certainty the bank's level of risk exposure to the system?***
TCH provides at least two vendor management sessions a year for Participants in TCH payment systems. These sessions address a range of topics, including governance, risk management, operations, and the regulatory framework that applies to TCH. TCH also cooperates with requests for audits and vendor management reviews by its EPN Participants in order to assist Participants in meeting their responsibilities to regulatory authorities.[35] In addition, TCH makes SOC1 and SOC 2 reports available to participants of its payment networks. EPN is subject to supervision and examination under the FFIEC's SSP program and reports of such examination are available to Participants from their supervisor authority upon request.
Characteristic #14 ***Is the payment system operated by or subject to oversight of a central bank or regulatory authority?***
TCH's operation of EPN is subject to supervision under the FFIEC's SSP program. This program includes supervision of TCH's governance, technology and operations, risk management, and financial condition. The Federal Reserve Board is the lead supervisory agency under the SSP program.
Characteristic #15 ***Is the payment system legally organized as a not-for-profit enterprise or owned and operated by a government entity?***
TCH is legally a for profit entity. However, it is bank-owned and operates on a utility model, charging fees only to cover the costs incurred in operating TCH's payment systems and to support future innovation.

[35] *See* Rule 4.11A of the EPN Operating Rules.

Characteristic #16 ***Does the payment system have appropriate systems and controls for timely communications to members of material events that relate to or could result in potential operational losses, e.g. fraud, system failures, natural disasters, etc.?***
TCH has the ability to communicate material events to EPN Participants via email announcements to business and operational contacts.[36] TCH has corporate communication procedures for material events impacting its payment operations.
Characteristic #17 ***Has the payment system ever exercised its authority under indemnification provisions?***
TCH has never exercised its authority under indemnification provisions. In addition, the FRBNY has authority to exercise the indemnity under Operating Circular 12. To date, the FRBNY has not exercised this indemnity with respect to EPN Participants.

[36] TCH also has the ability to communicate through postings to its public website and press releases.