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

Information Regarding Safety and Soundness Considerations (Image Exchange Network)

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 Image Exchange Network.

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 Image Exchange Network, EPN, 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 Image Exchange Network. Capitalized terms that are not defined herein have the meaning ascribed to them in the Image Exchange Network 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?***
Image Exchange Network settles transactions on a net settlement basis using the Federal Reserve's National Settlement Service (NSS). For this arrangement, The Clearing House acts as the settlement agent for Image Exchange Network 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 FRBNY to complete Image Exchange Network settlement is defined in the Image Exchange Network Rules.[12] For each Business Day, there are two settlements: one at 12:00pm ET and one at 4:00pm ET.[13] For each settlement window, TCH calculates a Participant's Multilateral Image Settlement Balance, which is based

[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 Image Exchange Network Membership and Operating Rules are available at https://www.theclearinghouse.org/payment-systems/image-exchange.
[12] Operating Rules VI(A) and VI(B).
[13] Operating Rule VI(B)(1)

on the value of Electronic Checks and Electronic Returned Checks sent and received by that Participant, up to its Image Ledger Cutoff, and may be either a credit Multilateral Image Settlement Balance or a debit Multilateral Image Settlement Balance. TCH submits an NSS settlement file to the FRBNY, which debits the Reserve Bank Accounts of Settlers that have a debit Multilateral Image Settlement Balance, and credits the Reserve Bank Accounts of Settlers that have a credit Multilateral Image Settlement 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] Image Exchange Network settlement is complete when TCH receives notification from the FRBNY that all Settlers with a credit Multilateral Image Settlement balance have received the corresponding credit in their Reserve Bank Account.

As a risk control regarding Participants' settlement obligations, the Image Exchange Network Rules provide TCH the authority to establish a Debit Cap (i.e., a limit on the debit Multilateral Balance that a Participant is permitted to incur in connection with the Network for any Settlement Day) that is monitored on an ex-post basis.[15]

The Image Exchange Network Rules also include provisions related to a delayed or abnormal settlement.[16]

Characteristic #2

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

The Image Exchange Network Rules limit TCH's liability to Participants. Specifically, the Image Exchange Network Rules provide that TCH shall have no liability to any Participant or third party for any Loss arising from TCH's or any third party's acts or failure to act pursuant to the Image Exchange Network Operating Rules.[17] Notwithstanding the foregoing, if TCH is found liable for a Loss arising from its action or failure to act pursuant to the Image Exchange Network Operating Rules, TCH's liability shall be limited to direct damages and shall not include consequential damages.[18]

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] Operating Rule VII(C)(1).
[16] Operating Rule VI(B)(3) and (4).
[17] Operating Rule XI(A)(2).
[18] *Id.*

TCH has a financial institution bond and computer crime policy with a $50 million aggregate limit and a $25 million single loss limit.[19] 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?

Participants are required to indemnify TCH for any Loss arising from TCH's or any third party's acts or failure to act pursuant to the Image Exchange Network Operating Rules.[20] The Image Exchange Rules set out a pro-rata loss allocation methodology under which each Participant shall pay TCH the portion of TCH's Loss that is equal to the proportion of the Network Usage of that Participant to the total Network Usage of all Participants during the three (3) months preceding the date on which a Loss was incurred.[21]

In addition, in relation to Image Exchange Network settlement, Settlers (Settler Participants and Settlers for non-settling Participants) are required to indemnify the Federal Reserve Bank of New York (FRBNY) under the Image Exchange Network Rules[22] and Federal Reserve Operating Circular 12. The Image Exchange Network Rules set out a pro-rata loss allocation methodology for any indemnity claim brought by FRBNY and the methodology provides Settlers the opportunity to reduce or eliminate liability exposure by decreasing or ceasing use of Image Exchange Network. Specifically, the Image Exchange Network Operating Rules provide that each Settler's pro rata responsibility for a claim under this indemnity is equal to the proportion of the Network Usage of that Settler (as a Participant) to the total Network Usage of all Participants during the three (3) months preceding the date on which a loss was incurred, plus if applicable the proportionate share of each Participant for which that Settler settles.[23]

[19] Operating Rule IX(F).
[20] Image Exchange Network Operating Rule XI(A)(2).
[21] Operating Rule XI(A)(3). In addition, the rules provide that "If one or more Participants fail to make any such payment (each, a "Defaulting Indemnity Participant"), the obligations hereunder of the remaining Participants shall be determined without regard to the Network Usage of the one or more Defaulting Indemnity Participants. Each Defaulting Indemnity Participant shall be liable to each other Participant in the amount by which such other Participant's payment or payment obligation was increased as a result of the Defaulting Indemnity Participant's failure to make payment plus interest thereon at the rate of eighteen percent per annum, applied to a 365-day year." *Id.*
[22] Operating Rule XI(A)(4).
[23] Operating Rule XI(A)(5).

While a Participant may eliminate future liability exposure by ceasing its use of Image Exchange Network or terminating its participation, the Participant will remain liable for obligations that accrued based on its Image Exchange Network usage prior to such cessation or termination.[24]

Characteristic #5

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

Participants may unilaterally resign from Image Exchange Network upon not less than 30 days prior written notice to TCH. The Image Exchange Network Rules also contemplate that TCH may accept shorter notice.

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 Image Exchange Membership Rules set forth general eligibility requirements and procedures for approval of Participants and state that prospective Participants will be evaluated in accordance with procedures established by TCH.[25] TCH's procedures for approval include confirmation of the prospective Participant's eligibility under the Image Exchange 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 Image Exchange Network; and evaluates Participants on an ongoing basis to ensure they continue to meet required standards. Based on the financial review, TCH may establish a Debit Cap, which is a limit on the debit Multilateral Balance that the

[24] Membership Rule 8.

[25] Membership Rule 2.

Participant is permitted to incur on any Settlement Day.[26] Any Participant with a high-risk rating that exceeds its Debit Cap frequently may be subject to suspension or termination.[27]

(b) Operational Capacities. TCH's onboarding procedures for Image Exchange Network require Participants to test and confirm their ability to send and receive files to and from the network before they are permitted to "go live" on Image Exchange Network. A Participant's operational failures that negatively impact TCH or other Participants may be addressed under TCH's risk management framework and TCH's authority under the Image Exchange Network Rules to suspend or terminate a Participant.[28]

(c) Risk Management Processes. TCH requires all Participants to be supervised depository institutions, including Edge Act Corporations chartered under the Federal Reserve Act, which are supervised by the Federal Reserve.[29] 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.

TCH has broad discretion to terminate a Participant if its continued participation in Image Exchange Network is not in the best interest of TCH, Image Exchange Network, or other Participants, including if the Participant is not being operated in a safe and sound manner.[30]

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 Image Exchange Network 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 Image Exchange Network Rules to suspend or terminate a Participant.

[26] Operating Rule VI(C)2.
[27] *Id.*
[28] Membership Rule 7.
[29] Membership Rule 1. Edge Act Corporations (EACs) are chartered under Section 25(A) of the Federal Reserve Act, and are established as subsidiaries of U.S. banks or bank holding companies for the purpose of engaging in certain foreign banking activities. Among other things, EACs are permitted to accept deposits and collect checks from a foreign person or government, or from a U.S. person if it is for a foreign purpose.
[30] Membership Rule 7.

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 a 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 The Clearing House and one or more Participants, failure or disruption of the Network's operations, or any other emergency, image exchange services shall be handled in accordance with decisions by TCH's CEO or his/her designee.[31] Under such circumstances, TCH would notify Image Exchange Network Participants as soon as reasonably practicable.

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 Image Exchange Network Rules set forth uniform, comprehensive and clear legal standards for Participants that address payment and settlement activities. The Image Exchange Rules generally incorporate the ECCHO Operating Rules, with certain modifications and supplemental provisions. The ECCHO Operating Rules were developed by depository institutions to facilitate private sector check image exchange throughout the United States. Each Image Exchange Network Participant must agree by contract (governed by New York law) to the Image Exchange Rules. The Federal Reserve's Regulation CC and Article 4 of the Uniform Commercial Code also apply to the exchange of check images through the Image Exchange Network.

[31] Operating Rule II(M).

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 Image Exchange Network is a low-value system, the PFMI does not apply and TCH has not undertaken to be fully in observance with it. However, Image Exchange Network 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 Image Exchange Network.[32] 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. Image Exchange Network 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?

Image Exchange Network 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 Image Exchange Network.

[32] *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 Participants in order to assist Participants in meeting their responsibilities to regulatory authorities.[33] In addition, TCH makes SOC1 and SOC2 reports available to participants of its payment networks. Image Exchange Network is subject to supervision and examination under the FFIEC's SSP program and reports of such examination are available to Participants from their supervisory 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 Image Exchange Network 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.

[33] Operating Rule XXII.

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 Image Exchange Network Participants via email announcements to business and operational contacts, as well as through the SVPCOView application used by network Participants.[34] 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 Image Exchange Network Participants.

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