

AFP® Annual Conference



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A Corporate Perspective on Nonbanks and Risk in Payments

Presentation to the
Association for Financial Professionals
2008 Annual Conference
Los Angeles, CA

October 20, 2008

Richard J. Sullivan
Federal Reserve Bank of Kansas City

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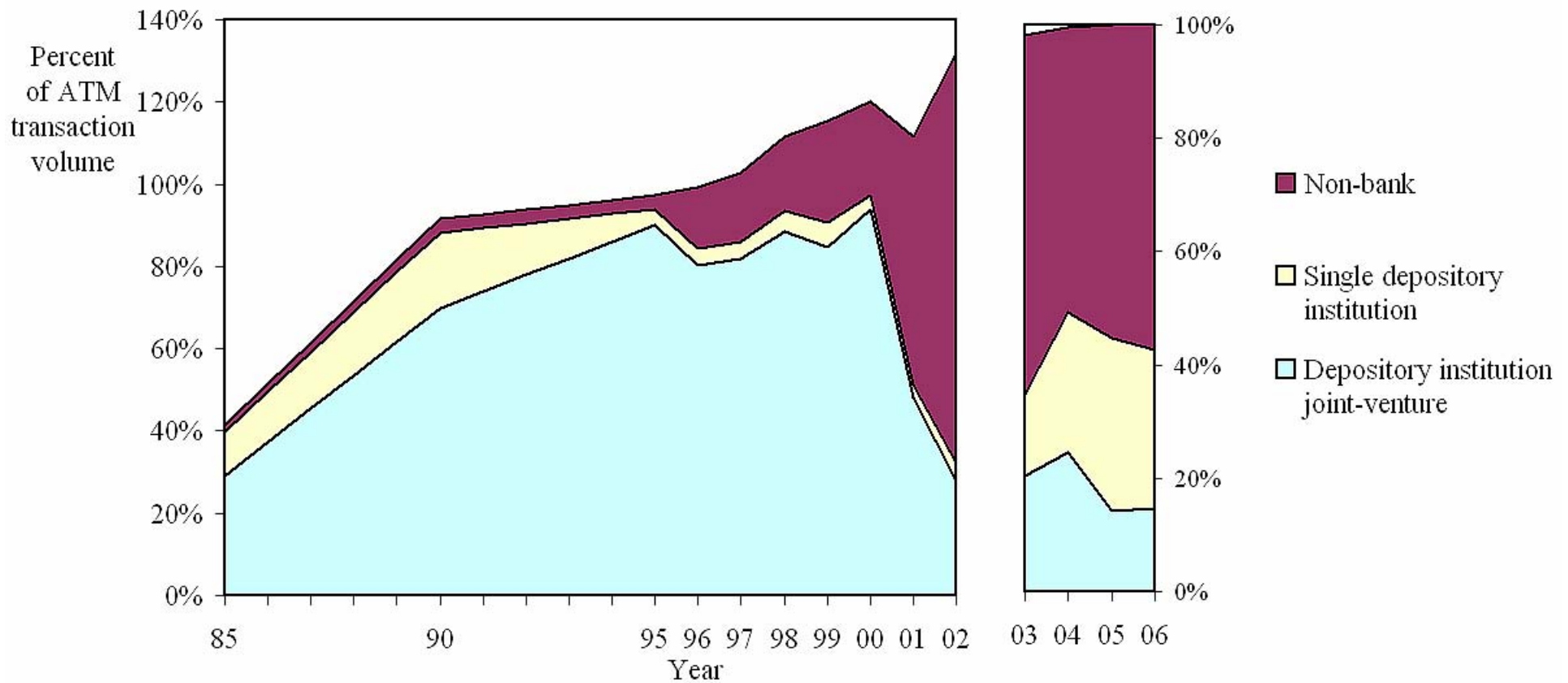


Agenda

- The extent of nonbanks in payments
- Risk and risk management
 - At the level of the firm
 - At the level of the payment industry
- A focus on data breaches and payments fraud

Share of Transaction Volume by Ownership of ATM Network

Top 20 Regional Networks--United States



Source: *EFT Network Data Book* (various years) and author calculations.

Method for Determining the Importance of Nonbanks in Payments

- Develop stylized model of payment process
 - Pre-transaction (21 subactivities)
 - During transaction Stage 1 (12 subactivities)
 - During transaction Stage 2 (14 subactivities)
 - Post Transaction (8 subactivities)
- Determine importance of nonbanks at each point of payment process
 - questionnaire completed by central banks

Nonbanks in Payments: Who are these guys?

- Back-end: process and/or facilitate payments
- Front-end: customer interface
- All enterprises that accept and originate payments
 - Including retailers, commercial firms, corporations

Importance of Nonbanks in Retail Payments: Europe

- Mixed bag
 - Important: Austria, Germany, the Netherlands, Italy
 - Not so important: Finland, France, Latvia, Slovenia
 - In between: Bulgaria, Cyprus, Czech Republic, Greece, Lithuania, and Portugal
- There appears to be a correspondence between use of payment cards and nonbank prevalence

Importance of Nonbanks in Retail Payments: United States

- U.S.: nonbanks important almost everywhere
- Both EU and U.S.: nonbanks unimportant at the point of settlement

Types of risk in payments

- Traditional risks: liquidity, credit, settlement agent risk
- More recent concerns
 - Operational risk: malfunctions, data security, counterfeit and associated fraud
 - Compliance and illicit use

Payment Activities and Selected Risks

Table 4: Payment Activities and Selected Risks

Payment Activity	Type of Risk							
	Liquidity and Credit			Operational			Compliance	Illicit use (AML, terrorist financing)
	Liquidity	Credit	Settlement agent credit risk	Malfunctioning and/or other operational problems	Data security risk associated with fraud or violations of privacy responsibilities	Counterfeit and associated fraud		
Pre-Transaction								
1	a		x		x	x	x	x
	b	x	x		x	x	x	x
2	a		x	x	x			
	b			x	x			
3	a			x	x	x	x	
	b			x	x		x	
	c				x			
	d			x	x	x		
4	a			x	x		x	
	b			x	x		x	
	c			x	x			
5	a			x	x		x	
	b			x	x	x	x	
	c			x	x		x	
	d			x	x	x		
6	a				x	x	x	
	b			x	x	x	x	
	c			x	x	x	x	
7	a				x		x	
8	a			x	x		x	

Note: Data security risk is associated with the online environment.

Payment Activities and Selected Risks

- Data security risk and compliance risk is present in a large portion of the payments process.
- Security upgrades, such as those required by the PCI DSS, attacks this type of risk.
 - One goal: reduce data breaches
- Issue: there are many points of vulnerability

s and Selected Risks
e of Risk

Operational Data security risk associated with fraud or violations of privacy responsibilities	Counterfeit and associated fraud	Compliance	Illicit use (AML, terrorist financing)
x	x	x	x
x	x	x	x
x			
x			
x	x	x	
x		x	
x			
x	x		
x		x	
x		x	
x		x	
x	x	x	
x		x	
x	x		
x	x	x	
x	x	x	
x		x	
x		x	

Risk management when there are spillover effects



Risk management in retail payments

- Pricing and insurance
 - Limitations force the payment industry to rely heavily on containment
- Containment
 - Centralized effort is valuable because individual efforts tend to benefit all payment participants
 - Works because access to the payment system can be restricted

Containment of Retail Payment Risk

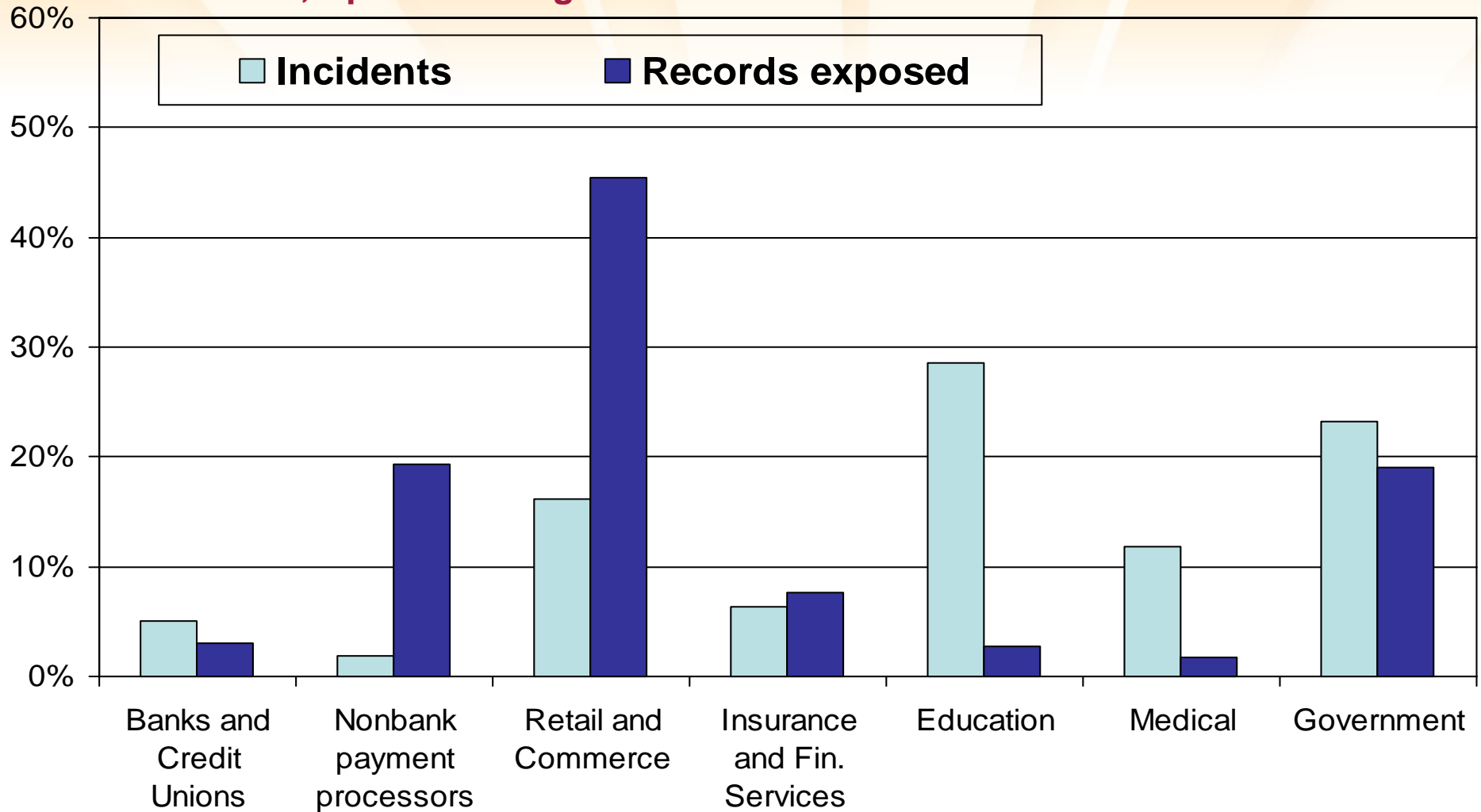
- Industry self-regulation
 - NACHA: sets security policies and access rules for the ACH system
 - Card Associations: PCI data security standards
- Government policy
 - Some rules but more recently principles-based expectations and promotion of appropriate internal controls

Nonbanks and the Challenge of Risk Management

- Alternative points of access to payment data
- Banks and networks as gatekeepers to the payment system
- Nonbanks with key roles in entire retail payment systems
 - Single point of failure?
- More complex system to manage risk

Industry Sources of Data Breaches

United States, April 2005-August 2008



Source: Privacy Rights Clearinghouse website and author calculations.

Annual Costs of U.S. Payments Fraud

	Payment type	Losses (billions)	Period
Banks	Credit cards	\$1.240	2006
	Checks	\$0.969	2006
	Debit cards	\$0.626	2005
	ACH	\$0.065	2005
	Subtotal	\$2.89	
Merchants	Checks at retail locations	\$10	2006
	Credit cards at online retailers	\$3.6	2007
	Debit and credit cards at brick-and-mortar retailers	\$2	2006
	Subtotal	\$15.6	
Consumers	All payment losses due to ID theft	\$5.6	2007

Source: Richard J. Sullivan, "Can Smart Cards Reduce Payments Fraud and Identity Theft?" *Economic Review*, Federal Reserve Bank of Kansas City (Third Quarter 2008), pp. 35-62.

AFP Fraud Survey

- AFP members have limited exposure to losses from payments fraud
- Tools to limit fraud are available and are effective when applied
 - Internal controls, positive pay, ACH debit blocks, ACH returns, segregation of duties, password changes, card spending limits
 - Working with your bank and payment providers is a good practice

Trouble ahead?

- Many AFP survey respondents experienced an increase in fraud (2007 over 2006)
- Trends are toward payment instruments with higher loss rates

	Respondents experiencing:	
	Fraud attempts	Attempts with losses
Checks	94%	17%
ACH	30%	15%
Corporate cards	13%	33%
Consumer electronic payments	4.3%	67%

Conclusion

- Nonbanks are important to retail payments in the U.S. and in some EU countries
- Overall, retail payment risk is sufficiently managed
- Balanced public policy seems warranted
 - Encourage industry self-regulation
 - Carefully design laws regarding responsibilities and liabilities
 - Prudent use of government regulation
- Keep in mind that confidence in the payments system is also a public good

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Richard J. Sullivan
Federal Reserve Bank of Kansas City

816-881-2372

Rick.J.Sullivan@kc.frb.org

www.kansascityfed.org/home/subwebs.cfm?subWeb=9



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