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- Updates
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Check Kiting Prevention Strategies

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Fraud does seem to be front and center in the corporate landscape these days, and banks are facing their share. It's not all new, high-tech types of fraud, though. One type of fraudulent scheme that has been around for years, called *check kiting*, is forcing U.S. banks to take a keener interest in how their customers are making deposits and withdrawals.

In its simplest form, the fraudulent kiting scheme generates non-existent revenue and produces questionable account balances. This type of bank fraud is so rampant and problematic that the OCC has recently issued an advisory letter on how to identify and combat check kiting. In this article, we examine check kiting schemes, how they work, and how to prevent them.

Check Kiting Defined

Check kiting is a fraudulent method to draw against uncollected bank funds. Normally, when a check is cashed, the funds supporting the draft are deposited in the account. However, clearing this draft typically takes between one to five days. During this clearing time, the bank gives the person cashing the check a short-term loan until the money is actually received from the financial institution that originally issued the check. There is a window of time during which the bank that cashed the check does not actually have the money. It is during this window when the bank that issued the check is unaware that the check was issued. The check-kiting scheme takes advantage of this transit vulnerability.

Check kiting is a crime prohibited by federal law (18 USC § 1344). Thus, individuals who perpetrate a check kite are frequently prosecuted and sent to prison. But that often does not help the banks, which are left with the loss after the check kite collapses.

A Basic Kiting Scheme

The typical check kiter opens two checking accounts at two different banks. Assume Joe Kiter opens accounts at Bank 1 and Bank 2 and deposits \$25 into each account. He then writes a check for \$25 against his Bank 1 account and deposits it into his Bank 2 account. Normal banking procedures would specify that the Bank 1 account would be closed by writing this \$25 draft because it reduces the account balance to \$0. However, before Bank 1 is aware that the check has been written, the Joe deposits a \$50 check from his Bank 2 account into the Bank 1 account.

The scheme is completed when Joe cashes a check for a *non-existent* \$75 that he wrote against his Bank 1 account into his Bank 2 account.

Financial institutions are most susceptible to this type of fraud for the following reasons:

- Direct or indirect conflicts of interest (lack of independence) on the part of management that permit the process to go unchecked despite suspicions by other bank personnel
- Insufficient or inadequate internal controls and reporting systems to monitor kiting
- Lax enforcement of existing internal control procedures
- Funds availability practices that are more liberal than necessary
- Lax wire transfer controls and reporting procedures

The problem is exacerbated when these kiting schemes take advantage of the bank's exposure brought about by complying with Reg CC (funds availability). This costly and challenging predicament has compelled the OCC to solicit new recommendations for handling check-kiting schemes. Using the OCC's recommendations, U.S. banks, thrifts, and credit unions must aggressively manage the risks posed by these fraudulent activities.

Examples of Suspicious Circumstances

The following examples have been provided by regulatory agencies to help banks identify suspicious transactions that may be an indication of check kiting:

- Several accounts with similar names, owned or controlled by the same individual
- Regular or excessive drawings against uncollected funds
- Frequent daily negative ending balances or overdrafts that eventually clear or are covered in a short time frame
- Frequent transactional patterns, such as deposits, transfers between accounts, withdrawals, and wire transfers with similar or increasing amounts
- Deposits of large checks drawn on nonlocal banks or foreign banks
- Frequent requests by the customer for account balances, collected items, or cleared items
- Frequent, large deposits drawn on the same institution

- Deposits drawn on other institutions by the same maker or signer
- Large debits and credits of even dollar amounts
- Frequent check withdrawals to the same institution, with the maker listed as payee
- A low average daily balance in relation to deposit activity
- A low collected funds balance in relation to the book balance
- A volume of activity or large debits and credits inappropriate in relation to the nature of the business of the account holder involved

If you are aware of an activity that suggests the existence of a check-kiting scheme, or is otherwise suspicious, you must file a suspicious activity report (SAR) in accordance with §21.11.

How to Protect Your Bank

Approving check drafts against uncollected funds, overdrafts, and wire transfers has unfortunately become routine in many U.S. banks. Effective internal controls are one of the keys to combating check kiting. The following list identifies a few of the more common internal controls that banks and thrifts use:

- Requiring officer approval on drawings against uncollected funds, overdrafts, and wire transfers. Such authority should be strictly enforced and not exceed an individual's lending authority.
- Daily reporting of all drafts against uncollected funds, overdrafts, large items, and significant balance changes.
- Regular review of internal reports to identify irregular conduct and to ensure proper investigation when warranted.
- Secondary level of administrative control that is distinct from other lending functions. This secondary level of control is designed to promote objectivity when granting significant drawings against uncollected funds or overdrafts.
- Regular overdraft activity reports to the board of directors or an appropriate subcommittee.
- Periodic review by an independent auditor to assess and report on the adequacy of all established uncollected funds internal controls.

Banks should also consider having independent fraud examiners conduct targeted fraud prevention reviews. In addition to helping to prevent future losses or possible scandals, such reviews can provide assurance to the institution's board of directors that they are being assertive and proactive in fraud prevention.

Reg CC Exceptions and Potential Changes

Although financial institutions are required to adhere to the time frames on availability of funds established by Reg CC, there are exceptions to these normal availability schedules. The OCC has recently reminded banks that bank personnel should use those exceptions as circumstances require. In addition, banks do not need to tell customers that they are a check-kiting suspect.

They need only to use the *Reasonable Cause* hold exception and check the box that says "*confidential information that check will not be paid*" when appropriate circumstances exist. (See Appendix E, Commentary to Reg CC 229.13(e) comment (2)(d).)

The regulatory agencies are exploring ways to reduce the risk of check kiting caused by Reg CC. In addition to the OCC's recent advisory letter, the Fed is now supporting the call for a minimum three-day hold period for local checks. The agencies want banks to continue to comply with Reg CC, but they also want them to take appropriate steps to protect themselves.

There is no absolute safeguard against check kiting or any other type of bank fraud. But there are account activities that can signal the need for greater scrutiny. Establishing adequate controls to identify fraudulent activity, and periodic review and assessment of those controls, is essential to reducing your bank's risk of loss or scandal caused by fraudulent check-kiting schemes. ■

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