NICE Actimize

White paper

Check Kiting in the Digital Age

Contents

Check Kiting: Nothing New

Check kiting is not a new fraud scheme. In fact, it dates back to 1920. The term "kiting" originated from a 19th century practice of issuing IOUs and bonds with no collateral behind them. The name comes from "flying a kite" which referred to the fact that there was nothing but air to support the loans. Check kiters also came to be known as "paper hangers." The term check kiting refers to the same concept of an account holder creating credit where none exists by leveraging clearing or float times. Taking advantage of the check clearing timelines gave account holders the opportunity to leverage this kite. Prior to the advent of Check 21 when checks moved to digital forms, there could be several days and sometimes weeks required for items and funds to catch up to the deposit accounts.

There are several variations on a theme with check kiting, but the basic premise is the same. A circular flow of funds is created to allow the perpetrator the ability to distribute payments with inadequate funds in the account. The intent is to fraudulently and intentionally inflate account balances. There's nothing to support the payments but air.

The laws surrounding check kiting can be equally as challenging. According to the U.S. Department of Justice, there are several federal statutes that can be used to charge check kiters. State laws, however, differ quite vastly. What most laws do lay out is how kiting is defined. The Cornell University College of Law describes check kiting as:

"A crime involving writing a check on an account, Account A, with insufficient funds and depositing it in another account, Account B, and then writing a check on Account B and depositing it in Account A to cover the first check written on Account A. Kiting takes advantage of the time it takes banks to clear checks. Before the bank in which Account B is held has time to clear the check written on Account A, the kiter has already written a second check on Account B and deposited it in Account A, making it appear as though the bank in which Account A is held has sufficient funds. The bank in which Account B is held then honors the check written on Account A. Through kiting, the kiter obtains an illegal, interest-free loan."[1]

Check kiting takes advantage of "the float," or the lag time between when an individual provides a check as payment and when the recipient cashes the check and the recipient's bank requests funds from the check writer's bank. A prime example is the case of the Dallas used car dealer that used kiting to scheme Ford Motor Company and several banks out of more than 50 million dollars.[2]

Most experts agree that there needs to be a repetitive nature to the action or a clear lack of recognized business purpose of the activity to qualify as a kite activity. Account holders can inadvertently perform check kiting, but the legal standard requires it to be purposeful and ongoing. Many statutes use "deliberate" as a descriptor of the fraud.

The Changing Face of Check Kiting

As checks become less popular in the digital age, it would seem logical that check kiting would decline due to real-time payments, debit card usage and other factors. Unfortunately, it has not. As check usage declines, the reality is that beginning in 2016, check fraud has increased. In fact, check fraud accounts for 35 percent of industry losses according to the ABA Banking Journal last year.[3] Many of the most impactful schemes seem to come from businesses. This was the case of a livestock dealer in Plainville, Kansas earlier this year. In that single fraud, the perpetrator and his spouse, who was a former banker, used check kiting and wire transfers to inflate account balances to obtain loans and clear checks. The indictment for the case alleges that the couple passed more than $2.2 billion in fraudulent items by using at least seven different banks.[4]

What makes these types of cases so difficult to detect? One challenge that banks face is the regulation regarding funds availability.

Passed as a consumer protection mechanism in 1987, Reg CC, requires financial institutions to make funds available to account holders within a defined time period, depending on the check type. Even though the law requires consumer access to funds, the bank may not receive the account funds in the same time frame. Another factor that increases the challenge is direct bank to bank check exchanges of the deposited items are cleared throughout the day and near immediate credit is given for those deposits. However, the returned deposit items flow in the normal daily process so notice of account balance deficiencies is delayed.

Since Check 21 was introduced more than a decade ago, many thought that it would minimize or eliminate check kiting. It did not. However, the law created hurdles in some cases. For example, Check 21 allowed a physical item to be destroyed or returned to the customer once scanned. However, this made the physical check copy unavailable for evidence in the case of a prosecution and details were lost in the scanning process. Check 21 has given way to technological innovations such as mobile remote deposit capture. Even though this increased the speed of deposits into accounts, it introduced additional complexities for banks such as re-depositing of physical items. In some fraud cases, checks were re-presented to branches for deposit again. This meant additional controls were needed to assure the items were not introduced multiple times to the bank. Mobile remote deposit capture (MRDC) increased the anonymity of making fraudulent deposits in support of kiting and increased the ease of making duplicate deposits. Check 21 also increased the ability to manipulate items by reducing the time the bank has to evaluate and respond to deposit items. All the technologies have changed the face of check kiting since the time frames have shortened; however, using ACH, wires, P2P and other channels have not eliminated the con. It has simply spread it out over multiple channels and mechanisms. Did these changes impact the numbers? For consumer markets, it has helped minimize overextending of accounts, but many businesses still use checks to run their businesses. Checks provide many advantages in physical documentation of payments and business expenditures. The larger kiting cases that we have seen in the past couple of years have been associated with business entities.

The Mechanics of Kiting

The mechanics of a check kite, according to the Association of Certified Fraud Examiners (ACFE), should involve a review of all items over a 90-day period. In forensic review of accounts that utilized kiting, there is a general theme: the actual cash deposits versus kited deposits were a fraction of the kited or float funds at any given time. This exercise is a good learning exercise. It serves to help create responsive controls by forensic review, but does not prevent or detect kite activity in real time.

One of the key questions when investigating kiting is why? There are typically a couple of motivations for the scheme. One is simply a matter of cash flow. In a business or even household account, bills exceed income. Kiting is used to keep things afloat. A second motivation is a lifestyle upgrade. Sometimes perpetrators want to live beyond their past or current means and this will show up in the spend. The purchase of trips, travel and expensive assets are the tip off as to the motivation for a lifestyle boost. This is in stark contrast to cash flow issues being a matter of just trying to cover bills for the business or household. An additional theory is the use of businesses and accounts as potential money laundering mechanisms. Reliance on injections of funds to support the spend can be slowed eventually and result in the kiting activity coming to the surface. A fourth reason could be an unexpected and unplanned short fall in funds due to a large returned deposited item (RDI), or a large chargeback, ACH Return, or other outflow of funds that prompt the kiter to fraudulently introduce funds to cover the short fall. For this reason, we strongly recommend monitoring returns and return reason codes.

Regardless of the motivation, there are some specific signs of systemic check kiting that should be monitored on the account. Incorporating these key indicators can help your institution systemically identify the risk of kiting across all transaction types that credit or debit from the account, not just checks:

- A high velocity of deposit activity, usually several per day.
- A high percentage of deposited funds coming from accounts under common control of your customer and a customer has several accounts with similar names, owned or controlled by the same individual(s)
- Same name maker Payee
- Uncollected float balances many times greater than closing bank balances
- Regular or excessive drawings against uncollected funds
- Steadily increasing uncollected funds amounts or percentage of collected balances
- More “real” money is being taken out than put in
- Deposit and withdrawal activity conceals negative actual balances (Be sure to calculate balance without float to look for signs of potential kiting)
- Total dollar debits and credits are almost equal
- Many deposit items drawn on the same bank(s) or many debits payable to the same payee
- Overdrafts covered with checks and not with cash
- Returned items for NSF, Refer to Maker, etc. indicating insufficient money in the opposite account (s)
- Checks written in “round” dollar amounts, and steadily increasing round dollar amounts

- Frequent requests by the customer for account balances, collected items, or cleared items
- Frequent requests for funds availability from counterparty banks
- Frequent use of different bank branches.
- Frequent use of ATMs to make deposits
- Frequent MRDC deposits right before same day availability time window cutoffs
- 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, large deposits drawn on the same institution
- Deposits containing checks drawn on the same bank account that are sequential in serial (check) number
- Deposits drawn on other institutions by the same maker or signer
- 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

The customers who tend to be involved in large scale check kiting are typically good customers. This is what makes the detection of kiting activities so challenging. Many customers, according to FBI case studies, are good customers. They tend to be attentive to their accounts and because they establish long-term relationships with their FIs, they are given passes when there are issues with their overdrafts and covering items, sometimes even getting special consideration about potential overdrafts in covering their accounts. Unfortunately, this creates challenges for the bank. When issues occur, banks are sometimes surprised as they see that clients were "never overdrafted." That caused the bank to make decisions that ultimately created large loss values. However, running the numbers and ratios in the account as detailed above can be initial signs of potential kiting activity.

So how do we consistently detect kiting? In this digital age with multiple channels and mechanisms, it creates a host of challenges. Using different channels like ACH, wire, RDC, and even P2P create an "asynchronous" timeline that allows the exploitation of the cyclical pattern of kiting. Careful mechanisms are sometimes created by perpetrators to avoid detection of the kiting scheme. But the bottom line from an FI perspective is that the bank in the cycle to detect kiting first is likely to limit their losses.

Finding the Red Flags

Kiting challenges are exacerbated by the need to comply with additional regulation like Reg CC and Reg E. Your best line of defense is an astute front line of tellers in working with customers. Some of the internal controls that can help mitigate and detect red flags are:

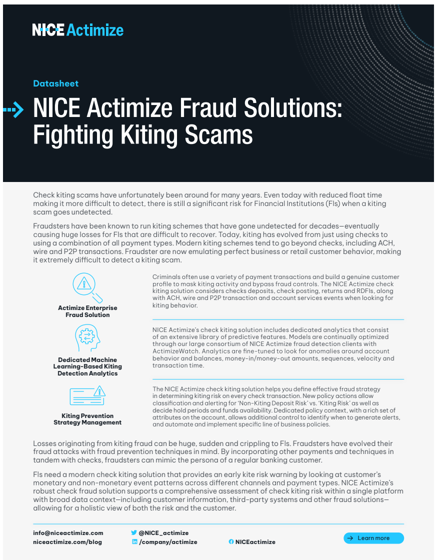
- Requiring officer approval on drawings against uncollected funds, overdrafts and wire transfers. Such authority should be strictly enforced and not exceed an individual's lending authority.
- Daily reporting of all drafts against uncollected funds, overdrafts, large items and significant balance changes.
- 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 draws 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.

The conditions listed above are critical in understanding the key indicators of kiting activity. Another critical component is a clear, cross-channel view of customer behavior. Applying the indicators across those channels and understanding money coming in and out of the account can give you a clearer picture of the intent, motion and risk of kiting activity in your financial institution. Does your system give you a holistic view of all activity across the account? Certainly a view of the ledger is critical, but understanding normal account business and potential risks of each of the channels and the 360 view of the customer is important. The profile risk is also a consideration. A business or individual who appears to have many bank accounts at many institutions that they control is a consideration for a risk factor. There are reasons for multiple accounts, but understanding the use and role of the accounts can assist in understanding the business or individual goals and motivations. The first question in an investigation is always, does this make sense? Is there a business or reasonable personal justification for the movement of funds?

Moving Forward

No matter how valuable a customer seems to be, the pattern of float being a large percentage of the daily balance and movements of funds between closely controlled accounts is a challenge that can put the bank at risk. Does your bank have that clear picture of the customer? Can you understand the profile and pattern risk? If the answer is no to any of these questions, controls should be put in place to mitigate the risk of loss to the institution.

Additional Resources



NICE Actimize

Datasheet

NICE Actimize Fraud Solutions: Fighting Kiting Scams

Check kiting scams have unfortunately been around for many years. Even today with reduced float time making it more difficult to detect, there is still a significant risk for Financial Institutions (FIs) when a kiting scam goes undetected.

Fraudsters have been known to run kiting schemes that have gone undetected for decades—eventually causing huge losses for FIs that are difficult to recover. Today, kiting has evolved from just using checks to using a combination of all payment types. Modern kiting schemes tend to go beyond checks, including ACH, wire and P2P transactions. Fraudster are now emulating perfect business or retail customer behavior, making it extremely difficult to detect a kiting scam.

Actimize Enterprise Fraud Solution

Criminals often use a variety of payment transactions and build a genuine customer profile to mask kiting activity and bypass fraud controls. The NICE Actimize check kiting solution considers checks deposits, check posting, returns and RDFIs, along with ACH, wire and P2P transaction and account services events when looking for kiting behavior.

Dedicated Machine Learning-Based Kiting Detection Analytics

NICE Actimize's check kiting solution includes dedicated analytics that consist of an extensive library of predictive features. Models are continually optimized through our large consortium of NICE Actimize fraud detection clients with ActimizeWatch. Analytics are fine-tuned to look for anomalies around account behavior and balances, money-in/money-out amounts, sequences, velocity and transaction time.

Kiting Prevention Strategy Management

The NICE Actimize check kiting solution helps you define effective fraud strategy in determining kiting risk on every check transaction. New policy actions allow classification and alerting for 'Non-Kiting Deposit Risk' vs. 'Kiting Risk' as well as decide hold periods and funds availability. Dedicated policy context, with a rich set of attributes on the account, allows additional control to identify when to generate alerts, and automate and implement specific line of business policies.

Losses originating from kiting fraud can be huge, sudden and crippling to FIs. Fraudsters have evolved their fraud attacks with fraud prevention techniques in mind. By incorporating other payments and techniques in tandem with checks, fraudsters can mimic the persona of a regular banking customer.

FIs need a modern check kiting solution that provides an early kite risk warning by looking at customer's monetary and non-monetary event patterns across different channels and payment types. NICE Actimize's robust check fraud solution supports a comprehensive assessment of check kiting risk within a single platform with broad data context—including customer information, third-party systems and other fraud solutions—allowing for a holistic view of both the risk and the customer.

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Citation

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About NICE Actimize

NICE Actimize is the largest and broadest provider of financial crime, risk and compliance solutions for regional and global financial institutions, as well as government regulators. Consistently ranked as number one in the space, NICE Actimize experts apply innovative technology to protect institutions and safeguard consumers' and investors' assets by identifying financial crime, preventing fraud and providing regulatory compliance. The company provides real-time, cross-channel fraud prevention, anti-money laundering detection, and trading surveillance solutions that address such concerns as payment fraud, cybercrime, sanctions monitoring, market abuse, customer due diligence and insider trading.

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