Stopping Check Kiting

Indicators, Defenses and Methods

This white paper is part of the Risk Management White Paper Series, which CUNA Mutual Group provides exclusively to its Bond policyholders.

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Introduction

Check kiting is an illegal practice that takes advantage of the time it takes checks to clear the payment system. This time, known as float, allows the "check kiter" use of nonexistent funds. Kiting can lead to enormous account balances on paper – and a loss for the credit union when the kite eventually collapses. In fact, check kiting is considered the largest loss exposure associated with any share draft/checking account program. Losses from check kiting can threaten the solvency of a credit union as the losses can be in the millions of dollars.

Both consumers and businesses have been guilty of check kiting schemes. The primary reason cited in kiting cases is financial difficulty leading to poor cash flow. In order to pay their bills, they resort to check kiting. The consumer or business inflates their checking account balance with nonexistent funds for the purpose of writing checks against the account. Business kiting schemes generally result in the largest losses.

Tellers are the first line of defense against any check fraud scheme, including kiting. Training tellers is critical for credit unions to avoid kiting losses. Kiting detection software also assists in identifying potential kiting schemes.

Typical Kiting Methods

There are several ways a person or business can kite. The most widely recognized method of check kiting involves using two or more checking accounts at different financial institutions. The kiter writes a check against the account at one financial institution (Credit Union A) and deposits it to their account at the other financial institution (Bank B) to cover previously written checks. However, the account on which the check is written (Credit Union A) contains insufficient funds to cover the item. Therefore, the kiter must reverse the process by writing a check against their account at Bank B for deposit to their account at Credit Union A. This process can go on for an indefinite period of time (see the Appendix for a detailed kiting scheme scenario).

As is evident from the above example, kiting takes a tremendous amount of work to keep the kite afloat. With checks clearing faster today as a result of Check 21, kiters must work even harder to maintain their kiting schemes.

Kiting Defenses

The best defense against any check fraud scheme, including kiting, is the "check hold". Federal Reserve Regulation CC (Reg CC) allows an exception hold when a credit union has suspicions of check kiting. This exception falls under the category 'Reasonable Cause to Doubt Collectability', and allows a seven business day hold on suspicious checks deposited by the member. A check hold prevents checks written by the member from clearing against uncollected funds. These checks will be returned unpaid to the other financial institution and the kite (and loss) will fall on that institution.

When invoking the exception hold, Reasonable Cause to Doubt Collectability, requires the credit union to provide an exception hold notice to the member indicating the reason for the hold. If this exception is used due to suspicions of kiting, the credit union can indicate as the reason for invoking the exception that it has confidential information indicating the check might not be paid.

Kiting Indicators

Even though there are a number of different kiting methods, the indicators will always be the same. Tellers should know the kiting indicators so they can stop a kite before it causes a loss to the credit union. The following are indicators, or characteristics, of a kiting scheme:

- Frequent deposits of even dollar amounts with subsequent share draft withdrawals in the same or similar amounts.

- Checks presented for deposit that are drawn on the member's account from another financial institution. An occasional deposit of this nature should not be viewed as a problem; however, the account should be flagged for review if this type of deposit increases in frequency.

- Deposits that increase in amount over time. Kites tend to start out small, especially by consumer-members. If undetected, the kiter becomes confident in the scheme and eventually makes larger dollar check deposits.

- Excessive use of the ATM or night depository. A typical kiting scheme may require several deposits each week, so to avoid suspicion, the kiter may make deposits at nonproprietary ATMs or the credit union's night depository.

- Frequent NSF deposits and overdrafts. This could be a signal that the kiter is not managing the timing of their deposits.

- Employees who handle returned items should be alert for items drawn on the member's account from another financial institution that are returned for insufficient and/or uncollected funds. Employees who handle overdrafts should be alert for checks written against member accounts at the credit union that are deposited to their accounts at other financial institutions.

- Inquiries by other financial institutions. The credit union may receive an inquiry from another financial institution to verify funds on a check written against a member's account at the credit union. If the member attempts to deposit the check to their account at the other financial institution, the institution might call to verify funds.

- Credit unions are cautioned against calling the other financial institution to verify funds on a check when they have suspicions that a member is engaged in a kiting scheme. The other institution will likely have the same suspicion and may place extended holds on checks the member writes against his/her credit union account for deposit to their account at that institution. The hold will result in checks being returned unpaid to the credit union and the kite will fall on the credit union. The first financial institution to impose check holds in a kiting situation will generally avoid the loss.

Additional Kiting Considerations

Kiting could involve collusion between account holders at different financial institutions. An example is a husband and wife who have checking accounts at different institutions (e.g., a credit union and a bank). While the accounts at both institutions may be titled in both names, the checks on one account might only contain the husband's name and the checks on the other account might only contain the wife's name. Tellers should be aware of this when evaluating kiting symptoms.

Filing Suspicious Activity Reports (SARs)

Credit unions should file a Suspicious Activity Report (SAR) when they discover a member is engaged in a check kiting scheme. The SAR should be filed even though the amount of the kite is less than the $5,000 threshold for filing a SAR. SARs are placed in an electronic data base that law enforcement officials can access. A SAR could be filed on the same person by more than one financial institution. This information could assist in the apprehension of the person. A SAR must be filed if the kiting scheme involves a director, officer, or employee of the credit union

Business account kiting schemes have caused the largest losses in the financial institution industry. Business owners resort to kiting due to poor cash flow. They inflate their checking account balance with nonexistent funds to pay bills, such as their payroll, mortgage/rent, loan payments, and such. The business owner may kite checks between their business account and personal account held at different institutions. The business owner may own another company and kite checks between the two business accounts.

It may be extremely difficult to spot a business account kiting scheme due to the volume of checks deposited daily. Nevertheless, tellers should be alert to the possibility that a business member could be engaged in a kiting scheme when processing the check deposits.

To address the risk associated with business account kiting schemes, credit unions should perform a risk assessment by evaluating the business member's creditworthiness before approving a checking account. The idea is to offer checking accounts to business members who are least likely to abuse the account, which could result in large losses to the credit union.

Appendix - Kiting Loss Scenario

John Kiter is in a bind. He owes his landlord $200 and has two checking accounts – one at Credit Union A and one at Credit Union B – with only $5 in each. John decides to try his hand at check kiting. Since his credit unions do not have effective check hold policies, he is able maintain his kite after paying his landlord the $200.

Here's how he did it:

Day	Credit Union A	Credit Union B
Monday	**Step 1** - John writes a check for $200 to his landlord against this account, and then worries about overdrawing it.	
Tuesday		**Step 2** - John writes a $200 check against this account to cover the check written against his Credit Union A account on Monday.
	Step 3- He deposits the $200 check from Credit Union B into this account. **Meanwhile...**Monday's $200 check written against this account now has uncollected funds to clear against; John worries about overdrawing his Credit Union B account.	
Wednesday	**Step 4** - John writes a $200 check against this account to cover the check written against his Credit Union B account on Tuesday.	
		Step 5 - He deposits the $200 check from his Credit Union A account. **Meanwhile...**Tuesday's check written against this account now has uncollected funds to clear against; John realizes he's jeopardizing his account at Credit Union A.

Thursday		**Step 6** - John writes a $200 check against this account to cover the check written on Wednesday against his Credit Union A account.
	Step 7 - He deposits the $200 check from his Credit Union B account. Wednesday's check written against his Credit Union A account now has uncollected funds to clear against. **Meanwhile...**It's the end of the week and John is still broke, but he has a date that night and needs $50. He decides to "grow" his kiting scheme by increasing the check amount to $250.	
Friday	**Step 8** - John writes a $250 check against this account to cover the check written against his Credit Union B account on Thursday.	
		Step 9 - He deposits a $250 check from his Credit Union A account and receives $50 cash back. Thursday's check written against this account now has uncollected funds to clear against; John also has $50 for his date. **Meanwhile...**The process goes on, but the checks John floats back and forth between his accounts must now be for at least $250.

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