March 28, 2024

The Honorable Michael J. Hsu
Acting Comptroller
Office of Comptroller of the Currency
400 7th Street, SW
Washington, D.C. 20219

The Honorable Jerome H. Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., NW
Washington, D.C. 20551

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Regarding: New member survey results and revised recommendations concerning fraudulently altered returned checks ("Fraudulent Returns") and deposit account check fraud ("Check Fraud")

Dear Prudential Banking Regulators:

The Community Bankers Association of Illinois ("CBAI") is proud to represent nearly 265 Illinois community banks. The results of our recent member survey ("Survey") indicate that a growing number of CBAI members are experiencing the pernicious problem of not being promptly and reasonably reimbursed for Fraudulent Returns. They have seen a fifty-percent increase in their fraud losses, and essentially the same largest banks and credit unions ("Largest Financial Institutions" or "Largest Institutions") are responsible for Fraudulent Returns. They have recommendations for not only addressing the symptoms but also the source of the problem of Check Fraud in the banking industry.

The issue of Check Fraud is rightfully becoming more widely recognized by the federal banking regulators ("Regulators"), the United States Postal Service ("USPS"), law enforcement and prosecutors, in addition to community banks and their many customers that are being harmed by this criminal activity.

The checks involved in these fraudulent activities are typically intercepted by criminals while being transmitted through the USPS, altered by a process of either "check washing" or "check cooking," and then deposited into accounts opened at many of the Largest Financial Institutions known as "drop accounts" or "mule accounts," which are later emptied. The unfortunate result of this criminal activity is that many of these fraudulent checks clear back to community banks, harming them, and their consumer and small businesses customers, and undermining the integrity of the United States banking system.

Our members report that they continue to be harmed by the protracted and frustrating process of being reimbursed for Fraudulent Returns by the Largest Financial Institutions which are the "bank of first deposit" for many of these fraudulent checks. Also, over the past 18 months, our members' vision of Check Fraud has clarified, and that Fraudulent Returns are actually a symptom of this problem, not its source. The source is the apparent Know Your Customer lapses at the Largest Institutions that allow fraudulent accounts, into which fraudulent checks are deposited, to be opened in the first place. They believe that if this problem were successfully addressed by the Regulators, and solved by the Largest Institutions, the problem and its symptoms would largely disappear. *

*A June 21, 2023, article in ***The Conversation*** titled ***In a Heist Worth Billions***, is an investigative report that shined a spotlight on fraud concerns with the online website and phone ap account opening processes at the largest banks that the authors characterized as a "competitive race to the bottom." The authors stated, "The pressure to make identification requirements easier is huge. And that, fraud experts say, is leading to an apparent collapse in the banks' adhering to Know Your Customer and other anti-money laundering rules – a reality fueling the explosion of drop accounts."

https://theconversation.com/us/investigations/mailbox-robberies-drop-accounts-checkwashing-fraud-gangs-of-fullz

The severity of this problem cannot be emphasized enough. One of our members characterized their plight by saying, "We are under attack from check fraud!" And our members agree that while Check Fraud is spreading like wildfire, a meaningful regulatory response is moving at a glacial pace.

Community bankers are not asking the regulators to pick winners and losers in bank vs. bank disputes but to ensure there is prompt and reasonable closure for Fraudulent Returns. Also, the Regulators must address the apparent compliance lapses at the Largest Financial Institutions concerning the opening of fraudulent deposit accounts. A strong engagement by the Regulators on both of these fronts is essential and will benefit all the banks they regulate, as well as consumers and small businesses, and will help maintain the integrity of the banking system.

Events of the Past Year

In February of 2023, CBAI alerted the Regulators to our members' experience and concerns with Fraudulent Returns along with recommendations for addressing and solving this problem. The Regulators eventually responded and, at the encouragement of CBAI, formalized a process by which community banks could escalate their reimbursement complaints to the senior regulators responsible for supervising the Largest Financial Institutions to help ensure that they address these complaints.

In July, CBAI delivered its Member Guidance* ("Guidance") explaining how they can escalate their complaints against the Largest Financial Institutions to their Regulators. Many of our members are now utilizing this resource and keeping CBAI appraised of the results of escalating their complaints. Also, a number of the community bank state associations have now adopted a version of this Guidance for use by their members.

*https://www.cbaionline.com/gr/CBAIMemberGuidanceJuly2023.pdf

In these formal complaints, our members are rightly highlighting the intersection between Check Fraud and a bank's CAMELS rating system. They see the failure of the Largest Financial Institutions to reasonably address this problem is a clear indication that they are not properly managing this process – the M in CAMELS. The fact that fraudulent accounts are being opened in the first place, through which these fraudulent items are being negotiated, is a clear indication that there is a problem with the Largest Institutions managing (the M in CAMELS) their KYC/BSA/AML/CDD/CIP compliance responsibilities.

Further, they believe the broader management and compliance failures of the Largest Financial Institutions in not resolving Fraudulent Returns are harming the earnings (the E in CAMELS) of community banks and their capital (the C in CAMELS). In addition, community banks are expending a great deal of time and energy in trying to resolve these returns (i.e., wasted management resources (the M in CAMELS)) that could be more productively used serving their customers and communities.

Also, and not to be discounted, community bankers must explain this problem to their customers who are the frontline victims of this fraudulent activity, which undoubtedly shakes the confidence of consumers and small businesses (i.e., the public confidence) in the United States banking system - which the Regulators are tasked with ensuring.

We hear from our Illinois members that they are utilizing our Member Guidance with a modest degree of success. Recently, a member that utilized the Guidance reported that they finally received $37,000 from one of the nation's largest banks on a six-month-old check fraud loss claim on a commercial customer. They thanked us for our assistance; however, they received no explanation from the large bank as to why it took six months to resolve this claim. The observation by another member was much more indicative of the norm, and about how much more needs to be accomplished, when he said that there are still a few large banks that "just don't seem to take these complaints [to the Regulators] very seriously."

CBAI's 2024 Member Survey Results

Again in 2024, CBAI conducted a member survey ("Survey") to learn about Illinois community bankers' experience with Check Fraud, including Fraudulent Returns. This Survey not only provides current data but also comparative data which we are hoping will light the path for the Regulators to follow in helping to address the symptoms and the source of Check Fraud.

To provide context for these Survey results, CBAI has nearly 265 members. There are a handful of bank members under $25 million in assets, over a dozen members near or over $1 billion, but none exceed $10 billion in assets. The average asset size of our community bank members is $300 million.

We began the Survey with a new question to determine the extent of the problem of fraudulent checks being presented to community banks by asking, **What was <u>the total number of fraudulent return items</u> your community bank received in 2023?** The response was an average of thirty (30) checks. When looking deeper into the results, 90% responded that they experienced one or more fraudulent checks and a small handful of our members responded near or over one hundred (100) items.

If these results are indicative of all community banks under $10 billion in assets, then Check Fraud is a problem that now confronts an astounding 4,200 community banks in the United States and involve more than 126,000 fraudulent items.

In response to the question – **Did your community bank <u>experience problems in being reimbursed</u> for fraudulent returns in 2023?**, seventy-two percent of the responses were in the affirmative. This represents an increase over last year when 60% responded in the affirmative. The increase in banks experiencing problems with being reimbursed for fraudulent returns indicates this problem is getting worse.

Again, if these results are indicative of all community banks under $10 billion in assets, then problems with being reimbursed for fraudulent returns is one that confronts 3,400 community banks (versus 2,800 during the prior year.) This data clearly proves more needs to be done by both the Regulators and the offending Largest Financial Institutions to address the reimbursement problem and its underlying cause.

We asked, **Which banks and/or credit unions have been <u>the most difficult for your community bank to deal</u> with regarding fraudulent return reimbursements?**, the results were mostly the same largest banks - just a change in their ranking. However, this year, five (5) credit unions were named, which shows that they too are a part of this problem.

The names of the offenders with the worst culprits listed first for 2024 and 2023, were as follows.

2024	2023
Chase Bank	Bank of America
Bank of America	Chase Bank
Wells Fargo	Wells Fargo
Regions Bank	Navy Federal Credit Union
US Bank	US Bank
Citi	PNC Bank
BMO Harris	Truist Bank

The five credit unions with more than one billion dollars in assets named by our members in the 2024 survey were – Navy Federal Credit Union, Directions Credit Union, Visions Credit Union, and Truliant Credit Union.

These results indicate that there are continuing and undeniable problems with reimbursements that are caused by the Largest Financial Institutions which are frustrating and harming community banks.

When asked, **How many <u>requests for reimbursement</u> for fraudulent returns has your community bank submitted <u>that remain unresolved</u>?**, the response was that on that day an average of three (3) items remain unresolved with a range of between zero and 20. Last year's results were five (5) unresolved items with a range of between zero and 30. These results were a slight improvement compared to last year but this problem obviously still exists. When asked the **total dollar amount** of these items, the answer was an average of $31,000 (versus $23,300 for the prior year) which represents a significant increase in the average size of the unresolved fraudulent items compared to last year.

These results indicate that little progress has been made over the past year despite consistent advocacy by community banks, and the Regulators being completely aware of the extent and severity of this problem. CBAI urges the Regulators to demonstrate an increased sense of urgency in addressing and solving this problem which is harming community banks.

We asked, **Of the number of items that remain unresolved, how many of these items have you received <u>no response</u> from the other financial institution?**, the answer was 50% (versus 65% for the prior year), which represents a slight improvement. However, half of the time the

Largest Financial Institutions do not even feel the need to extend the bank seeking reimbursement the common courtesy of acknowledging the reimbursement request and indicating when they can expect to have closure.

This behavior by the Largest Institutions is completely unacceptable. The continuing frustrations experienced by community bankers are explained in much greater detail later in the Survey.

In response to the question, **On average, approximately how many months has it taken to get closure for fraud return reimbursement requests?**, the largest number of responses was three (3) months, but more than half of those responses were longer at four (4), five (5) or six (6) months. A number of responses were in the range of between 1-3 months, 6-8 months, and some even longer. Less than 20% responded that reimbursements were made within 60 days.

Here again, by any reasonable measure, these response times are completely unacceptable. One community banker highlighted the difference between large and small banks by saying, "Most local banks resolve their reimbursement requests within 30 days of issuance. We often see results in approximately 3-18 months for large, non-local banks."

We asked a new question, **Throughout 2023, has the dollar amount of each fraudulent return tended to increase, decrease, or remained about the same?**, and 42% responded that they have seen an increase in the average dollar amount, followed by 29% who responded that the amount has stayed the same, but only 1% saw a decrease.

These responses are consistent with what we have seen elsewhere in the Survey confirming how the fraudsters are becoming more emboldened and seeking larger paydays.

When asked another new question, **How has the response time to get closure for fraud return requests changed from the beginning to the end of 2023? Did it improve, worsen, or stay the same?**, two-thirds responded, "about the same." One quarter of those indicated the response time had worsened and less than a handful said there was an improvement.

When so few of those responding saw an improvement in the response time to get closure for fraudulent return claims this clearly indicates little progress is being made and the situation remains completely unacceptable.

In response to the question, **For 2023, what has been your bank's <u>total amount of losses for fraudulent returns</u>?**, the response was an average of $47,000. This average loss represented almost a 50% increase from last year's average loss of $30,000. Again, if you were to extrapolate these results for all community banks under $10 billion in assets that have experienced this problem, the estimated total losses from this type of fraud could be more than $146 million, which is approximately a 65% increase from last year.

Community bankers are increasingly concerned and justifiably upset that these stolen funds are going to expand criminal enterprises and could be used to fund terrorist activities. Community bankers take their responsibility very seriously to identify and prevent financial crimes, including tax evasion, money laundering and terrorist financing. They are confounded that on the one hand, the regulators are strictly enforcing compliance with KYC/BSA/AML/CDD/CIP/OFAC and SARs on community banks, but they are apparently not insisting on the same level of compliance for the Largest Financial Institutions regarding Check Fraud which is a serious financial crime.

In response to another new question, **Do you agree that the primary cause of check deposit fraud, and more specifically fraudulent returns and problems with reimbursements, is that <u>fraudulent accounts are allowed to be opened at banks in which these fraudulent items are being deposited</u>?**, a resounding approximately 90% agreed.

We also asked, **Would you support legislation or regulation that would place the <u>liability for fraudulent items on the bank of first deposit</u>, not the bank the check was drawn on or their customer?**, and again, a resounding approximately 90% agreed.

We encouraged the respondents to explain the reason they support this position to shift the liability to the bank of first deposit and we received the following comments which are indicative of the whole.

> The bank of first deposit should know their customers and review the account activity to make sure it makes sense.
>
> We agree. They should know their customer and who is depositing or cashing checks and they are the ones who are able to see the physical check being

> presented to see if anything looks suspicious; if they agree to accept mobile deposits, they decide to accept that risk.
>
> They have the duty to know their customer based on their CIP. If an item doesn't match the customer's banking pattern, a hold can be placed and should be placed on that item. This would allow them time to verify the funds with the maker's bank and conduct any further necessary research into the matter.
>
> The biggest problem is that apparently, no one [at the Largest Financial Institutions] looks at the checks for deposit. In most cases, they are clearly altered.
>
> The victims of check fraud and their banks should not be held liable for other's [bank of first deposit] activity. Paying [community banks] are trying to lessen the amount of fraud claims being opened by reviewing checks for signature and stock. We are doing our part.
>
> Shifting the liability would force [the Largest Financial Institutions] to impose greater security measures to prevent fraud from [even] entering the banking system.
>
> If this requirement were put into place, the odds are so much greater that banks that know their customers (i.e., community banks) would suffer less losses.

Many expanded their response to include the broader issue of fraudulent accounts being opened into which these fraudulent items are being deposited.

> The big banks are obviously not doing a good enough job at new customer due diligence.
>
> I know our community bank must bend [over] backward to collect this [account holder identity] information so that we have a reasonable assurance that this customer is not opening an account for fraudulent purposes.
>
> This is 100% the reason for the continuing fraud. If the large banks did not open online accounts with fraudulent identities and had a PERSON reviewing deposit items, and placing proper holds on funds, we would most likely not have these issues.

> The regulators expect community banks to adhere to the Know Your Customer requirements, but it does not appear that they hold the larger banks to the same standard.
>
> We do our due diligence and expect the same in return.

One member rightly raised the perennial issue of how regulatory changes meant to reign in the misdeeds and excesses of the largest banks will eventually trickle down to impact innocent community banks when he said, "[W]e are not generally supportive of new laws and regulations that always end up being a compliance burden for small community banks like ours."

This is a caution that CBAI is constantly raising with the Regulators.

Again, this year, we asked, **Please describe <u>your bank's most frustrating single experience</u> in trying to resolve a fraudulent return, and/or, describe the attitude you have experienced by the offending banks/credit unions in trying to resolve these items.** In this and the following question, our members were vocal about their frustrations. These responses are indicative of the whole.

> Most of these [large] banks don't even communicate or care that they have fraudulent customers who are doing business through their institution and are unwilling to assist in these cases.
>
> I contacted a large bank to make them aware that their customer was depositing fraudulent checks and was told they could not speak with me because I was not their customer.
>
> We attempted to contact one of the nation's largest banks in hopes of alerting them to fraudulent activity by their customers at one of their branches and in hopes of freezing that account while the [reimbursement] paperwork was being processed. We got passed around to seven (7) different departments and at the end of the day, we got absolutely nowhere. There was no urgency on their part at all.
>
> Every check fraud claim has been a long process that requires a lot of manpower hours on phone calls, research, and more calls to try to get a satisfactory resolution.

> Many large banks immediately indicate that it is the drawee bank's problem without completing any research and or knowing there is an issue with the account at their big bank.
>
> They keep giving you the runaround and ask for more information, and then act like they never received that information, and keep dodging the issue.
>
> We return it, they return it … it's a waste of time and resources.
>
> Megabanks do not take the precautions that small community banks do, which is probably why many of these checks are deposited through them.
>
> Their attitude is, it's not their problem – it's ours.
>
> It is completely unconscionable what the largest banks have foisted onto community banks.

There were three comments that clearly warrant additional robust investigation by the Regulators.

> Large banks are automatically sending back late claim returns, <u>even those returned on the same day</u>.
>
> One of the nation's largest banks was running us in circles for "additional information" <u>that is not required by regulation</u>. We were asked for a copy of a police report, a letter of circumstance, an account agreement, and a Positive Pay confirmation for them to process the claim.
>
> We see larger banks responding with "Claims under $1,000 will not be processed" – then we must fight them to just follow the regulations as <u>there are no set dollar limits.</u>

One success story was highlighted when the community bank escalated their complaint to the large bank's prudential regulator.

> In the spring of 2022, we initiated a breach claim against one of the nation's largest banks. After six attempts [to resolve the matter], in the fall of 2023, we escalated the complaint to the bank's prudential regulator. We then received a

> check for the full recovery after nearly 18 months from the time we initiated the original claim.

It would seem that in the first instances several of the largest banks may not be following the regulations and in the last instance, one of largest banks apparently only satisfied a reasonable and justified claim against them when they were singled out in a complaint to their prudential regulator. Such behavior is completely unconsionable and entirely within the Reguators' responsibility to identify, address, and prevent.

Illinois community banks are wondering when they will start to see meaningful results of that engagement.

We asked our members to, **Please share any additional information that would help policymakers to better understand the issue, and how to resolve it, for the benefit of your community bank and the integrity of the banking industry.** We received the following thoughtful comments.

> Review the privacy laws and guidance for check verification between FIs. Privacy laws have tied many banks' ability to verify if a check is valid. We are not trying to gain personal information; we are only trying to protect our customers and their customers as well.
>
> We need simpler, clearer rules and laws that state who is responsible for the different varieties of check fraud.
>
> Fraudulent or counterfeit checks should have a 60-day return window which is the same as ACH transactions. Customers often have no idea there was a fraudulent transaction on their account until they receive their statement.
>
> With Reg CC timelines being so short, there is no way to be sure checks are good before banks are required to make funds available.
>
> One of the biggest issues we face is the amount of time it takes for banks to process claims and the lack of updates we receive during that process. If timeframes were put in place requiring claims to be resolved in sixty (60) calendar days, we would need fewer updates and also have the legal standing to back us up when claims are not resolved in a timely manner. Really, it doesn't

> take four months to determine if a check made payable to ABC or XYZ, LLC was deposited erroneously into John Doe's account.
>
> I believe there is a lack of understanding and appreciation [by the Regulators] for what community banks spend on serving and protecting their customers. Increased human resources are required and while new technologies are being put in place to address fraud - it's expensive. Most small community banks cannot continue to bear all these additional costs.

Recommendations

<u>Joint Supervisory Guidance</u>

In CBAI's February 2023 letter, we called on the Regulators to issue Joint Supervisory Guidance which would clearly identify the current problem and state the regulators' expectations for the largest banks' good business practices, professionalism, and common courtesy in reasonably attending to, communicating about, and prompt closure of Fraudulent Returns being submitted to them for reimbursement.

Our members believe that the Largest Financial Institutions are creating a weak link in this chain of criminal activity in the banking system by permitting fraudulent accounts (many of which are opened online through websites and using phone apps) to be opened in the first place. The fraudulently altered checks are then deposited in these fraudulent accounts (many delivered remotely and through remote deposit capture) and then cause significant harm when the checks clear back to community banks and their customers' accounts.

Consequently, this year CBAI is expanding our urging for Joint Supervisory Guidance to also include rigorous examination and enforcement to ensure the Largest Financial Institutions are complying with all laws, rules and regulations concerning the opening of deposit accounts.

We hear that the Regulators are reluctant to issue Joint Supervisory Guidance which is directed solely at the Largest Financial Institutions regarding Check Fraud. In the face of the urgent need for this Guidance, the lack of any such guidance being issued in 2023 would strongly suggest this is the case. Our members remind the Regulators that these Large Institutions are apparently the source of the Check Fraud problem in the banking industry and this absolutely does warrant such regulatory guidance. In addition, it is a well-established responsibility of the Regulators to tailor regulation and guidance based on the risks and business models of different financial institutions. CBAI believes the community bank business model and risks, given their superior due diligence in knowing their customers and not opening fraudulent accounts, warrant their being exempt from regulatory guidance concerning detecting and deterring check fraud.

CBAI renews its call on the Regulators to promptly issue Joint Supervisory Guidance directed at the Largest Financial Institutions to ensure they are able to detect and deter the opening of fraudulent accounts and promptly and reasonably reimburse community banks for Fraudulent Returns.

<u>Enhanced Supervision and Enforcement</u>

Hand in hand with Joint Supervisory Guidance, the Regulators must robustly examine and enforce against the Largest Financial Institutions for any compliance failures regarding Check Fraud. Here again, over the past year, CBAI is not aware of any enforcement actions against the Largest Institutions despite the Regulators being completely aware of the significant extent of Check Fraud, the problems with community banks receiving reimbursements for Fraudulent Returns, and the obvious harm it is causing community banks, their customers, and the negative perception it creates by those being harmed by Check Fraud which jeopardizes the integrity of the banking system.

The Regulators' examination of the Largest Financial Institutions should focus on their apparent failure to adequately comply with KYC/BSA/AML/CDD/CIP which permits fraudulent accounts to be opened. In focusing on the Largest Institutions' policies, procedures and practices, and where there are suspicions regarding an account application (i.e., red flags), they should not be opening the account until all the suspicions have been dispelled. In questionable situations, using how community banks operate as an example, they should either refuse to open a suspicious account, perform enhanced due diligence, place an extended hold on the deposited item(s), or put them through for collection, all of which increases the likelihood of a fraud being deterred before a loss is suffered by any bank.

CBAI urges the Regulators to promptly embrace their examination and enforcement responsibility with respect to the Largest Financial Institutions and Check Fraud.

Increased Involvement by the Regulators in Reimbursements for Fraud Returns

As stated earlier by one of our members, there has been some progress in resolving reimbursements for Fraudulent Returns. Resources provided by others have helped to better inform banks about how to navigate the reimbursement process, although these efforts have fallen short of addressing the origin of Check Fraud in the banking industry. Much more needs to be done by the Regulators and the Largest Financial Institutions to address reimbursements for Fraud Returns.

The continued frustration of community bankers illustrates how unreasonable it is for a community bank to spend many months trying to resolve a fraud reimbursement claim sometimes even after they have escalated their complaint to the federal banking regulators.

CBAI believes this lack of progress in addressing the problem of delays in being reimbursed for fraudulent returns is unacceptable and does an enormous disservice to and harms the community banks. CBAI urges the Regulators to increase their involvement in resolving Fraudulent Returns.

Other Recommendation

CBAI encourages the Regulators to engage with community banks and their trade associations to explore other avenues to address Check Fraud and Fraudulent Returns. CBAI would happily participate in those discussions.

Conclusion

CBAI and its members believe Fraudulent Returns and Check Fraud in the banking industry are problems caused by the Largest Financial Institutions. Our Survey results clearly indicate the problem is increasing in scope and severity. The Regulators have the responsibility, and CBAI urges them to significantly increase their involvement and impact and become a meaningful part of the solution to the symptom and origin of this problem.

CBAI urges the Regulators to initiate Joint Supervisory Guidance, to ensure that reimbursement requests for Fraudulent Returns are being resolved promptly and reasonably by the Largest Financial Institutions. The Regulators should also robustly examine and enforce against the Largest Institutions to identify and address any compliance shortfalls that permit the opening of fraudulent accounts (many of which are opened online through websites and phone apps). These are the fraudulent accounts into which fraudulent items are deposited and which clear back to community banks, harming them and their customers, and undermining the integrity of the banking system. These Large Institutions need to be held accountable for their apparent safety and soundness and compliance failures by all their Regulators.

If you have any questions or need any additional information, please contact David Schroeder at (847) 909-8341 or davids@cbai.com.

We thank you in advance for your timely response to this letter.

Sincerely,

/s/

David G. Schroeder
Senior Vice President
Federal Governmental Relations