



JODI PRATT & ASSOCIATES
Fraud Consulting for the Financial Services Industry

A White Paper on:
**Remote Deposit Capture and
Its Unintended Fraud Consequences**

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Overview



With the rate of change, the risk of creating new dangers increases dramatically.

Every new banking¹ solution threatens to create unrecognized fraud exposures. With the rate of change currently experienced in the industry, the risk of creating new dangers increases dramatically as criminals discover ways to leverage the new processes against the old. As an industry, bankers must temper their enthusiasm over new potential revenue streams with thorough assessments of where new threats may lurk and how to best neutralize these risks before releasing offerings that cannot easily be recalled. Without this care, the industry will find itself exposed to even more devastating vulnerabilities, the results of which return to financial institutions in increased losses, increased regulations and increased customer dissatisfaction, not to mention increased criminal funding.

An example of this is the case of “converting” paper checks into electronic transactions in order to expedite payments. While bankers are well aware of the need to eliminate the nation’s dependence on a paper-based payment system, the process of releasing the paper check from the payments process before final payment creates entirely new risks that the industry has not faced before. This issue first emerged with the Automated Clearing House’s (ACH) “hybrid” transactions (i.e. “Point of Purchase” or “POP”, “Represented Check” or “RCK” and “Account Receivables” or “ARC”). Fortunately, the checks which launch these transactions - and which become payment flotsam after they are converted - remain in somewhat controlled and limited “private” environments after conversion and large-scale fraud issues have not yet been attached to them.²

¹ Use of the word “bank” in this paper (in all of its forms) is intended to include commercial banks, savings banks, thrifts, credit unions and any other financial institutions that offer RDC or have customers whose checks could become converted in the RDC process of another bank.

² POP paper checks are handed back to the maker after being converted by a participating merchant’s cashier, where it is expected the maker will retain the check appropriately. RCK checks are used by banks to try to collect on previously returned checks and ARC checks are used in lockbox operations, both of which tend to be fairly well controlled environments.



Banks are on the verge of an even more adventurous conversion service: “Remote Deposit Capture” (RDC, also known as “Distributed Capture”). With RDC, business customers are allowed to image the check on their own premises, electronically submitting their deposits. There are many benefits for both customers and banks. From a fraud perspective, however, the retention of the paper check in “public” hands once an RDC transaction has been created threatens to result in increased counterfeiting, forgery and identity theft (including account takeover) as criminals realize these items are available in a large number of non-bank - and very likely less diligently monitored - locations.



Disenfranchised checks threaten to increase counterfeiting, forgery and identity theft losses.

The Importance of Image and Remote Capture

There is no question that converting paper checks into electronic payments to expedite processing is a necessary step to better protect the national payments system. From a fraud perspective, the time and location factors required to move paper checks from negotiation to payment create days of opportunity for float-oriented frauds. The American payments system, once an innovative and globally envied payment clearing network (which dates back to the 1960s and has been relatively unchanged), now seems archaic as the rest of the modern world has leap-frogged into the electronic payments age.

From the 9/11 experience it was realized that continued dependency on a paper-based payments system creates a tremendous exposure to the nation’s economic infrastructure where monetary flow can be brought to a near-standstill by simply impeding the national transportation system. While financial institutions are working diligently to encourage customers to use electronic payment vehicles such as credit cards, debit cards, ACH and on-line bill payments, nearly 40M checks still are written in the U.S. every year and are declining at a much slower rate than most banks have been anticipating.³ Electronic payments have been increasing steadily, but many are replacing cash, not check, transactions. Considering

³ Recent “check decline” statistics range widely, usually between 3-10% per year. According to Wade Delk, Executive Director of the Check Payments System Association, however, studies related to check order volumes indicate a less than 3% decline from 2004 to 2005. This suggests that checks will continue to be a popular method of payment for a much longer time than many expect.

that paper is still and will continue to be a significant portion of the payments business for the foreseeable future, a method of conversion of paper to electronics is crucial to eliminate national solvency vulnerabilities.

Banks have been moving aggressively to update the clearing system to a predominantly electronic model since October 2004, when Check 21⁴ removed the last barrier through the creation of the “substitute check”. Originally, the purpose of this effort was to enable banks to truncate the paper checks that they receive and to use electronic means, in lieu of paper, to send image and payment information between banks. With the checks remaining in the banks’ control until destruction, there was little concern about the checks getting into the wrong hands.

With the implementation of Check 21, banks realized that they could also use this process internally to easily and quickly move images of items to operating centers anywhere around the world, allowing them to further consolidate and centralize functions, such as exceptions processing. ATM deposit processing is another example of a procedure that could benefit from this option: daily pick ups from ATMs in outlying areas could be reduced to once or twice a week by image-enabling ATMs and using deposited check images for daily transaction posting. Although bulk filing transit checks would present a new challenge, the checks would remain within the banking domain and would still enjoy the protection and control of banking security.

However, the next step, certainly a natural extension of the remote capture concept, subtly creates a significant but unintended fraud risk consequence that, to this point, has been largely overlooked and underappreciated.



There is expectation that electronic check settlement will eliminate check fraud. This is incorrect.

The Unintended Fraud Risk of Paper Check Conversion

There is great excitement about the “fraud reduction” opportunity of check image capture and electronic settlement to the extent that some believe this “will eliminate check fraud”.

⁴ Common name for “The Check Clearing for the 21st Century Act”

This is incorrect. While electronic check presentment will greatly reduce *float-related* check fraud, there are aspects of check *and other payment frauds* which it does not address. In fact, it easily contributes to them.

First, the removal of paper checks from the payment process in this manner does not resolve the issue of the *existence* of the paper checks. The fact that paper checks are being created means that check fraud will continue to exist. Electronic check payment does not address counterfeit check or forgery (neither maker's signature nor endorsement) losses.⁵

Further, the check contains personal customer and account information that is needed to commit other types of payment frauds:

- The name, address, phone number and all too often, driver's license number and social security number imprinted on check stock provides a good foundation for use in identity frauds.
- A check that includes the customer's signature provides the criminal with a sample of the customer's legitimate signature so that a "skilled" forgery can be developed.
- The MICR line on the bottom of the check provides valid complete payment routing information so that debit transactions - such as telemarketing drafts or internet charges - can be affected against that account number.

Every individual written check - pre- or post- conversion - in the wrong hands bears the risk of being source information for any number of payment frauds downstream.

With RDC, both the banks and the banks' business customers are putting others at increased personal risk - without their knowledge or consent. With society's and the government's concern over privacy, security and accountability, fraud resulting from poorly implemented RDC is bound to receive much unwanted attention.

⁵ In that payment is expedited, frauds may be discovered sooner and therefore subsequent fraud attempts also may be identified sooner, minimizing overall losses. The fraud prevention field has developed a number of image-based fraud prevention concepts that can be moved to the point of check presentment that will help alleviate additional fraud, but it will be several years before widespread deployment of these is possible as the needed network infrastructure does not yet exist.



RDC increases the personal risk to check writers without their knowledge or consent.

How does the danger manifest itself? To provide a little more clarity, first consider the strengths of the historical paper check clearing process. When a check is first entered into the clearing process, it is presented as the debit half of a two part transaction. When presented as a deposit, the check is coupled with a credit to an account, and from that point until it is paid against the drawer's account, perhaps even at another bank, the check cannot be removed from the payment stream without being noticed - something would be out of balance. Money does not leave the drawer's account until the check has been received at the drawer's bank, at which point the check is either returned to the customer or retained in safekeeping at the bank until it is destroyed after the appropriate retention period. Therefore, someone wishing to use the check or the information that is on it for any other purpose would have great difficulty in removing it from the payment stream without being caught, if not immediately, soon thereafter due to the audit trail provided. Opportunity for loss is greatly diminished.



The paper check clearing process kept checks protected within the payment stream; with RDC, the check is removed from this protection.

With the RDC process, the check is removed from this protection. The payment continues and will be made based on the electronic debit. The check, no longer important to achieve payment, is out of the tracked process. Where it goes from there and what might happen to it along the way is not monitored and will very likely remain unknown.

Remote Deposit Capture Risk Mitigation

Even the best of ideas can become an albatross if implemented hastily. Before the basic “remote image capture” process has been in production - internally in the banking community - long enough to be thoroughly tested, RDC already is being extended to business customers. Where it was originally discussed by only a few of the largest banks as a special product to be offered to only a few, very special business customers, RDC suddenly has become a major competitive product to offer by banks of all sizes and for business customers of all sizes to participate in.⁶

⁶ “Making the Case for Remote Deposit Capture”, Karen Epper Hoffman, Banking Strategies, May/June 2006.

RDC, offered broadly by competing banks, could create an economic environment where tens of thousands of businesses each hold a portion of the millions of disenfranchised paper checks which have become an inconvenient by-product of their primary business purpose. These businesses are likely to be completely unaware that converted checks still have value to the criminal community, and many will not have the knowledge or the ability to provide adequate protection for them. If the banking community, which *is* in the financial information security business, has found itself challenged to protect its customers' information, how prepared and able will their non-bank customers be to handle this same type of hazard? And what will the public perception of the bank's responsibility be in offering this service, knowing the risk that results from it? Most importantly, how can these risks be mitigated, before RDC becomes an established practice?



Banks should establish a risk analysis process specific for RDC to determine whether or not a business customer should be a candidate for the service.

Understanding that the banking industry is moving forward with RDC, the following are recommendations to reduce the risk to the extent possible:

- Risk rate potential RDC business customers. Banks should establish a risk analysis process specific for RDC to determine whether or not a business customer should be a candidate for the service. The checklist should include: reviewing their process of receiving checks for payment; their plans for converting the checks into images and securing the paper checks after conversion; their plans for maintaining control over the retained checks in a secure environment; the process for check removal and destruction after the retention period; etc. It also should include a review of the business's general management practices. Many businesses are lax in handling their own sensitive information, as evidenced by lack of segregation of bookkeeping duties; easy access to the company's own check stock and signature plates by employees; control of petty cash; etc. Businesses who do not appear to understand or appreciate their own risks should not be allowed to participate in RDC, where so many others' information would be put in jeopardy.
- Ensure that responsibility for paper check control is clearly articulated in the RDC customer agreements. Along with all the other terms, the RDC customer agreement should also make clear the expectations for paper check handling before and after the RDC process, including the retention schedule and the method of proper destruction. It should also articulate the client's responsibility for damages done to

the bank or any of its customers as a result of the RDC customer's lack of proper compliance and control, since accountability encourages responsibility.

- Educate the RDC customer about criminal interest in acquiring paper checks. As mentioned earlier, RDC customers are unlikely to realize the fraud risk associated with the retention of the paper checks from the RDC process. Bank officers offering the service should be responsible to explain why the control of these items is so important. This education should include: white-collar criminals have use for any kind of check, even an already negotiated one; scanning, photocopying or faxing checks is just as dangerous as having checks removed from the premises so control over these functions also should be monitored; “insiders” (e.g. employees, contractors, agency temporary staff), including the most trusted employees, can be compromised with surprising ease and therefore, should have extremely limited access to the checks before, during and after conversion during RDC; if *their* customers become victims of fraud due to failure of the business to protect their paper check, it will very likely damage their relationship with that customer.
- Document the education session. Both the RDC customer and the bank officer who performs the education should sign a statement that confirms that these risks were explained, which should be retained as part of the bank documentation. This process will re-enforce the importance 1) to the bank officer to review this with the customer and 2) to the customer regarding the risks.
- Offer check safekeeping and destruction services. Banks can offer a service to allow RDC customers to deliver their RDC checks in a convenient manner and timeframe (e.g. through night deposit or by registered mail service) to the banks for retention and eventual destruction. The image technology used for RDC can be used both to create a separate image file for the “safekeeping” checks and to automate the verification of checks received against the images sent. This would greatly reduce the risk of check misuse. It would also allow the bank to offer another revenue generating service that supports RDC.
- Increase public awareness of “check conversion” and what it means. The only way to eliminate check fraud is to eliminate the creation of paper checks in the first place. This is a good opportunity to inform the general public about the changes in the payments environment, why they are necessary and that many of their checks



Education of all customers could produce the long anticipated watershed event – a shift from paper checks to a predominantly electronic payments preference.

soon may be converted into electronic payment before reaching the banking system. This is also a good time to explain the benefits in the electronic payment methods provided by your bank⁷ as a way to minimize the exposure of sensitive information that is presented with paper checks.

Summary

The general public will hold banks responsible for RDC and, therefore, any negative reactions that occur from it. Not only is the RDC customer in jeopardy, but also the retail customer whose information is being put at risk. Compromised accounts and fraud losses become the banks' problem and expense, and their customers' enmity will be directed toward the bank as well. Beyond that, with the continued attacks of white-collar crime and escalating attempts by criminals to fund their far-reaching enterprises, as leaders of the socio-economic community, banks will want to be viewed as proactive in minimizing new exposures.

Other check conversion services are in development that create the same "check disenfranchisement" risks as RDC⁸. With the awareness that new threats are emerging from changes in old practices, banks will be expected to demonstrate sound judgment in the creation and offering new services. Education of all customers could help RDC usher the long awaited watershed event - a societal shift from the paper check to a predominantly and fully electronic payments preferences.

For assistance in creating your fraud-related RDC policies, practices and customer risk analysis process, or other payments fraud issues, feel free to contact Jodi Pratt and Associates via email at jpratt@jodiprattandassociates.com.

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⁷ Offerings may include bill payment services, on-line banking, debit card use, ACH, etc.

⁸ For example, the National Automated Clearing House Association (NACHA) has recently approved the "BOC" (Back Office Conversion) echeck transaction, allowing merchants to convert checks in the back room, similar to ARC.