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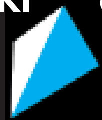
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THE CHECK FRAUD LANDSCAPE: Banks, Acts, Amendments, and Controls

Banks and Governance

It is no accident that stories in the press covering board room shake-ups, financial scandals and tales of corporate-land fraud steer back to a singular theme: governance. "If you read the headlines in the financial press, you might think that every financial institution in the United States discovered corporate governance two years ago when the Sarbanes-Oxley act was enacted" stated Dr. Susan Schmidt Bies before the Annual Convention of the Arkansas Bankers Association on May 17, 2004. And she was not too far off the mark based on data she provided. In the same speech, Dr. Bies referenced studies performed on community banks that give bank corporate governance practices a 'C' grade "with a needs improvement notation". Her point was to show the linkage of underperforming governance to the risk of loss resulting from inadequate internal processes, people, and systems. She then offered three best practices to all banks, imploring them to modify Sarbanes-Oxley to be relevant for individual businesses and cultures.

These recommendations were to:

1. Adopt a recognized internal control framework, i.e. a version of COSO
   - Because this framework describes how the elements of internal control can be scaled up and down for large and small companies, application can be cost-effective, providing stakeholders with timely, decision-critical information.

2. Adopt a program for independently assessing the effectiveness of internal controls on at least an annual basis
   - Such an assessment can validate the internal control system designed by senior management and effected throughout the organization, assisting oversight bodies in comprehending specific business risks and the quality of the controls in place to address those risks.

3. Adopt a framework for assessing operational risk
   - As exposures to risk proliferate from evolving business processes and changes in the regulatory and litigious environment, understanding, measuring, and evaluating risk now is paramount to identifying improvement and devolvement in the future.

In light of the governance-rejuvenating guidance provided to the bankers association, all companies would benefit to know that there are standards of ordinary care that should be followed to prevent check fraud and minimize losses if check fraud occurs.

Acts and Amendments

On October 28th, 2004 The Check Clearing Act for the 21st Century, or "Check 21", became effective. Although this law's purpose is to promote innovation in the payment system and to improve payment system efficiency, many think the law will create new fraud risks. Check 21 permits financial institutions to process a "substitute check" or a digital image of an original check in an attempt to cut down on paper usage in the banking industry. Banks are expected to broaden their services to cater to the needs of

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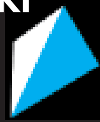
CENDROWSKI  CORPORATE ADVISORS
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customers by offering things such as online digital check viewing. However, according to Unisys, an institution that processes half of the world's checks, banks are not properly equipped to mitigate fraud associated with this new technology.

Now, couple that with some recent amendments to articles 3 and 4 of the Uniform Commercial Code that make it easier for banks to share check fraud losses with banking customers and you've got evidence suggesting those customers' exposure to fraud has risen. But there are ways to reduce this exposure. The first relates to how banks deflect loss liability to the customer. To do that, the bank must show comparative negligence in the standards of ordinary care customers should have had in place to prevent check fraud. This comparative negligence scheme is new and it allows losses to be attributable based on fault. For instance, if standards of ordinary care as regards to internal controls, taking advantage of certain bank services (e.g. Positive Pay), using quality check paper stock, and physically securing checks, signature stamps, and other such paraphernalia, are not followed, the banking customer may be 75 percent at fault and the bank only 25 percent at fault. And therefore, any monetary loss would be split based on those percentages.

Updating Practices

Additional ways to prevent check fraud - and other types of corporate fraud - depend on assessing and updating governance and control practices as needed. For example, Unisys suggests that financial institutions synchronize both written and online check functions in order to better protect their customers from Check 21 related fraud. That would be a new key control. We recommend that customers institute fraud deterrence practices proactively and not only after fraud is found or discovered. Such an effort would begin by implementing the three best practices Dr. Bies highlights above. It may be an effort that initially surprises companies by the extent of necessary improvements they find, but an honest assessment of where you stand as an organization will help define the action plans of continuous improvement.

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