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COMMUNITY BANKING ADVISOR



OLD SCHOOL SCAMS IN A DIGITAL WORLD
Combating the surge in check fraud

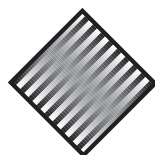
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COMMUNITY BANKING
ADVISORY NETWORK

OLD SCHOOL SCAMS IN A DIGITAL WORLD

Combating the surge in check fraud

Despite the rapid growth of digital payment methods, paper checks are still widely used. The Federal Reserve processed nearly 3 billion commercial checks and 36 million government checks in 2024. So, it's no surprise that check fraud continues to pose a significant threat to banks, businesses and consumers. Indeed, incidents of check fraud have surged in recent years. The U.S. Department of the Treasury reported in early 2024 that check fraud had increased nationwide by 385% since the beginning of the pandemic.

To combat check fraud, banks need to familiarize themselves with the most common schemes, learn to spot red flags, and take steps to protect their customers and themselves.

WHAT ARE SOME COMMON CHECK FRAUD SCHEMES?

Check fraud typically falls into one of two categories:

1. Counterfeit instrument schemes. In a counterfeit instrument scheme, a criminal with access to routing and account numbers may create a fake check that looks like the real thing and attempt to deposit or cash it. Some counterfeiting schemes take advantage of misconceptions regarding "guaranteed" forms of payment, such as cashier's checks or money orders. Contrary to popular belief, deposits of these payments can be reversed, even after the funds have been made available to the depositor.

For example, suppose Sara accepts a job offer via LinkedIn. The "employer" sends her a cashier's check for \$5,000 to purchase a computer, printer, and other equipment and

supplies from an "approved vendor." She deposits the check, and the funds become available the next business day, so she wires the money to the vendor as instructed. The computer and other items never arrive, and a few days later, the payor bank, flagging the check as counterfeit, returns it unpaid. Sara's bank reverses the deposit, so the wire transfer comes out of her own funds.

2. Mail theft-related check fraud. As the name suggests, this involves criminals who steal checks from U.S. Postal Service (USPS) collection boxes or residential mailboxes and use them to commit fraud. Once checks are stolen, they can be misused in several ways, including:

- ▶ Check washing, where a criminal uses a solvent to remove ink from a check and enter a new amount and payee,
- ▶ Using the bank routing number and account number to create counterfeit checks,
- ▶ Fraudulently endorsing and depositing checks,
- ▶ Forging signatures on blank checks, and
- ▶ Selling them on the "dark web."



This type of fraud is widespread. The Financial Crimes Enforcement Network (FinCEN) recently reported that in the six months after issuing an alert on this topic in February 2023, it received more than 15,000 Bank Secrecy Act (BSA) reports from more than 800 financial institutions on mail theft-related check fraud. This represented nearly \$700 million in reported suspicious activity. Further analysis revealed three primary uses of stolen checks: 1) 44% were altered and then deposited, 2) 26% were used as templates to create counterfeit checks, and 3) 20% were fraudulently signed and deposited.

WHAT CAN BANKS DO?

There are several steps banks can take to combat check fraud. These include:

Using secure check stock. This may incorporate watermarks, microprinting, holograms or chemicals to make counterfeiting harder.

Offering positive pay to customers. With a positive pay program, a business customer sends the bank a list of checks it has issued. When checks are presented for payment, the bank cross-checks them against the list and, if the details don't match, sends them to the business to approve or reject them.

Educating customers and bank employees. Both customers and employees need to be aware of common check fraud schemes and the red flags of suspicious transactions. (See "Check fraud red flags" at right.)

Establishing a policy for exception holds. Current regulations require banks to make funds available quickly. However, banks can extend hold periods when there's reason to believe a check is counterfeit or has been altered.

Encouraging customers who mail paper checks to protect themselves. This may include not letting mail sit in their mailboxes, depositing mail inside the post office, and signing up for the USPS's Informed Delivery service, which allows them to preview mail that's scheduled to arrive soon.

CHECK FRAUD RED FLAGS

The Financial Crimes Enforcement Network (FinCEN), working with the U.S. Postal Service, has identified several red flags of check fraud for banks to monitor. For example, take note if a customer:

- ▶ Writes an unusually large check to a new payee,
- ▶ Complains that checks were stolen from the mail and deposited in an unknown account,
- ▶ Claims that the intended recipient never received a check,
- ▶ Uses check stock that's noticeably different than that used by the issuing bank for known, legitimate transactions,
- ▶ Makes a sudden, unusual check deposit (often electronically) followed by a rapid withdrawal or transfer of funds,
- ▶ Produces a check that shows faded handwriting underneath darker handwriting, or
- ▶ Opens an account that's used only to deposit checks, followed by frequent withdrawals and fund transfers.

These red flags aren't conclusive indicators of fraud. But they may warrant further investigation.

Of course, the most effective deterrent against mail theft-related fraud is to encourage customers to use electronic payment methods rather than paper checks whenever possible.

HOW CAN YOU PROTECT YOUR BANK?

Despite advances in digital payments, check fraud remains a costly threat. Banks can take proactive steps to deter and detect these schemes, thereby reducing their exposure. This includes educating employees on how to spot fraud and educating customers on how to protect themselves. ■

DOES YOUR BANK HAVE A SOLID SUCCESSION PLAN?

Management stability is a critical factor in your bank's long-term profitability. A well-crafted succession plan can help ensure that any key personnel changes, whether expected or unexpected, are handled in a way that minimizes operational disruptions and ensures a seamless transition.

Yet many community banks fail to proactively address succession planning or forget to update their plans when circumstances change. Here's a look at some strategies to help ensure your bank's continuity — regardless of personnel loss or any other developments.

CONSIDER THESE FACTORS

A bank's succession plan must be tailored to your bank's size, complexity, location, culture, risk profile, product and service mix, management "bench strength," and other characteristics. With that in mind, here are some strategies to consider:

Look within. There are many advantages to identifying internal candidates to succeed the CEO and other key management personnel. They're already immersed in your bank's culture and familiar with its operations, goals and strategies. Another big advantage of promoting from within is that your board of directors is likely familiar with internal candidates' work and personalities.

Create a leadership development program.

A formal program for developing potential successors improves your chances of identifying internal successors. By providing training, mentoring and coaching, you help candidates develop the skills they need to succeed in a management role — and you have an opportunity to evaluate their performance over time. In addition, investing in your employees' professional development may help with retention.



Consider external candidates. Although promoting from within has significant advantages, in some cases, considering external candidates may be necessary or desirable. For example, if a CEO or other executive departs unexpectedly, you might not have a suitable internal candidate. Or perhaps the board feels that your bank would benefit from an outsider's fresh perspective or experience at other types of institutions.

Look beyond the CEO. Many banks' succession plans are limited to the top role. But it can be equally important to plan for the departure of other key positions — such as the CFO, chief risk officer or chief technology officer — as well as division or department heads who are critical to the bank's operations and success. As you review your bank's organizational

chart, examine each position, consider the potential impact of a sudden vacancy and plan accordingly.

Think both short- and long-term. It's important to have a short-term plan in case someone leaves unexpectedly. This may involve designating interim successors who can fill in until a permanent replacement is found (which, in some cases, may be the interim successor). To minimize disruptions, a bank can use cross-training to ensure the availability of backup staff who can temporarily assume management responsibilities.

Make implementation part of your plan.

Outlining your succession goals and strategies isn't enough. Your plan should also include a "playbook" that sets forth the implementation process. For example, if you plan to hire from outside the bank, the playbook should specify where you'll look for candidates, where you'll post job listings and how you'll identify the right people for the job. It might include checklists or other tools for evaluating candidates.

Communicate your plan. Transparency is key. Discuss your plans with all involved and manage

candidates' expectations to avoid losing people when one person is selected as successor. Make sure participants view the process as a career development opportunity, not a competition, and that you have a clear career path for those who aren't chosen.

A succession plan isn't something you can put on a shelf and forget about until it's time to implement it. To ensure that your plan continues to make sense for your institution, review it periodically and update it if necessary to reflect changes in your bank's strategies, size, product and service offerings, regulatory environment, or other circumstances.

PLANNING PAYS

To minimize operational disruptions, establish a comprehensive, formal succession plan before any personnel losses occur. Your plan should be multifaceted and encompass everything from job descriptions to essential qualifications to evaluation methods. Having a robust plan waiting in the wings helps ensure leadership continuity, preserve institutional knowledge and maintain stakeholder confidence. ■

CECL compliance

DON'T OVERLOOK Q FACTORS

Now that the industry has fully adopted the current expected credit loss (CECL) model, federal banking agencies have shifted their attention from assessing banks' preparation for and implementation of the model to evaluating banks' allowances for credit losses (ACLs). One important area the agencies are now focusing on is the impact of qualitative factors ("Q factors") on the ACL. So, banks must get ready to explain and document how they incorporate Q factors into their ACL calculations.

DEFINING Q FACTORS

Before the CECL guidance went into effect, banks generally measured credit impairment based on incurred losses. The CECL standard requires a forward-looking approach, under which banks recognize an immediate allowance for all expected credit losses over an asset's life. Various methods are available for estimating ACLs, and banks have significant flexibility in selecting a model that's both appropriate and practical in light of a bank's complexity, resources and available data.

Many models rely on quantitative calculations based on a bank's historical loss experience. As a result, they may not fully capture a bank's future loss expectations. To ensure that these loss expectations are captured, the CECL guidance advises banks to consider relevant and supportable Q factors that address risks not captured by quantitative calculations. These factors include (but aren't limited to) the:

- ▶ Nature and volume of the bank's financial assets,
- ▶ Existence, growth and effect of any credit concentrations (for example, if 80% of a bank's loans are concentrated in real estate),
- ▶ Volume and severity of past-due financial assets,
- ▶ Value of underlying collateral for cash-flow-dependent loans,
- ▶ Bank's lending policies and procedures, including changes in underwriting standards, collections, write-offs and recoveries,
- ▶ Quality of the bank's credit review function,
- ▶ Experience, ability and depth of the bank's lending and other staff,
- ▶ Existence of external factors, such as the regulatory environment, competition or natural disasters (for instance, if a new bank that offers similar products opens in the community), and
- ▶ Impact of actual and expected changes in market conditions in the bank's locality or other areas in which it operates (for instance, if the local unemployment rate is higher than the national average).

The updated credit loss standard also lists several additional Q factors specific to held-to-maturity debt securities as of the reporting date.

INCORPORATING Q FACTORS INTO ACL CALCULATIONS

The CECL standard provides little guidance on how banks should incorporate Q factors into their ACL calculations. However, the Office of the Comptroller

of the Currency outlines adjustment approaches for banks to consider. Some examples from the Comptroller's Handbook include:

- ▶ Standalone adjustments made after the quantitative ACL is calculated,
- ▶ Model overlays, or adjustments to individual inputs within a model to raise or lower historical loss rates for a loan pool, and
- ▶ A combination of both approaches.

THE CECL GUIDANCE ADVISES BANKS TO CONSIDER RELEVANT AND SUPPORTABLE Q FACTORS THAT ADDRESS RISKS NOT CAPTURED BY QUANTITATIVE CALCULATIONS.

Although the approach of developing these factors is necessarily subjective, it is essential for banks to develop a comprehensive Q-factor methodology. This will ensure the bank is applying the factors consistently, providing support for the decisions with quantitative data as much as possible, and generating thorough documentation to the examiners to support the bank's adjustments.

A TEMPORARY ADJUSTMENT

Revisit qualitative adjustments at least annually to ensure they're not duplicating information reflected in the quantitative loss estimation process. Suppose, for example, a bank adjusts projected losses based on newly relaxed underwriting standards. Over time, the bank's quantitative ACL calculations would begin to capture actual losses (such as charge-offs) resulting from those relaxed standards. Eventually, the Q-factor adjustment amount should decline (and ultimately disappear) as its impact is reflected in the bank's historical loss data. Stay on top of these developments to keep your bank in compliance with CECL guidance and ensure you're not overestimating its expected losses. ■

BANK WIRE

ARTIFICIAL INTELLIGENCE IN FINANCIAL SERVICES

A recent report by the U.S. Department of the Treasury, *Artificial Intelligence in Financial Services*, examines the ways artificial intelligence is transforming the banking industry. The report covers the opportunities AI creates for innovation and efficiency, as well as the many risks it presents, including risks related to data security, bias, consumer protections and reliance on third parties. It makes a number of recommendations for enhancing current regulatory frameworks and encouraging collaboration among governments, regulators and the industry to mitigate these risks.

The report also highlights the need for banks that rely on AI models and systems developed by others to conduct robust due diligence on their AI providers. You can find the report at <https://home.treasury.gov/system/files/136/Artificial-Intelligence-in-Financial-Services.pdf>. ■



WATCH OUT FOR “TRIGGERING TERMS” IN MARKETING MATERIALS

When developing marketing materials — including website content and ads — banks need to watch out for “triggering terms” that require additional disclosures under the Truth in Lending Act and Regulation Z. For example, triggering terms for closed-end credit offerings, such as mortgages and auto loans, include the amount or percentage of any down payment (for

example, “only 5% down”), the number of payments or the repayment period (for example, “60-month payment terms”), payment amounts (such as “\$200,000 loan for only \$700 per month”) or finance charges (such as “\$750 total cost of credit”). Ads that include any of these terms must also “clearly and conspicuously” disclose the down payment amount (though the term “down payment” need not be used), the repayment terms and the annual percentage rate.

Banks should establish policies, procedures and tools (checklists, for example) to ensure that their ads and other marketing materials comply with Regulation Z. ■

SURVEY SAYS ...

The Conference of State Bank Supervisors (CSBS) recently published the results of its 2025 Annual Survey of Community Banks, which provides valuable insights into the challenges, risks and opportunities banks face. Here are some highlights:

- ▶ Community banks cited net interest margins as the most important external risk they face, followed by core deposit growth, economic conditions, cost of technology and cost of funds.
- ▶ Regulation, named the top external risk in 2024, fell to sixth, “as community bankers expressed less concern over regulatory burden amid a changing political landscape.”
- ▶ The top internal risk reported by community banks was cybersecurity, followed by technology implementation and related costs, and credit. Liquidity dropped from third to fourth.
- ▶ Community banks’ biggest competitors in most areas, respondents said, are other community banks, while local regional banks are their primary competitor for payment services. In addition, in-market nonbanks are their top competitor for wealth management and retirement services.

To view the survey, visit <https://www.csbs.org> and type “annual survey of community banks” in the search box. ■

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ANDREWS HOOPER PAVLIK PLC
5300 Gratiot Road, Saginaw, MI 48638

Community Banks

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