Evaluation Report
2024-SR-B-004
February 7, 2024

Board of Governors of the Federal Reserve System

Material Loss Review of Heartland Tri-State Bank

Office of Inspector General
Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

Office of Inspector General
Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

Executive Summary, 2024-SR-B-004, February 7, 2024

Material Loss Review of Heartland Tri-State Bank

Finding

Heartland Tri-State Bank failed because of alleged fraudulent activity conducted by the bank's chief executive officer (CEO), who initiated a series of wire transfers totaling about $47.1 million of Heartland's funds, among other suspicious activities, as part of an apparent cryptocurrency scheme referred to as "pig butchering." Significant internal control breakdowns and the influence of the CEO as a dominant management official created an opportunity for the series of apparently fraudulent wire transfers to be initiated and processed. These wire transfers significantly impaired Heartland's capital and liquidity, causing the bank to become insolvent.

The Federal Reserve System began supervising Heartland in 2017, when the bank converted from a national bank to a state member bank. From 2017 through 2022, the Federal Reserve Bank of Kansas City (FRB Kansas City) participated in one full-scope examination led by the Kansas Office of the State Bank Commissioner (OSBC) and conducted two risk-focused full-scope examinations. These examinations included reviews of Heartland's compliance with the Bank Secrecy Act and related anti-money laundering regulations. FRB Kansas City examiners determined that Heartland had adequate internal control policies for a bank of its size.

FRB Kansas City promptly initiated a target examination on July 25, 2023, after Heartland's chief financial officer contacted FRB Kansas City and the OSBC to discuss the CEO's alleged fraudulent actions and Heartland's deteriorated condition. As a result of a target examination of Heartland's condition, FRB Kansas City examiners concluded that the wire transfers significantly impaired Heartland's capital and liquidity and that the volume and severity of problems identified appeared to be beyond the ability of the bank's board and management to control or correct. These weaknesses prompted a significant downgrade of the bank's CAMELS composite rating and each of the component ratings to a 5, or *critically deficient*.

On July 28, 2023, the OSBC closed Heartland and appointed the Federal Deposit Insurance Corporation as the receiver.

Recommendations

Our report contains recommendations designed to increase awareness of cryptocurrency scams and relevant preventive and detective controls at banks. In response to our draft report, the director of the Division of Supervision and Regulation concurs with our recommendations and outlines actions to address them. We will follow up to ensure that the recommendations are fully addressed.

Purpose

In accordance with the requirements of section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, we conducted a material loss review of Heartland to determine why the bank's failure resulted in a material loss to the Deposit Insurance Fund (DIF); to assess the Board's and FRB Kansas City's supervision of Heartland during our period of review, January 2017 through July 2023; and to make recommendations, as appropriate.

Background

Heartland, headquartered in Elkhart, Kansas, a rural community in southwestern Kansas, was a state member bank primarily focused on agricultural lending with about $139 million in assets as of March 31, 2023. FRB Kansas City, under delegated authority from the Board, supervised Heartland along with the OSBC. On August 9, 2023, our office received notice that Heartland's failure would result in a material loss to the DIF.

Office of Inspector General
Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

Recommendations, 2024-SR-B-004, February 7, 2024

Material Loss Review of Heartland Tri-State Bank

Finding: The Board Can Increase Awareness of Cryptocurrency Scams and Relevant Controls to Prevent and Detect Potentially Fraudulent Wire Activity

Number	Recommendation	Responsible office
1	Increase awareness among state member banks of cryptocurrency scams by providing an informational update that a. describes characteristics of prevalent cryptocurrency scams and how banks can identify such scams. b. reminds state member banks of existing guidance on how and when to report suspicious activity.	Division of Supervision and Regulation
2	Provide training to examiners on prevalent cryptocurrency scams and relevant preventive and detective controls at banks.	Division of Supervision and Regulation

Office of Inspector General
Board of Governors of the Federal Reserve System
Consumer Financial Protection Bureau

MEMORANDUM

DATE: February 7, 2024

TO: Michael S. Gibson
Director, Division of Supervision and Regulation
Board of Governors of the Federal Reserve System

FROM: Michael VanHuysen
Associate Inspector General for Audits and Evaluations

SUBJECT: OIG Report 2024-SR-B-004: *Material Loss Review of Heartland Tri-State Bank*

We have completed our report on the subject evaluation. We conducted this evaluation to satisfy our statutory mandate to review the Board of Governors of the Federal Reserve System's supervision of a failed institution when the loss to the Deposit Insurance Fund is material. This mandate is in section 38(k) of the Federal Deposit Insurance Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

We provided you with a draft of our report for review and comment. In your response, you concur with our recommendations and outline actions that will be taken to address our recommendations. We have included your response as appendix B to our report.

We appreciate the cooperation that we received from the Board and the Federal Reserve Bank of Kansas City during our evaluation. Please contact me if you would like to discuss this report or any related issues.

cc: Jennifer Burns
Arthur Lindo
Mary Aiken
Todd Vermilyea
Kavita Jain
Karen Caplan
Suzanne Williams
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Contents

Introduction

Objective

Our objective for this evaluation was to determine why Heartland Tri-State Bank's failure resulted in a material loss to the Deposit Insurance Fund (DIF); to assess the Board of Governors of the Federal Reserve System's and the Federal Reserve Bank of Kansas City's (FRB Kansas City) supervision of Heartland during our period of review, January 2017 through July 2023; and to make recommendations, as appropriate.[1]

Background

Institution Overview

Heartland, headquartered in Elkhart, Kansas, a rural community of about 2,000 people, was a state member bank with about $139 million in assets as of March 31, 2023.[2] The bank operated four branches primarily focused on agricultural lending. FRB Kansas City, under delegated authority from the Board, supervised the bank along with the Kansas Office of the State Bank Commissioner (OSBC).[3]

Heartland's Chief Executive Officer

Heartland's chief executive officer (CEO) had prominent roles in the bank, the Kansas banking community, and the local community in Elkhart. The CEO joined Heartland's predecessor bank in 1993. In late 2011, he led a group of investors that acquired the National Bank of Elkhart. From 2011 to 2017, he served as CEO and president of that bank, which would eventually become Heartland. He was one of the larger shareholders in Heartland's holding company. The CEO previously held roles, such as committee member and chair, in state and national banking trade associations. Interviewees described the CEO as an important figure in Elkhart who held leadership roles in local organizations.

Heartland's Failure

On July 28, 2023, the OSBC closed Heartland and appointed the Federal Deposit Insurance Corporation (FDIC) as the receiver. The FDIC estimated the cost of the failure to be about $54 million, which exceeds the $50 million threshold for a material loss to the DIF. Another bank in Kansas acquired Heartland on July 28, 2023. On August 9, 2023, our office received notice that Heartland's failure would result in a material loss to the DIF.

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[1] This review fulfills a statutory mandate and does not serve any investigatory purpose.

[2] On the date of its failure, July 28, 2023, Heartland had approximately $122 million in total assets.

[3] In 2017, the OSBC and FRB Kansas City began supervising Heartland following their approval of the National Bank of Elkhart's charter application for the bank to become a state member bank named Heartland Tri-State Bank.

When a loss to the DIF is considered material, section 38(k) of the Federal Deposit Insurance Act, as amended by section 987 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires that the inspector general of the appropriate federal banking agency

- ascertain why the institution's problems resulted in a material loss to the DIF
- review the agency's supervision of the failed institution
- make recommendations, as appropriate

Federal Reserve System Supervision Structure

The Board plays a significant role in supervising and regulating banking organizations, including bank holding companies and state member banks.[4] The Board seeks to ensure that the banking organizations under its supervisory authority have safe and sound business practices and comply with all applicable federal laws and regulations. Within the Federal Reserve System, the Board delegates to each Federal Reserve Bank the authority to supervise financial institutions located within the Reserve Bank's District. The Board's Division of Supervision and Regulation (S&R) oversees the Reserve Banks' execution of these responsibilities and issues supervisory policy and guidance to assist the Reserve Banks in executing that authority.

[4] A *bank holding company* is a company that owns or controls a bank. A *state member bank* is a depository institution that is chartered as a bank by a state and is a member of the Federal Reserve System.

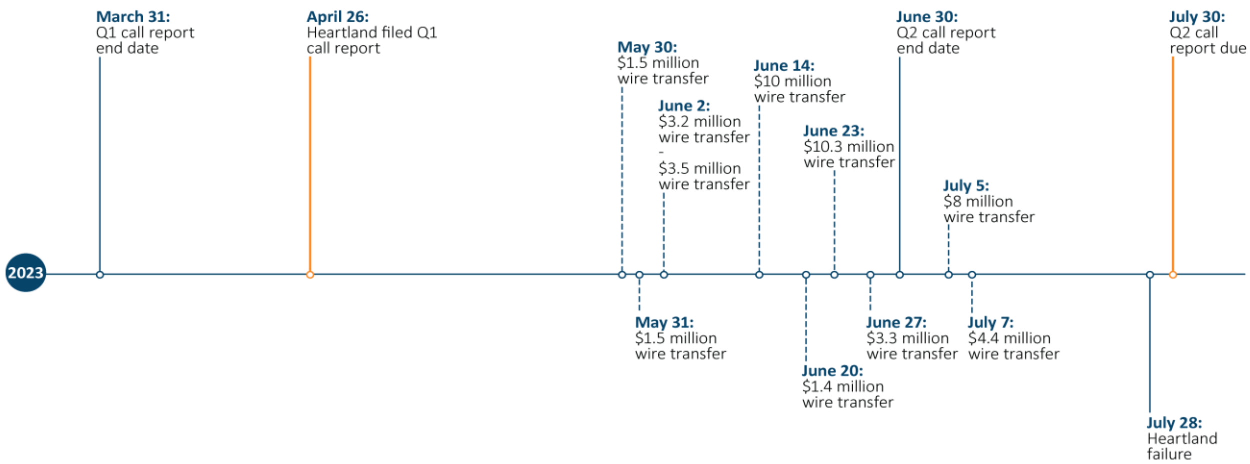
Causes of Failure

Heartland failed because of alleged fraudulent activity conducted by the bank's CEO, who initiated a series of wire transfers totaling about $47.1 million of Heartland's funds, among other suspicious activities, as part of an apparent cryptocurrency scheme referred to as "pig butchering."[5] Significant internal control breakdowns and the CEO's influence as a dominant official created an opportunity for the series of apparently fraudulent wire transfers to be initiated and processed. These wire transfers significantly impaired Heartland's capital and liquidity, causing the bank to become insolvent.

CEO's Alleged Fraudulent Activity

From May 30, 2023, to July 7, 2023, Heartland's CEO initiated a series of 10 outgoing wire transfers totaling about $47.1 million of Heartland's funds to a cryptocurrency wallet in the CEO's name (figure 1).[6] According to FRB Kansas City staff, the CEO then transferred the funds to cryptocurrency accounts that FRB Kansas City staff believed were controlled by scammers. These wire transfers were made between call report due dates.[7]

Figure 1. Timeline of Outgoing Wire Transfers



Source: OIG analysis of wire transfers initiated by Heartland's CEO and call report data.

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[5] U.S. Department of the Treasury, Financial Crimes Enforcement Network, *FinCEN Alert on Prevalent Virtual Currency Investment Scam Commonly Known as 'Pig Butchering'*, FIN-2023-Alert005, September 8, 2023.

[6] Heartland relied on the services of a correspondent bank to process its wire transfers. A correspondent bank provides payment services for another bank, which can include wire transfers; check clearing and payment; trade finance; cash and treasury management; and securities, derivatives, or foreign exchange settlement; among other services.

[7] Every national bank, state member bank, insured state nonmember bank, and savings association is required to file a Consolidated Report of Condition and Income, known as a *call report*, as of the close of business on the last day of each calendar quarter. Bank regulatory agencies use call reports to monitor the condition, performance, and risk profile of individual institutions and the industry. Except for certain institutions, call reports are due no more than 30 calendar days after the report date. Heartland's call report as of March 31, 2023, which was due by April 30, 2023, was filed on April 26, 2023, and its call report as of June 30, 2023, was due by July 30, 2023. Institutions do not provide call reports to bank regulatory agencies between call report dates.

The dollar size of the wire transfers made from May 30, 2023, to July 7, 2023, appears to be unusual for Heartland. For example, as part of FRB Kansas City's 2022 full-scope examination, the bank provided the Reserve Bank with a list of wire transfers made in April 2022. Heartland initiated 16 outgoing wire transfers in April 2022 ranging from $500 to approximately $2.6 million. The $2.6 million transfer was the only wire transfer that the bank initiated over $1 million during that time frame. In contrast, the 10 wires sent from May 30, 2023, to July 7, 2023, ranged from $1.4 million to $10.3 million.

Heartland nearly exhausted its sources of liquidity to fund the CEO's wire transfers. Heartland funded the CEO's wire transfers through its lines of credit at a correspondent bank and by borrowing from a federal home loan bank.[8] According to its March 31, 2023, call report, Heartland had no borrowings from any institutions. As of the last week of July 2023, the week of Heartland's failure, the bank had used about $24 million of its lines of credit at the correspondent bank leaving only about $700,000 of that credit line unused.[9] During June and July 2023, Heartland borrowed about $21 million from a federal home loan bank. The federal home loan bank borrowings were not typical for Heartland. In the 3 prior years, Heartland had not borrowed any funds from a federal home loan bank.

Apparent "Pig Butchering" Cryptocurrency Scam

FRB Kansas City interviewees said the CEO's wire transfers appear to be part of a cryptocurrency scam known as "pig butchering." According to an alert issued by the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN), this scam involves a scammer convincing a victim (a pig) to invest in supposedly legitimate virtual currency investment opportunities and then steals the victim's money—butchering the pig.[10]

Scammers may use fictitious identities, false relationships, and elaborate storylines to make the victim believe they are in a trusted partnership. Once a relationship has been established, the scammer introduces the victim to a supposedly lucrative investment opportunity in virtual currency and directs the victim to use investment websites or applications designed to appear legitimate but that are fraudulent and ultimately controlled or manipulated by the scammer. The scammer convinces the victim to deposit increasingly larger amounts. Often, once the victim invests with the scammer, the scammer will show the victim fictitious, extraordinary returns.

Before the wire transactions that led to the failure, the CEO executed small cryptocurrency transactions through another bank as early as January 2023—some of those transactions appeared to involve his personal funds and funds potentially belonging to other entities. In the subsequent weeks and months, the CEO began transferring larger dollar amounts including the 10 wire transfers that caused the bank to

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[8] The Federal Home Loan Bank System is composed of 11 regional banks, which are privately capitalized and owned as cooperatives by their member financial institutions. A federal home loan bank may make a secured loan to a member financial institution. Loans for terms of more than 5 years may only be for residential housing finance or to community development financial institutions for certain small business and development activities, while loans for terms of 5 years or less may be for any purpose.

[9] We were unable to determine the stated purpose of these transactions or who initiated the transactions from the examination records.

[10] According to media reports, organized crime and human trafficking organizations in some foreign countries are some of the groups that perpetuate pig butchering scams.

fail.[11] These transactions to cryptocurrency exchanges that are of increasing amounts over time appear to be consistent with the progression of a pig butchering scam.

FRB Kansas City staff conducted two interviews with Heartland's CEO during the week of the bank's failure to better understand the events that occurred. The CEO provided Reserve Bank staff screenshots of messages and supposed cryptocurrency account statements. Reserve Bank staff found the CEO's explanations for his activities to be unreliable and inaccurate because the CEO's explanations for the transactions did not make sense and were difficult to follow.

Internal Control Breakdowns and the Influence of a Dominant Official

Heartland employees circumvented the bank's internal controls and policies; following those internal controls and policies may have prevented or detected the alleged fraudulent activity. We believe that the CEO's dominant role in the bank and prominent role in the community contributed to a reluctance on the part of Heartland employees to question or report the alleged fraudulent activities earlier.

Internal Control Breakdowns

The events leading to Heartland's failure revealed a significant breakdown of internal controls, including controls related to wire transfers and suspicious activity reports (SARs). Specifically, senior bank employees circumvented the bank's wire policy and daily limits to approve and process the CEO's alleged fraudulent wire transfer requests. Additionally, Heartland employees did not follow the bank's Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) (together, BSA/AML) policy.

Heartland Employees Circumvented the Bank's Wire Policy and Limits

Before June 24, 2023, Heartland employees had daily wire limits of $5 million per sender, which were built into the wire system. Heartland's board approved a wire policy on June 24, 2023, that

- reduced the daily wire limit to $3 million per sender
- listed the employees who were trained and approved to access the wire system
- implemented a dual control system that required more than one employee to complete a transaction
- required that every wire be approved by an officer
- required the information technology officer to oversee compliance with the policy and report periodically to Heartland's board

The CEO's wire requests were inconsistent with both Heartland's prior and recently implemented wire transfer limits and appeared to be unusual given the bank's agricultural lending business. The wire

[11] A media report on the events related to Heartland's failure noted the CEO's increasing desperation to obtain funds, presumably to perpetuate the cryptocurrency scheme. Because of the nature of the CEO's alleged fraudulent actions and how quickly Heartland's condition deteriorated, we do not know the source of funds for all of the CEO's transfers to cryptocurrency platforms.

requests included the name and account numbers of a cryptocurrency platform. Three of the seven wire transfer requests processed before June 24 exceeded the applicable $5 million limit. These requests exceeded the $5 million applicable limit by $1.7 million to $5.3 million per sender. All three of the wires processed after the implementation of the wire policy on June 24 exceeded the new $3 million limit. Those wires exceeded the limit by $300,000 to $5 million per sender. Despite the atypical recipient and the dollar amounts of each transfer significantly departing from prior wire activity and established limits, Heartland's chief financial officer (CFO) and other bank employees approved the wire transfers. We believe that had Heartland employees followed the bank's policies, they would have not processed the wires that led to the bank's failure.

A senior bank regulator noted that bank wire policies should establish a tiered system of approvals based on the title or duties of the requester and the dollar amount of the requested wire transfer. For example, if an officer requests a wire transfer above a certain dollar threshold, the transaction should require the board's approval. Heartland did not have such a tiered wire policy. We believe if Heartland had implemented a tiered wire policy, Heartland's board of directors may have had an opportunity to detect and potentially prevent the unusual activity that eventually caused the bank's failure.

Heartland Employees Did Not Comply With the Bank's BSA/AML Policy

Heartland's BSA/AML policy instructed bank employees to remain alert to possible suspicious transactions. The policy also states that either the BSA officer or BSA team should discuss potentially suspicious activity and decide whether to file a SAR.[12] Among other expectations, Heartland's BSA/AML policy required employees to file a SAR for insider abuse involving any dollar amount. It also required the BSA compliance officer to identify whether incoming and outgoing wire transfer activity was consistent with a customer's business.

Heartland employees did not comply with the bank's BSA/AML policy. The 10 wires, processed from May 30, 2024, through July 7, 2024, significantly varied in dollar size from Heartland's typical wire activity and were directed to a cryptocurrency platform, and many exceeded the bank's daily wire policy limits. We did not identify evidence that Heartland employees assessed the CEO's wire transfer activity to determine whether to file a SAR. It was not until July 24, 2023, after processing the 10 wires, that the bank's CFO/BSA compliance officer filed a SAR. On July 27, 2023, an FRB Kansas City staff member assisted the CFO in filing an amended SAR that included additional information about the CEO's wire transfer activity. We believe that had Heartland employees questioned the wires and filed a SAR on the CEO's potentially fraudulent activity sooner, the losses to the DIF may not have been as significant.

[12] Heartland's BSA/AML policy required the BSA compliance officer to file SARs within the expected filing period. Under SAR regulations, financial institutions are required to file a SAR within 30 calendar days from the date on which facts are initially detected that may constitute a basis for filing a SAR if a person of interest is known. If no suspect was identified on the date of detecting the incident requiring the filing, a financial institution may delay filing a SAR for an additional 30 calendar days to identify a suspect. In no case shall reporting be delayed more than 60 calendar days after the date of initially detecting a reportable transaction. The date of initially detecting the facts may be different than the date of the potentially reportable transaction. We were unable to determine an exact date when Heartland employees initially detected that the CEO's wire transfer activity may have constituted a basis for filing a SAR.

Influence of a Dominant Official

FRB Kansas City interviewees said that bank employees may have been hesitant to question or report the CEO's activities because he had a dominant role in the bank and was a prominent figure in the community. As previously noted, the CEO had worked at Heartland and its predecessor bank for about 30 years. He was one of the larger shareholders in Heartland's holding company. Interviewees noted that the CEO also held important leadership roles in the local community.

Examiners described the CEO as a dominant official in their 2017 and 2022 examination reports. FRB Kansas City interviewees said that the CEO was a dominant figure with respect to policies and procedures because he was highly involved in the daily operations of Heartland. FRB Kansas City interviewees said that it is not uncommon for small banks to have a dominant official and that it is not necessarily a cause for concern.

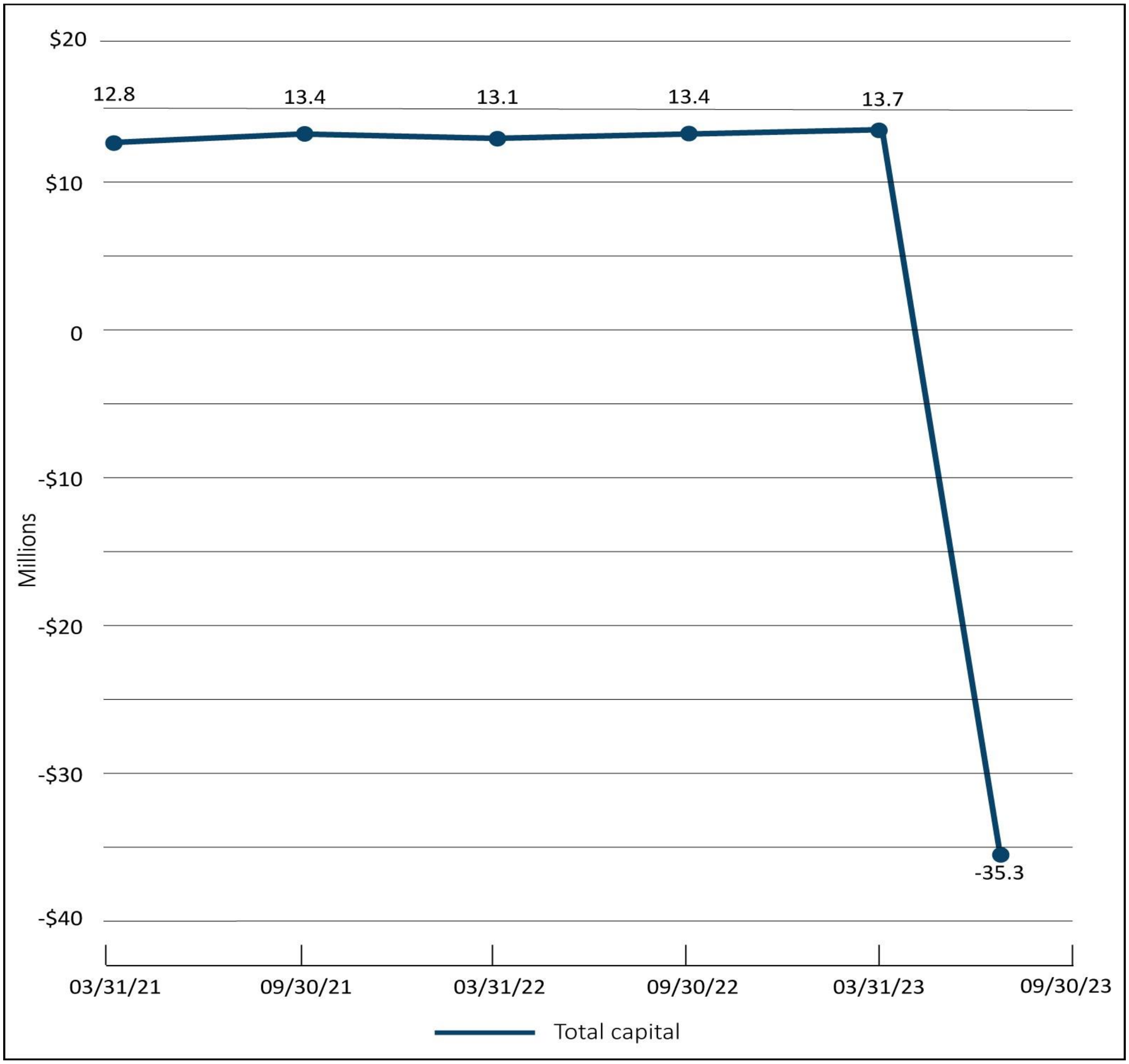
We believe that while it may not have been a cause for concern at the time, the CEO's position and prominence in the community contributed to the failure. Heartland's CEO was active in the Kansas banking industry and served on many boards and committees. The CEO evaded the applicable wire transfer policy limits by allegedly instructing bank employees to execute transactions for his apparent benefit. An interviewee noted that typically when suspicious activity involving insider abuse occurs at a bank with a dominant official, most employees involved explain that they were following the orders of that dominant official. In our view, the CEO's role and reputation, as well as the fact that the bank employees who approved the wires were the CEO's subordinates, contributed to the employees' reluctance to raise questions or report the suspicious activity sooner.

Critically Deficient Capital

Heartland was well capitalized before the CEO's wire transfers. According to Heartland's March 31, 2023, call report, the bank had $13.7 million in capital. Because the wire transfers occurred during the second and third quarters of 2023, the impairment to Heartland's capital was not evident in the call report as of March 31, 2023, the most recent call report Heartland filed. Heartland failed before filing its call report as of June 30, 2023, which was due by July 30, 2023.

During the week of Heartland's failure, FRB Kansas City staff determined that Heartland had a capital deficit of about $35.3 million (figure 2).

Figure 2. Heartland's Total Capital, March 31, 2021, Through July 27, 2023



Source: Federal Financial Institutions Examination Council call report data and FRB Kansas City staff analysis.

In a letter to Heartland's board, FRB Kansas City staff also concluded that the funds the CEO distributed to other cryptocurrency addresses were largely uncollectable and, as a result, that Heartland's capital and liquidity were critically deficient. According to an interviewee, Heartland's board was unable to recapitalize the bank, so the OSBC closed the bank.

Supervision of Heartland

From August 2017 through June 2022, FRB Kansas City complied with the examination frequency guidelines in section 1000.1 of the *Commercial Bank Examination Manual* (CBEM).[13]

Table 1. Supervisory Overview of Heartland, 2017–2023

Examination				CAMELS composite, component, and risk management ratings							
Start date	Report issue date	Scope	Agency conducting examination	Composite	Capital	Asset quality	Management	Earnings	Liquidity	Sensitivity	Risk management
08/14/2017	10/13/2017	Full	FRB Kansas City, OSBC	2	1	2	2	2	2	2	No rating
04/01/2019	05/24/2019	Full	FRB Kansas City	2	2	2	2	2	2	2	2
10/26/2020	01/05/2021	Full	OSBC	2	2	2	2	2	1	1	No rating
06/21/2022	08/10/2022	Full	FRB Kansas City	2	2	2	2	2	1	1	2
07/25/2023	07/26/2023	Target	FRB Kansas City, OSBC[a]	5	5	5	5	5	5	5	No rating

Source: FRB Kansas City and Kansas OSBC examination reports from January 2017 to July 2023.

[a] Supervisory actions taken included a Prompt Corrective Action letter and troubled condition notice.

[13] The System and the state banking agency can examine certain small institutions once during an 18-month period if those banks have total assets less than $3 billion, are well capitalized, received a CAMELS management component rating of 1 or 2 in the most recent Reserve Bank or applicable state agency examination, received a CAMELS composite rating of 1 or 2 in the most recent Reserve Bank or applicable state agency examination, and were not subject to a formal enforcement proceeding or action, among other requirements.

Supervision History From 2017 to 2022

The Federal Reserve System became the primary federal regulator for Heartland in 2017, when the bank converted from a national bank to a state member bank. FRB Kansas City participated in the 2017 full-scope examination led by the OSBC. The 2017 examination assessed Heartland's condition as part of the charter conversion application process. Subsequently, FRB Kansas City conducted risk-focused, full-scope commercial examinations in 2019 and 2022. According to those two examination reports, examiners evaluated Heartland's critical risks and its management's and board's ability to identify, measure, monitor, and control those risks. These examinations also included full-scope reviews of the bank's compliance with the BSA and related AML regulations.

Matters Requiring Attention

FRB Kansas City's 2019 full-scope examination report contained four Matters Requiring Attention (MRAs).[14] One MRA required Heartland's management to improve credit risk practices for agricultural lending. Two MRAs involved information technology issues. The other MRA required Heartland to document the bank board of directors' annual reviews and approvals of the per-person daily wire transfer dollar limits. In its follow-up activities related to the wire limit MRA, FRB Kansas City reviewed documentation evidencing that Heartland's board had reassessed the wire transfer dollar limits. In our view, the resolution of this MRA had no bearing on the bank's eventual failure—the internal control breakdown that contributed to Heartland's failure involved bank employees processing the wire transfers in violation of the established daily wire transfer dollar limits, apparently at the CEO's behest.

The 2022 FRB Kansas City report of examination noted that Heartland had no outstanding MRAs and concluded that Heartland's board and management appropriately addressed all previous MRAs identified at the 2019 examination. Examiners did not identify any new MRAs during the 2022 examination.

Assessments of Heartland's Board of Directors, Management, and Control Environment

Heartland's board of directors comprised six external directors and three internal directors. The outside directors were farmers and local small business owners with expertise in agriculture and commercial sales. During the 2022 examination, FRB Kansas City examiners determined that Heartland's board oversight was adequate.

In both the 2019 and 2022 full-scope examination reports, FRB Kansas City concluded that Heartland's operational risk was moderate and stable and that the bank had acceptable risk management practices. In addition, the reports concluded that management was satisfactory. The examiners also concluded that Heartland's BSA/AML compliance program was satisfactory in relation to the bank's size, location, and low money laundering and terrorist financing risk profile.

In each examination between 2017 and 2022, FRB Kansas City examiners determined that Heartland had adequate internal controls. The examiners also determined that Heartland's management had

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14 The CBEM defines *MRAs* as matters that the System expects a banking organization to address over a reasonable period of time.

established a sound internal control environment through separation of duties, dual controls, and timely and independent account reconciliations. FRB Kansas City examiners concluded that Heartland had an audit function that was appropriate for its size and the nature and scope of its activities consistent with the expectations outlined in the CBEM.

July 2023 Target Examination

On Friday, July 21, 2023, Heartland's CFO alerted its FRB Kansas City central point of contact of the bank's troubled financial condition.[15] The CFO reported that the CEO had initiated a series of outgoing wire transfers totaling a significant amount relative to the bank's capital. Upon receiving this alert, FRB Kansas City examination staff and Board staff acted swiftly. Once FRB Kansas City and the Board became aware that the CEO's alleged fraudulent activities likely caused irreparable damage to Heartland's capital and liquidity, they effectively coordinated with other regulators to ensure an orderly resolution of the bank. FRB Kansas City satisfied applicable prompt corrective action (PCA) notice requirements by issuing a PCA letter and designating the bank as critically undercapitalized.[16]

Target Examination Activities

According to interviewees, FRB Kansas City contacted the OSBC and the FDIC to share information and coordinate a response over the July 22–23, 2023, weekend. FRB Kansas City then initiated a target examination to better understand the potentially fraudulent activity and Heartland's condition. FRB Kansas City staff conducted interviews with the CEO and reviewed Heartland's wire transfer and accounting records. FRB Kansas City staff began working onsite at Heartland on Tuesday, July 25, 2023.

An FRB Kansas City analyst with previous cryptocurrency crime experience analyzed the alleged fraudulent transactions. The analyst explained that once the scammers had control of the funds, they immediately divided and transferred the funds to many different cryptocurrency account addresses. The analyst indicated that this created a spiderweb effect with many different trails, some of which were fake, and that tracing these trails and mapping the location of the cryptocurrency would be difficult because of the spiderweb. We believe locating and recovering the cryptocurrency the CEO purchased with Heartland's funds would have been impossible during the week of the bank's failure. FRB Kansas City ultimately determined that the funds from the cryptocurrency transactions were largely unrecoverable.[17]

Supervisory Ratings Downgrade and Notice of Troubled Condition

As a result of the target examination, FRB Kansas City and OSBC examiners concluded that the wire transfers significantly impaired Heartland's capital and liquidity and that the volume and severity of problems identified appeared to be beyond the ability of its board and management to control or correct.

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[15] The *central point of contact* is the individual designated to lead the supervision of the institution.

[16] The main purpose of PCA is to promptly resolve capital deficiencies at insured depository institutions and thereby reduce bank failures.

[17] After Heartland's failure, the FRB Kansas City analyst determined that law enforcement could freeze and potentially recover a portion of the cryptocurrency funds, totaling about $8 to $12 million. However, the recovery of these funds would take time and would not have been sufficient to restore Heartland's capital.

These weaknesses prompted a downgrade of Heartland's CAMELS (capital, asset quality, management, earnings, liquidity, and sensitivity to market risk) component and composite supervisory ratings.[18] Specifically, FRB Kansas City and the OSBC downgraded each of Heartland's CAMELS component ratings three or four levels, from previous component ratings of 2, 2, 2, 2, 1, 1 in August 2022 to 5, 5, 5, 5, 5, 5 in July 2023. FRB Kansas City also downgraded Heartland's composite rating three levels, from 2 to 5, or *critically deficient*.

Representatives from FRB Kansas City, the OSBC, and the FDIC held an exit meeting with Heartland's board of directors on July 25, 2023. The next day, FRB Kansas City and the OSBC issued a joint letter providing formal notice to Heartland's board of directors that they downgraded the bank's composite rating and deemed the bank to be in troubled condition. The letter informed Heartland's board that the bank posed a significant risk to the DIF and that the bank's failure was highly probable.

Implementation of PCA

FRB Kansas City examiners reviewed Heartland's capital during the July 2023 target examination. An interviewee noted that there was $36.2 million in a suspense account, which another interviewee said obscured Heartland's capital losses. An additional interviewee stated that the regulators required Heartland to properly record the amount as a loss to capital. FRB Kansas City examiners then analyzed Heartland's capital and determined that Heartland's tangible equity ratio was -19.3 percent, far below the 2 percent threshold for *critically undercapitalized*.[19] On July 27, 2023, FRB Kansas City sent a PCA letter to Heartland's board of directors, informing them of the change in Heartland's capital category.

Once examiners determined that Heartland's capital depletion was irreparable, FRB Kansas City interviewees said the Reserve Bank's goal became ensuring that the bank remained solvent until July 28, 2023, so the FDIC's Division of Resolutions and Receiverships had time to market Heartland to other banks for acquisition. Another bank in Kansas acquired Heartland on July 28, 2023—1 week after FRB Kansas City became aware of the events that led to the failure.

Conclusion

FRB Kansas City supervised Heartland based on its risk profile. In our view, the Reserve Bank had no reason to suspect that the events that led to Heartland's failure were likely or probable given its prior history as a satisfactorily rated bank. Once FRB Kansas City and the Board became aware of the alleged fraudulent activity and its crippling effect on Heartland's capital and liquidity, they acted promptly to address the issues at Heartland. We determined that FRB Kansas City also issued a PCA letter, designating the bank as critically undercapitalized.

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[18] For state member banks, examiners assign a numerical composite rating as well as individual component ratings. Ratings range from 1 to 5, with 1 indicating the least supervisory concern and 5 indicating the greatest supervisory concern.

[19] The tangible equity ratio is calculated by subtracting intangible assets, such as goodwill, from the bank's common equity and then dividing the result by the bank's tangible assets. Per the CBEM, PCA assigns state member banks to one of five capital categories (*well capitalized*, *adequately capitalized*, *undercapitalized*, *significantly undercapitalized*, and *critically undercapitalized*). The PCA statute and accompanying regulations for state member banks, subpart D of Regulation H, impose mandatory and discretionary restrictions on a state member bank to remain at least *adequately capitalized*. PCA defines *critically undercapitalized* as a tangible equity ratio of less than 2 percent.

Finding: The Board Can Increase Awareness of Cryptocurrency Scams and Relevant Controls to Prevent and Detect Potentially Fraudulent Wire Activity

According to the Federal Bureau of Investigation (FBI), cryptocurrency investment scams have seen significant increases in the number of victims and the dollar losses to those victims. Losses from cryptocurrency investment fraud increased 183 percent from 2021 to 2022. Multiple FRB Kansas City interviewees indicated that state member banks could benefit from additional information about common cryptocurrency scams. State member banks would be better positioned to protect themselves and their customers with an increased understanding of these types of scams. Heartland's internal controls failed to ensure that the CEO's alleged fraudulent wire transfer activity was prevented and reported in a timely manner. If Heartland employees had assessed and reported the CEO's wire transfer transaction activity earlier, law enforcement and regulators may have intervened sooner, potentially reducing losses to the DIF from Heartland's failure.

Significant Rise in Cryptocurrency Scams

According to the FBI's Internet Crime Complaint Center (IC3), the incidence and sophistication of cryptocurrency scams are increasing significantly. The FBI also stated that cryptocurrency investment scams saw unprecedented increases in the number of victims and the dollar losses. Fraud schemes involving cryptocurrency, including pig butchering, represented the majority of investment scams reported to the IC3. Cryptocurrency investment fraud rose from $907 million in 2021 to $2.57 billion in 2022, a 183 percent increase.

Need for Greater Cryptocurrency Scam Awareness

Multiple FRB Kansas City interviewees indicated that state member banks could benefit from additional information about common cryptocurrency scams. Banks could better protect themselves and their customers with an increased understanding of these types of scams. An FRB Kansas City senior official stated that bankers at other institutions asked for more information about the scam that contributed to Heartland's failure so they could take steps to prevent such events from happening at their banks.

Heartland's Internal Controls Failed to Prevent and Report Potentially Fraudulent Activity Timely

As part of an alleged pig butchering cryptocurrency scheme, Heartland's CEO sent 10 wires using the bank's funds to a cryptocurrency wallet in his name. The CEO then transferred the funds to cryptocurrency wallets controlled by scammers. Despite a cryptocurrency exchange listed as the beneficiary on the wire requests, Heartland staff approved 10 transfers totaling to $47.1 million in bank funds over a 6-week period. Additionally, Heartland staff did not file a SAR until the week of the bank's failure.

Heartland required dual controls to process wire transfer requests and had established daily wire transfer limits for approved employees. While Heartland employees followed the dual control requirements of the bank's wire policy, the CEO and employees did not follow Heartland's daily wire transfer limits. A senior bank regulator said Heartland's wire transfer policy could have been improved by establishing a tiered system for approving wire transfer requests. Another senior bank regulator stated that any exceptions to the wire policy should have required escalation to the board of directors for approval. We reviewed the CBEM and the Federal Financial Institutions Examination Council's *Retail Payment Systems Booklet* and did not identify any specific guidance on tiered systems for wire transfer approvals.

Heartland had a BSA/AML policy in place to implement the BSA and SAR regulations. SAR regulations require a financial institution to file a SAR if it knows, suspects, or has reason to suspect a transaction conducted or attempted by, at, or through the financial institution (1) involves funds derived from illegal activity; (2) is intended or conducted to disguise funds derived from illegal activity; (3) is designed to evade regulations promulgated under the BSA; (4) lacks a business or apparent lawful purpose; or (5) involves the use of the financial institution to facilitate criminal activity, including pig butchering. These regulations also require that financial institutions file a SAR no later than 30 calendar days from the date on which facts are initially detected that may constitute a basis for filing a SAR if a person of interest is known.[20] Heartland's BSA/AML policy required employees to remain alert to potentially suspicious transactions and states that either the BSA officer or team should discuss potentially suspicious activity and decide whether to file a SAR. As previously noted, we did not identify evidence that Heartland employees assessed the CEO's wire transfer activity to determine whether to file a SAR. We believe that a lack of awareness of the growing threat from cryptocurrency scams on the part of Heartland staff contributed to employees not detecting, assessing, and reporting the activity sooner.

Regulators and law enforcement were unaware of the CEO's suspicious activity until Heartland's CFO notified regulators on July 21, 2023. Had Heartland's board been required to approve limit exceptions for large wire transfers, the CEO's alleged fraudulent wire transfers may have been prevented. Additionally, had Heartland employees assessed and reported the CEO's wire transfer activity earlier, law enforcement and regulators may have intervened sooner, potentially reducing losses to the DIF from Heartland's failure.

Recommendations

We recommend that the director of S&R

1. Increase awareness among state member banks of cryptocurrency scams by providing an informational update that
    a. describes characteristics of prevalent cryptocurrency scams and how banks can identify such scams.

[20] 31 C.F.R. § 1020.320 (2024).

   b. reminds state member banks of existing guidance on how and when to report suspicious activity.

2. Provide training to examiners on prevalent cryptocurrency scams and relevant preventive and detective controls at banks.

Management Response

In response to our draft report, the director of S&R concurs with our recommendations. The response states that Board and System staff are committed to sharing relevant information with state member banks and ensuring that examiners are trained to be best positioned against future threats and vulnerabilities. To address recommendation 1, the response states that S&R will provide an informational update to state member banks. To address recommendation 2, the response states that S&R will conduct examiner training. The response states that S&R will complete its planned actions to address these recommendations by December 31, 2024.

OIG Comment

The planned actions described by the director of S&R appear to be responsive to our recommendations. We will follow up to ensure that the recommendations are fully addressed.

Appendix A: Scope and Methodology

To accomplish our objectives, we reviewed the Board's and FRB Kansas City's supervision of Heartland from January 2017 until its failure in July 2023. We reviewed the CBEM and relevant supervisory guidance. We also reviewed relevant documentation from FRB Kansas City, the OSBC, and S&R. We reviewed supervisory documentation related to Heartland, including MRAs, examination reports and associated examination workpapers, surveillance reports, and correspondence. In addition, we obtained and reviewed publicly available information for Heartland, including local market data.

To gather perspectives on the supervision of Heartland, we conducted 15 fieldwork interviews with Board and System officials and staff, including senior Board officials, S&R officials, and staff responsible for overseeing the supervision of small state member banks, as well as FRB Kansas City officials and staff involved in the supervision of Heartland. In addition, we conducted interviews with officials from the OSBC and the FDIC's Division of Risk Management and Supervision and Division of Resolution and Receiverships.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*. We conducted this work from August 2023 through December 2023.

Appendix B: Management Response

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, DC 20551

January 25, 2024

Michael VanHuysen
Associate Inspector General for Audits and Evaluations
Office of Inspector General
Board of Governors of The Federal Reserve System
Washington, DC 20551

Dear Mr. VanHuysen,

Thank you for the opportunity to comment on your draft report, *Material Loss Review of Heartland Tri-State Bank*. We appreciate the effort that the Office of Inspector General (OIG) put into this report and the recommendations to increase awareness of cryptocurrency investment scams among state member banks and train bank examiners.

The objective of the evaluation was to determine why Heartland Tri-State Bank's failure resulted in a material loss to the Deposit Insurance Fund (DIF) and to assess the supervision of the bank by the Board of Governors of the Federal Reserve System (Board) and the Federal Reserve Bank of Kansas City.

The review determined that Heartland Tri-State Bank failed because of alleged fraudulent wire transfer activity conducted by the bank's Chief Executive Officer as part of his involvement in an apparent cryptocurrency investment scam, along with significant internal control breakdowns. The review also determined that if bank staff properly executed the bank's policies and procedures, then the wire transfers that led to the bank's failure would not have been processed. Also, as stated in the report, recent supervisory examinations concluded that the bank's internal controls and board oversight were adequate, and that its Bank Secrecy Act / Anti-Money Laundering (BSA/AML) compliance program was satisfactory in relation to its low money laundering and terrorist financing risk profile.

Given the rise in cryptocurrency investment scams, the report includes a recommendation to increase state member banks' awareness of these types of scams as well as an awareness of related existing guidance on reporting suspicious activity. In light of the internal control breakdowns leading to the bank's failure, the report also includes a recommendation to provide training to examiners on cryptocurrency scams and relevant preventative and detective controls at banks.

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The Board's Division of Supervision and Regulation agrees with the conclusions in this report. The Board takes very seriously the threat of cryptocurrency investment scams. Federal Reserve staff are committed to sharing relevant information with state member banks and ensuring that examiners are trained, in order to be best positioned against future threats and vulnerabilities.

Please see our responses below to the recommendations.

Recommendation 1: Increase awareness among state member banks of cryptocurrency scams by providing an informational update that:

- **a.** describes characteristics of prevalent cryptocurrency scams and how banks can identify such scams.
- **b.** reminds state member banks of existing guidance on how and when to report suspicious activity.

Recommendation 2: Provide training to examiners on prevalent cryptocurrency scams and relevant preventive and detective controls at banks.

Management Response: We will provide an informational update to state member banks and conduct examiner training by year-end 2024.

Regards,

Michael S. Gibson
Director, Division of Supervision and Regulation
Board of Governors of the Federal Reserve System

Abbreviations

AML	Anti-Money Laundering
BSA	Bank Secrecy Act
CBEM	*Commercial Bank Examination Manual*
CEO	chief executive officer
CFO	chief financial officer
DIF	Deposit Insurance Fund
FBI	Federal Bureau of Investigation
FDIC	Federal Deposit Insurance Corporation
FinCEN	U.S. Department of the Treasury’s Financial Crimes Enforcement Network
FRB Kansas City	Federal Reserve Bank of Kansas City
IC3	Internet Crime Complaint Center
MRA	Matter Requiring Attention
OSBC	Office of the State Bank Commissioner
PCA	prompt corrective action
SAR	suspicious activity report
S&R	Division of Supervision and Regulation

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