Insider Abuse

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Roadmap for Today's Presentation

- Sociological forces driving fraud
- Insights from current fraud research
- Fraud Classification System
- Usefulness of viewing fraud in three stages
- Case examples
- Questions

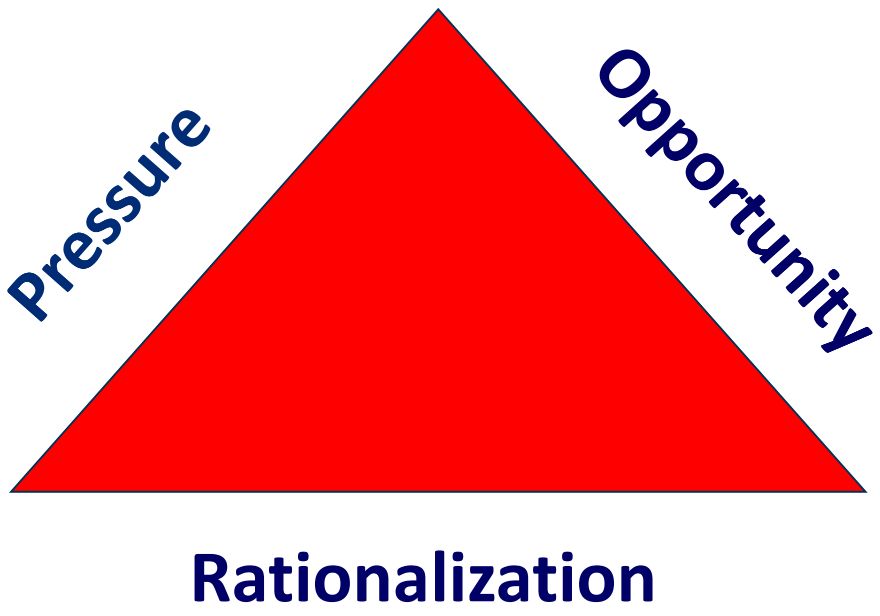
Why do Insiders Commit Fraud?

- Donald R. Cressey was a doctoral student in criminology at Indiana University in the 1940s

- Interviewed 200 imprisoned embezzlers for his thesis
  - Key Question: "What led previously honest people to embezzle?"

- Research led to a theory now known as the "Fraud Triangle"

Fraud Triangle



Perceived Pressure

- Perceived in the mind of the person at risk
- They believe it to be non-sharable because of the risk of loss of social status
- Examples:
    - Addictions (drugs, gambling, other)
    - Family member illness or job loss
    - Excessive debt / living beyond means
    - Status gaining
    - Employer-employee relations

Perceived Opportunity

- Low perception of detection
- Weak internal controls
- Poor oversight
- No/weak code of conduct
- Failure to discipline other perpetrators
- Information about procedures / controls
- Technical Skill
- Authority
- Trust
- Dysfunctional organizational culture

Example of the Power of Perception of Detection

- This example comes from a credit union in Iowa
- A new compliance officer was appointed and announced implementation of independent cash counts at all locations
- The manager of one of the branches, perceiving that the risk of detection just went to 100 percent, immediately went to the police and confessed to stealing $250,000 from the vault of his branch over seven years.
- A subsequent audit found the outage to be $431,000 and also included embezzlement from one depositor’s account.

Rationalization

The first person a potential fraudster must deceive is themselves!

Cognitive dissonance is commonly relieved by:

- Blaming the victim
- Dehumanizing the victim
- Denying the existence of injury
- Posturing as a victim of circumstance
- Normalizing deviance

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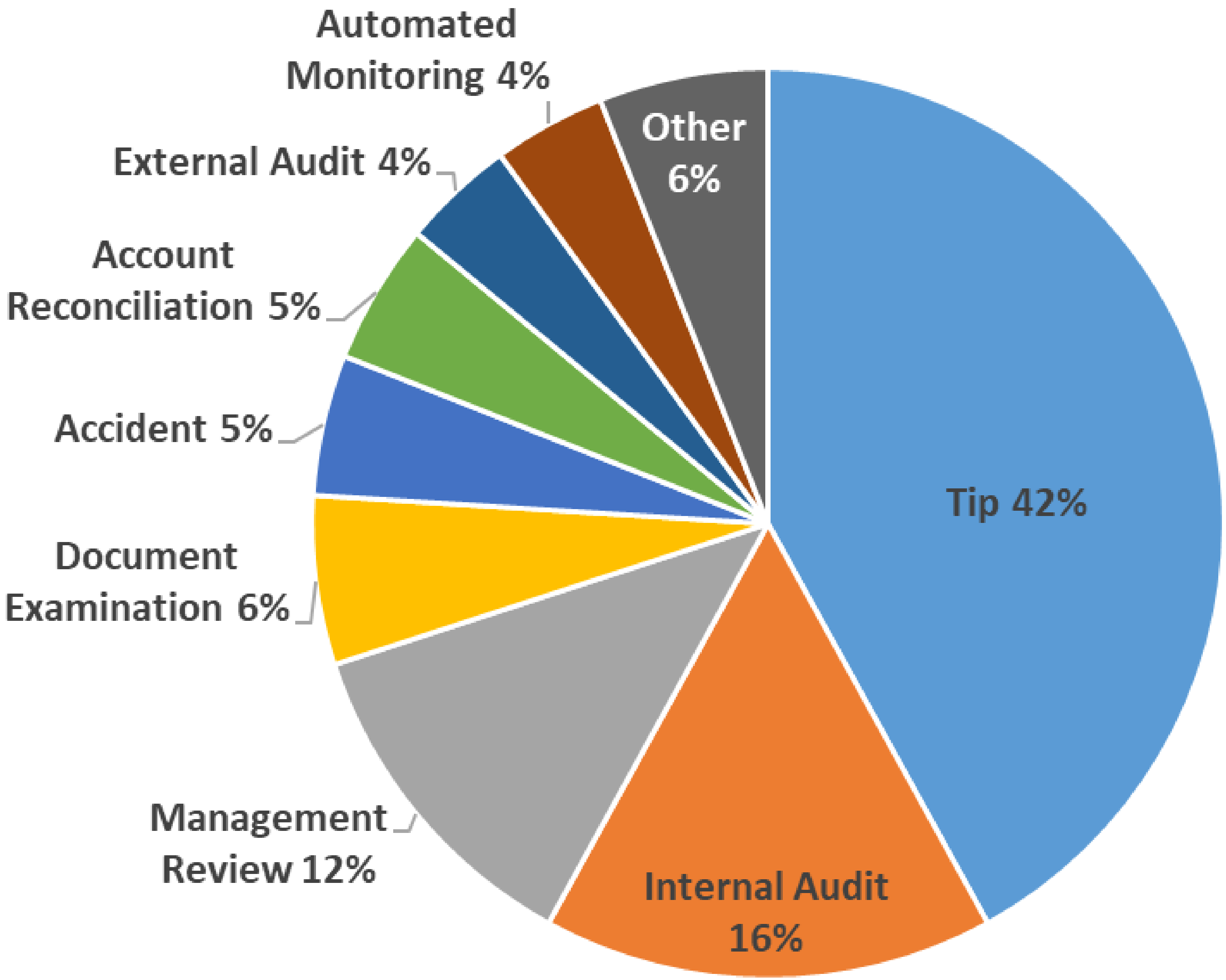
Fraud Research

Association of Certified Fraud Examiners

2022 Report to the Nations
on Occupational Fraud and Insider Abuse

Survey Results: How Fraud is Discovered



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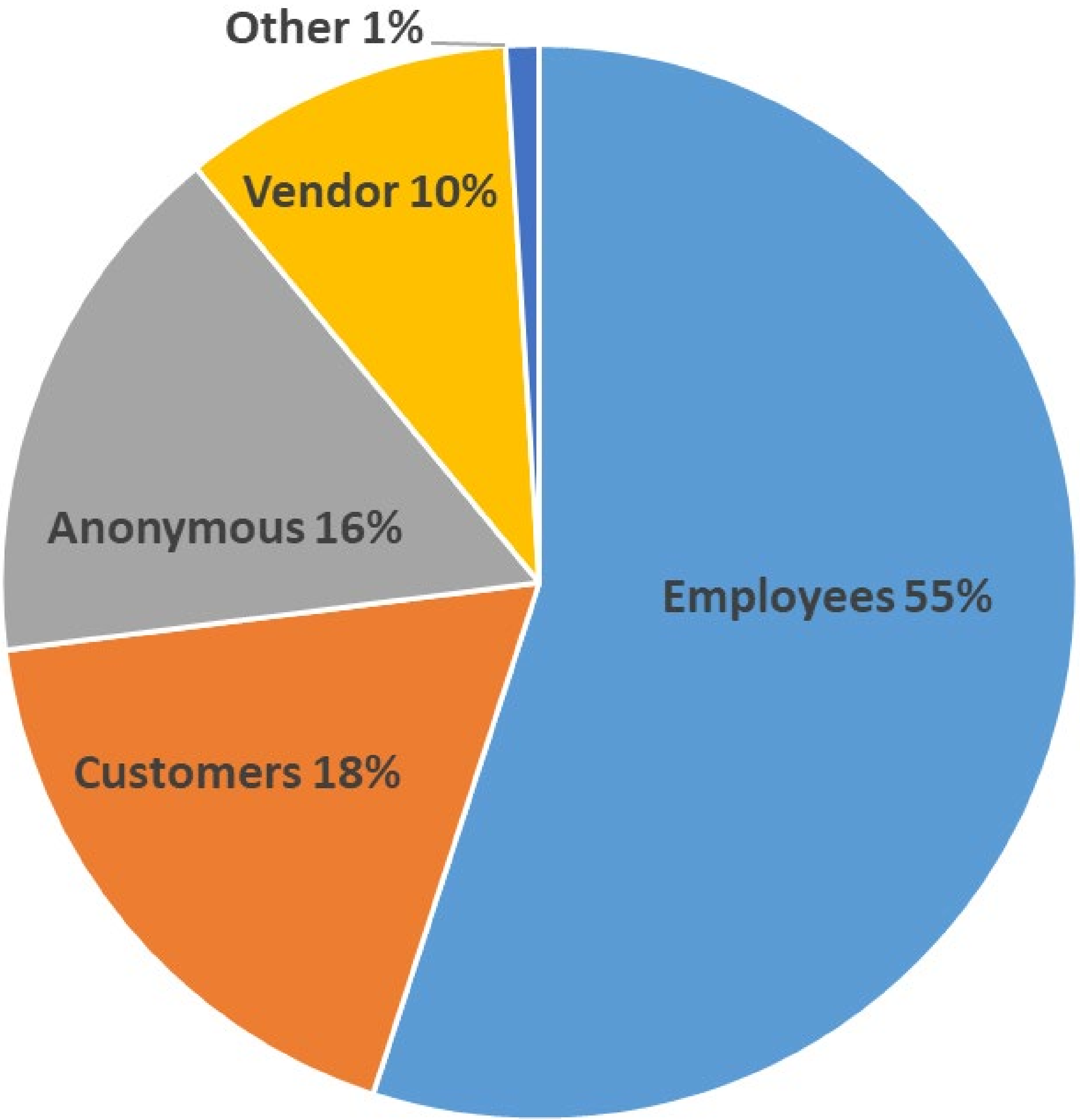
Survey Results: Sources of Tips



Factors That Make Reporting Systems More Effective

- The process is well designed and easily understandable
- The system is empathetic and supportive
- Reports are handled with confidentiality
- The system is independent of those who might be the subject of reports
- Having a single mechanism that is widely publicized
- All reports are welcomed
- The organization has a track record of supporting whistleblowers
- Outcomes are consistent, fair, and proportionate

Source: Fraud Magazine article by Ryan C. Hobbs and Julia Kniesche of Ernst and Young

Survey Results: Behavioral Red Flags

- 39% living beyond means
- 25% financial difficulties
- 20% unusual closeness with vendor or customer
- 13% control issues or unwillingness to share duties
- 12% bullying or intimidation
- 12% irritability / suspiciousness / defensiveness
- 11% divorce or family problems
- 10% ‘wheeler-dealer’ attitude
- 8% excessive performance pressure from victim organization
- 7% addiction problems
- 7% complaints about pay
- 7% refusal to take vacations

Survey Results: Characteristics of the Perpetrators of the Largest Losses

- Frauds by executives had a median loss 2.7x that of managers and 6.7x that of low level employees.
- People with the organization > 10 years had a median loss 3x that of those < 5 years, even at similar levels of authority.
- Those with the organization > 10 years took 2.4x as long to catch than those < 5 years.
- Fraudsters over 60 have more than double the median loss of the next highest age cohort.
- People with college degrees cause 2.3x the median loss of high school graduates.
- Men in high level positions cause higher losses than women in similar roles.

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Responsibility for Detecting Fraud at a Bank

- Who is responsible for detecting fraud at your bank?
- How does a director do that?
- Are regulatory examinations designed or intended to detect fraud?

Fraud Classification System (Fraud Tree)

- Until the 1990s it was generally believed that there were an unlimited number of ways to commit fraud
- The Association of Certified Fraud Examiners (ACFE) used its first member survey in 1993 to categorize frauds by type
- Patterns became apparent

Value of the Fraud Tree

“The Fraud Tree has changed the nature of how occupational fraud has been codified. It clearly shows that there are only so many ways to skin a cat. And when professionals know and understand those ways, responding to fraud issues takes the mystery from them.”

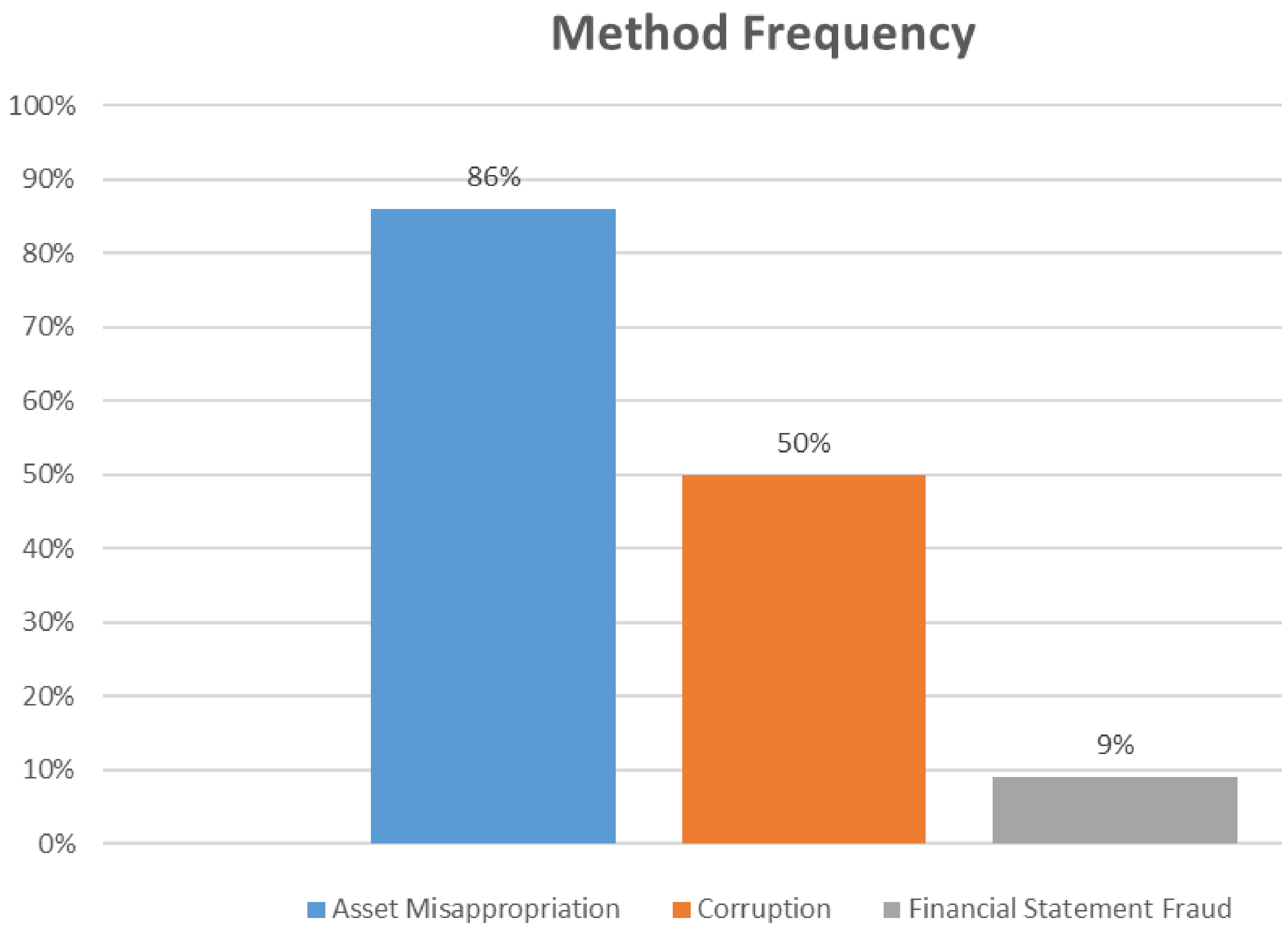
Joseph T. Wells

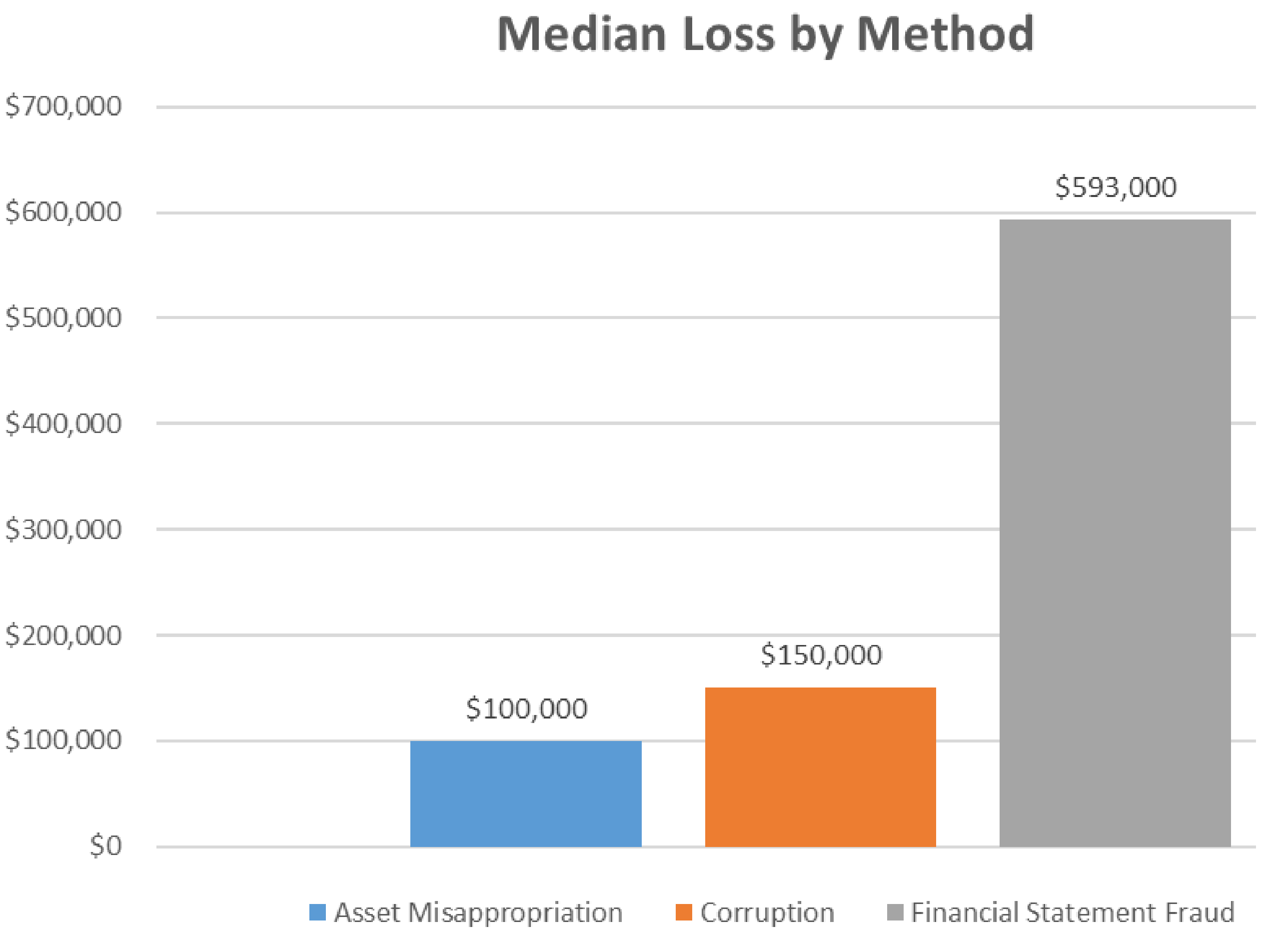
ACFE Founder

Main Fraud Tree Categories

- Corruption
- Asset Misappropriation
- Financial Statement Fraud / False Statements

Fraud Method vs. Median Loss
(2022 ACFE Survey)





Corruption

- Conflicts of Interest
  - Hidden interest in a transaction
  - Relationships with borrowers/vendors/suppliers/service providers
- Bribery (offering, giving, receiving, or soliciting anything of value to influence a business decision)
  - Loan kickbacks
  - Bid rigging on vendor contracts
- Illegal Gratuities (something of value given to reward a favorable decision after it has been made)
- Economic Extortion (pay, or else harm will come)
  - Flip side of bribery
  - Bank insider demands payment from outside party to get a favorable decision

Asset Misappropriation

- Cash
  - Theft of cash on hand
  - Theft of cash receipts (skimming)
  - Fraudulent disbursements
    - Billing schemes (fake vendors)
    - Ghost employees / rate and time schemes / manipulation of bonus
    - False or overstated expense reimbursement claims
    - Check tampering / diversion
    - Buying an asset for the bank that doesn't exist
    - Overstating an asset or expense or understating a liability, with offsetting entry to perpetrator's benefit
- Inventory and all other assets
  - Misuse
  - Larceny

Financial Statement Fraud

- Timing differences
- Fictitious or overstated assets or revenues
- Concealed or understated liabilities or expenses
- Improper asset valuations
- Appraisal issues
- Improper disclosures

Examples:

- Understating past due, nonaccrual, or restructured loans
- Manipulation of loan loss reserve assumptions

Three Stages of the Fraud Process

To maximize our chances of detecting fraud, we should view it in three phases which each provide opportunity for detection:

- The direct act of fraud itself
- Acts to conceal the fraud
- Exfiltration of the proceeds

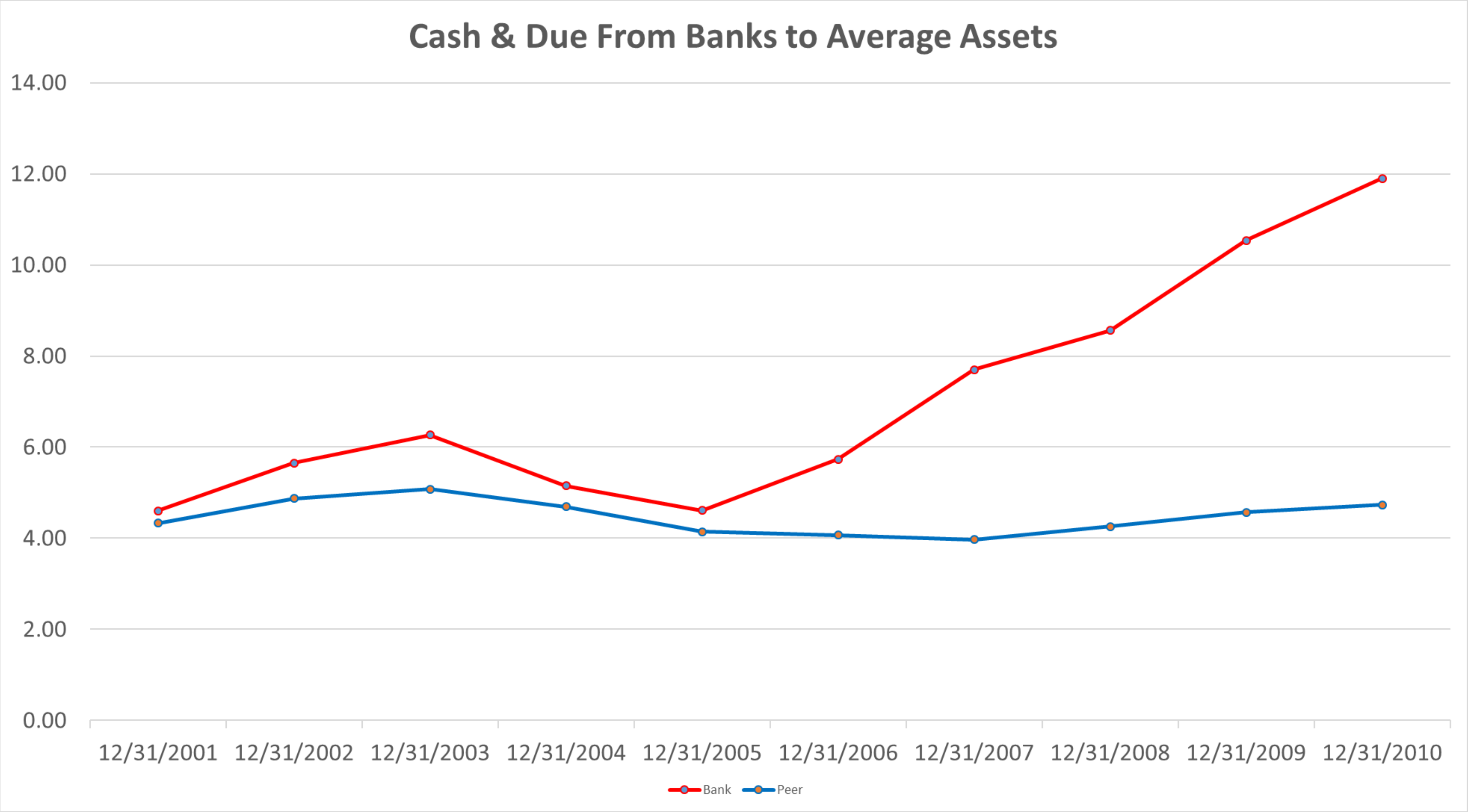
Common Methods of Concealing Fraud

- Offsetting entries in the accounting system
- Lapping
- Extending due dates on fictitious loans
- Falsifying reports
- Placing holds / do not mail on customer statements
- Placing untrained or incompetent employees in critical positions where fraud could be detected
- Getting the loss approved as a charge off
- Placing the loss in expenses, which are closed out at the end of the accounting period

Concealment Method: Offsetting Entries

- Offsetting entries are necessary under dual accounting to keep the accounting equation in balance
- Offsets to expense accounts are useful to the fraudster because they typically don’t receive scrutiny after the current cycle
- Offsets to asset or liability accounts build up over time and cause structural distortion in financial statements
- Ratio analysis can provide red flags for investigation

Example of Ratio Analysis



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Concealment Method: Lapping

- Lapping involves using successive items to hide missing funds
- Discrepancies are dismissed as "timing differences"
- The first transaction in the series is the theft, and subsequent transactions hide the theft (unless they are larger, in which case the theft is growing)
- Lapping can grow over time, much like a check kiting scheme

Exfiltration Methods

How ill-gotten gains leave a bank

Cash

- Teller drawer
- Vault
- Night drop bags
- ATM

Bank Official Check

Examples:

- Loan proceeds from a fraudulent loan
- Expense check for an illegitimate expense
- Debit without credit
  (no funding source, so official check account becomes overdrawn)

Wire Transfer

- Can move large sums of money quickly around the globe
- Hard to retrieve
- Leaves an initial trail, but layering transactions can be used to disguise it further on

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Transfer to Personal Deposit Account

…then exfiltrate funds via all the channels your customers have access to:

- Cash withdrawal
- Check
- Wire
- ACH
- Online bill pay
- Transfer between accounts

Theft of Assets Other than Money

Transfer of bank-owned property without requisite approval or compensation:

- Real estate
- Automobiles
- Electronics
- Furniture
- Art
- Diverted repossessions

Diversion of Assets Before they are Recorded on the Bank's Books

Examples:

- Skimming of rent payments on ORE
- Skimming from customer deposits in a night depository

Conclusion

- Fraud is often not complex
- Red flags are almost always present
- Frauds are committed by trusted people
- Having a fraud awareness mindset is key to recognizing it
- The Fraud Triangle is a useful model for understanding the circumstances that may result in someone violating their organization's trust.
- You are the person responsible for preventing and detecting fraud by insiders at your bank

Questions?

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