

Why No Financial Services Institution Is Immune to Fraud

The introduction to this book painted a less-than-rosy picture of the ethical fabric of the American financial services industry. It is true that the industry has been wracked by colossal incidents of fraud and abuse and sometimes multiyear scandals that threatened its very survival.

In reality, despite what you read in the newspapers, which thrive on bad news, there are still plenty of financial institutions that run a tight ship, take care of their customers, invest depositors' cash prudently, and show a profit almost every quarter.

It is to the managers of *these* institutions, as well as those in institutions that have experienced fraud and who wish to prevent further incidents, that this book will be most useful. For, as stated earlier, even those institutions with the best of intentions and the highest of ethical standards cannot fully protect themselves from the large and growing population of financial fraudsters and the continuously evolving methods to their criminal *modus operandi*.

► Statistical Perspective

It cannot be denied that fraud is becoming an increasingly serious and costly problem in American business—especially in the financial services industry. The statistics that follow will demonstrate that. Despite this threat, the important thing to remember is that it is still possible to manage a bank or other financial institution in a relatively fraud-free manner. The upcoming chapters of this workbook will provide you with practical, actionable techniques for doing exactly that.

The next statistics will provide you with perspectives on the big picture of organizational fraud in America and on the seriousness of the fraud problem in the financial services industry in particular.

Starting with the big picture, did you know that:

- Organizations of all kinds collectively lose an average of 7 percent of gross revenue to fraud every year? In 2008, that represented approximately \$994 billion.¹

- The most common method by which fraud is detected is tips? Over 46 percent of cases that are detected are reported via a tip from an employee, vendor, or other whistleblower.²
- Billing schemes—the most common form of employee-level fraud—are twice as common in organizations as fraudulent financial reporting, which is the main form of *management* fraud?³
- Organizations that implement entity-wide fraud awareness training cut fraud losses by 52 percent?⁴
- Seventy-four percent of employees report that they have observed or have firsthand knowledge of wrongdoing in their organization in the past 12 months?⁵
- The average fraudulent financial reporting fraud costs the victim organization \$2 million, while the average loss per incident of billing fraud is only \$100,000?⁶
- The majority of public companies investigated by the Securities and Exchange Commission (SEC) for fraud subsequently suffer a substantial (50 percent or more) decline in stock price?⁷
- It takes an average of 24 months for a fraud to be detected?⁸
- One-third of large-organization executives say they have no documented investigative policies or procedures for fraud and one-half have no incident response plan?⁹
- The most common type of fraud affecting organizations—by far—is theft of assets, which can include money, services, or physical assets?¹⁰

Financial Institution Fraud in Statistics

- All financial institutions insured by the Federal Deposit Insurance Corporation (FDIC) together held \$80.3 billion in asset-backed securities on December 31, 2005. By the same date in 2008, that number had ballooned to \$129.2 billion.¹¹
- Between 2005 and early 2009, the percentage of nonperforming real estate loans on the books of FDIC-insured institutions exploded from approximately 0.6 percent to 2.8 percent. See Exhibit I.1.
- Seventy-one percent of financial institutions experienced attempted or actual payments fraud in 2007 (check fraud, Automated Clearing House [ACH] fraud, or credit card fraud).¹²
- Ninety-three percent of all financial institutions that were targets of payments fraud reported attempted check fraud in 2007.¹³
- Although electronic payments are steadily gaining on checks as the preferred payment method by many organizations, the incidence of check fraud remains far greater than that of ACH fraud.¹⁴
- Twenty-six percent of organizations that were targets of payments fraud in 2007 were hit by at least one incident of ACH debit fraud—down from 35 percent in the previous year.¹⁵
- Of 21 industries surveyed by the Association of Certified Fraud Examiners for its 2008 *Report to the Nation on Occupational Fraud*, “Banking/Financial Services” topped the list in the percentage of total fraud cases, with 14.6 percent.¹⁶

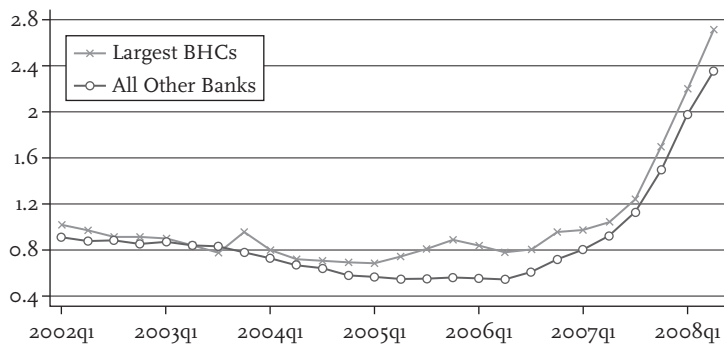


Exhibit 1.1: Nonperforming Real Estate Loans (Percent of Real Estate Loans)

Source: Federal Reserve Bank of New York, *Quarterly Report on Banking Statistics* (November 2008), p. 4.

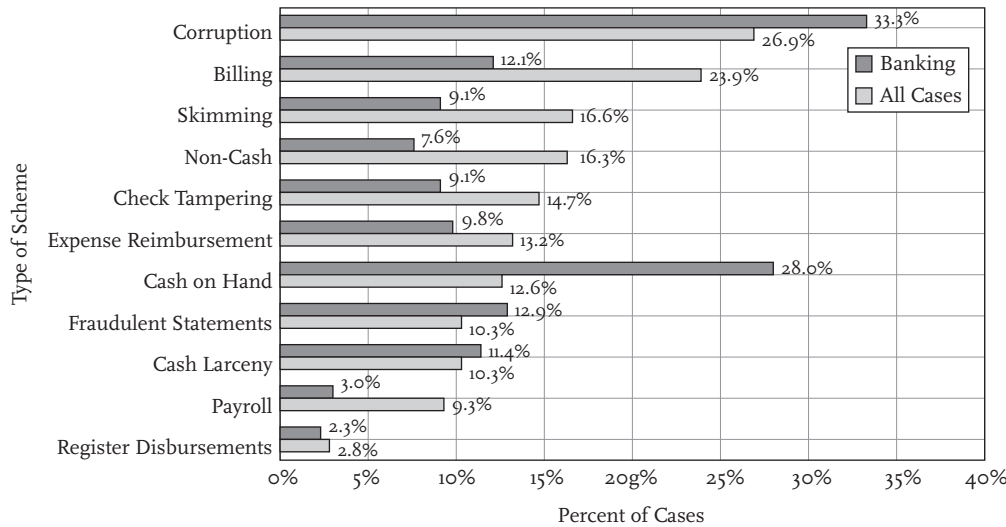


Exhibit 1.2: Occupational Fraud Schemes in Banking and Financial Services Industry

Note: Based on 132 cases. The sum of percentages in this chart exceeds 100 percent because several cases involved multiple schemes from more than one category.

Source: Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud and Abuse*, p. 29.

- The most common types of internal fraud affecting the financial services industries (see Exhibit 1.2) are corruption (primarily bribery and kickbacks), theft of cash, fraudulent financial statements, and expense reimbursement schemes.¹⁷
- In 2008, financial services companies were defendants in 103 class action filings, representing 49 percent of *all* securities-related class actions across nine industries represented in the Standard & Poor's (S&P) 500. Of the 103 filings in which financial services firms were defendants, 91 were related to the subprime credit crisis.¹⁸
- In 2008, 32 percent of the financial services companies in the S&P 500 were defendants in securities class actions, up from 9.4 percent the year before.¹⁹
- Reported incidents of mortgage fraud were up by a startling 45 percent in the second quarter of 2008 compared with the same period in 2007.²⁰
- The number of reported mortgage fraud incidents represented by fraudulent appraisals jumped by 21 percent between the second quarter of 2008 and the same quarter of the previous year.²¹



Remember

If you hear from a colleague or boss that your organization does not experience much fraud, the statistics prove the opposite. If anything, fraud is getting worse. For that reason, everyone in the organization must be more alert to it than ever.

► What Is Fraud?

Most people in the fraud-fighting business have their own concept of what fraud is . . . and what it is not. The result is that we have a grab bag of definitions to choose from in guiding our day-to-day work. Some are legal definitions. Others are academic, while still others are based on personal experience. Out of the lot, the most useful definitions boil down to two.

According to the Association of Certified Fraud Examiners, fraud is:

Any illegal acts characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the application of threat of violence or of physical force. Frauds are perpetrated by individuals and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.²²

According to the American Institute of Certified Public Accountants, fraud is:

A broad legal concept that is distinguished from error depending on whether the action is intentional or unintentional.²³

Regardless of whose definition of fraud you accept, you will find that nearly all incidents of fraudulent activity—also called white-collar crime—fall into one or both of two categories: theft and deception. Exhibit 1.3 is a graphic illustration formulated by White-Collar Crime 101 of this dual-category definition of fraud.

In attempting to narrow down the definition of fraud to criminal conduct specific to the financial services industry, it is fair to say that the same division between theft and deception holds true. However, as you will learn in upcoming chapters, the *types* of fraud scheme that this definition applies to differ in many instances from those in other industries. For example, in financial services companies, mortgage fraud is a significant subcategory of the overall fraud definition, whereas this type of fraud would obviously *not* be represented in the definition of fraud in, say, the food and beverage industry.

For now, keep in mind the broad definition of fraud as a combination of theft and deception (both of which, by the way, apply to many forms of mortgage fraud, as you will soon find out).

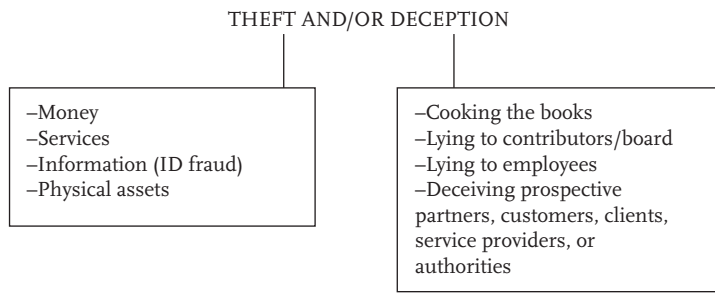


Exhibit 1.3: White-Collar Crime 101 Definition

Remember

There are various definitions of the term “fraud,” but the bottom line is that all fraudulent activities fall into the category of either theft or deception—or a combination of both.



► Myths and Realities about Financial Services Fraud

According to research by the anti-fraud consulting firm Protiviti, released just prior to the full-blown meltdown of the financial markets, management at a majority of organizations is still surprisingly complacent about the threat of fraud.

For example, the Protiviti study determined that only 49 percent of executives believe their organizations’ strategies for addressing fraud risk are “very well defined.”²⁴

Less than half of organizations proactively identify fraud risk and have anti-fraud programs, policies, and controls in place that are monitored and enforced by the board and senior management.

Similarly, a Deloitte Forensic Center survey concluded that only 41 percent of executives considered their companies to be “more effective” in the area of fraud control, compared with the remaining 59 percent who described their organizations’ fraud control efforts as “less effective.”²⁵

While Deloitte notes that companies overall have in recent years enhanced their anti-fraud measures, a substantial “fraud control gap” is still glaringly evident from the data collected.

These findings suggest that six-plus years into the Sarbanes-Oxley era, and in the throes of the worst financial and economic catastrophe since the 1930s, most companies—including financial services firms—still are highly vulnerable to fraud of all kinds, and management appears to show little intention of tightening up its anti-fraud defenses. In fact, as recession-phobic executives slash budgets for anti-fraud training, internal audit, and security, the opportunities for fraudsters to exploit softened anti-fraud defenses naturally multiply. As a result, new forms of fraud targeting financial services organizations are cropping up all the time.

This fact brings us to the critical psychological aspect of corporate fraud, which squarely addresses the myths and realities as to why no financial institution is immune.

■ Myth #1: We Have Very Little Fraud Here

A costly problem arises when this assumption is made without adequate and unimpeachable quantitative proof. In too many financial institutions, senior management believes there is little fraud because it *wants* to believe that. Meanwhile, employees, vendors, or customers could be stealing huge amounts of money.

Conveniently, one of the best examples of the we-have-no-fraud-here myth is the case of subprime mortgage fraud. Banks were lending dollars to unqualified mortgage borrowers by the billions in the 1990s and leading up to the housing crash that began in early 2007. Top executives at large mortgage lenders were making money hand over fist as their salespeople, underwriters, and independent mortgage brokers essentially threw every standard for loan qualification out the window, confident that if a borrower ultimately defaulted, the bank could foreclose and sell the property at a profit because housing prices were on a seemingly endless upward trend.

What the bankers failed to address was the issue of how much fraud was being perpetrated by brokers, appraisers, attorneys, and even their own underwriters in order to meet increasingly challenging volume quotas for loan closings.

The truth was that throughout the country, lenders were approving more and more so-called liar's loans, a colloquialism for "stated income" loans—which are approved by lenders without checking tax returns, employment history, credit history, or any other pertinent financial documentation on the applicant.

Moreover, leading up to the subprime crisis, prospective borrowers were directly *encouraged* by mortgage brokers to defraud lenders by filling out mortgage applications with completely fictitious income figures, made-up numbers reflecting their assets and liabilities, and so forth. But to shareholders, regulators, and the general public, bank executives claimed that their lending operations were completely professional and that no fraud was involved.

The truth came out only after the crash—when regulators, lenders' attorneys, and politicians started digging into the matter and discovered that as much as 90 percent of stated income loans were approved despite the existence of at least *some* fraudulent application information.

This example is only one of many that you could find to debunk the no-fraud-here myth that many senior executives throughout the U.S. financial services industry continue to embrace.

In reality, financial services organizations experience less fraud than others. But anyone in the anti-fraud profession will tell you that if a financial company says it has *no* fraud, it is either outright lying or hopelessly naive.

◀ Case Study #1

Alleged Mortgage Fraud of Massive Proportions

Washington Mutual, or “WaMu” as it was affectionately called until its dramatic and unceremonious demise in late 2008, was for decades one of the country’s top home mortgage lenders.

It amassed huge profits through the 1980s and 1990s as its aggressive home mortgage juggernaut pressed into more and more local markets, ultimately becoming active in nearly every state in the country.

Not until late 2008 did the truth about WaMu’s real financial condition and, more important, how it got there start coming to light.

The real story of WaMu’s collapse appears in a 400-plus-page federal class action complaint against WaMu and its former chief executive, Kerry Killinger, in which numerous former employees offer gory details about highly questionable—possibly fraudulent—lending practices as well as alleged securities fraud.

In one exceptionally vivid account, a former WaMu employee explained how the illegal practice of inflating appraised values of homes whose prospective buyers were applying for mortgages was a common practice among appraisers working for WaMu. The experience of this particular “Confidential Witness” (CW)—one of 89 former WaMu employees and others who, on condition that their names not be revealed in the class action filing, provided firsthand accounts of their experiences to the class action attorneys—was described in the filing in this way:

[I]n-house appraisers received kickbacks from loan consultants to “hit” value on appraisals. Despite CW 25’s complaints to management about the appraisal process at WaMu, WaMu management did nothing to change the situation. Indeed, CW 25’s job was threatened on many occasions in response to CW 25’s complaints of appraisal corruption.

CW 31, who was a contract appraiser with eAppraiseIT after leaving WaMu as an in-house appraiser, also confirmed that WaMu pressured appraisers to inflate appraisal values.

Specifically, CW 31 stated that WaMu dictated appraisal values that it needed to satisfy the LTV [Loan-to-Value] ratios it desired. CW 31 explained that WaMu pressured the third-party appraisers by (i) badgering them to meet the Company’s desired appraisal values, and (ii) ceased to hire appraisers who did not bring in the inflated appraisal value that WaMu desired.²⁶

How could this fraud have been prevented? List as many controls as you can. Compare yours with those listed in Appendix B.

1. _____
2. _____
3. _____



The bottom line. Even as WaMu was on its way down, its top executives were publicly stating that “everything was okay.” Whether the C suite knew that alleged appraisal fraud and other potential forms of mortgage fraud were being systematically perpetrated by its employees may never be known for sure.

Chapter 3 addresses the thorny issue of subprime mortgage fraud in greater detail. However, the key lesson here is that even widespread financial wrongdoing can exist in an organization with or without top management’s knowledge. This finding teaches us to be skeptical at all times when evaluating the ethical and legal activities of financial services institutions, since *none* is without its fair share of fraud.

■ **Myth #2: Ethics and Compliance Training “Has Us Covered”**

The Sarbanes-Oxley Act of 2002 requires all publicly traded companies to inform the Securities and Exchange Commission if they have a code of conduct in place. If they do not, they are required to explain why. For better or worse, most publicly traded financial services firms do have such codes in place. And along with them, most have over the past several years offered ethics and compliance training.

The ethics and compliance training myth assumes that such training addresses key issues about fraud and instructs employees how to detect the red flags of fraud and how to report it.

The problem is that compliance and ethics typically have little to do with fraud. Most of the codes of ethics that companies now have in place do not even contain the word “fraud.”

In most organizations, such a code informs employees about issues like sexual harassment, antitrust issues, accepting gifts from vendors, and other ethical issues that are important—but are not related to fraud.

The important thing to remember is that while all fraud is unethical, not all unethical conduct is fraudulent. For example, accepting a generous gift from a vendor—such as a free vacation, tickets to professional sporting events, or other such items—is unethical and most likely in violation of your organization’s ethics policy. However, such gifts are *not* necessarily illegal, and hence they often do not represent fraud.

In any case, the statistics indicating an ongoing increase in the incidence of fraud suggest that ethics training is definitely *not* deterring many employees from breaking the law.

■ **Myth #3: Fraud Is an Unavoidable Cost of Doing Business**

This is a concept often heard in reference to credit card fraud: It is commonly believed that when credit card fraud occurs, the credit card companies have already accounted for it, so they do not go after the perpetrators aggressively.

As for credit card companies, it may be true that fraud is a fact of business life, but it certainly does not mean the card companies are doing nothing to reduce their risk of fraud.

As for other financial services institutions, the cost-of-doing-business mind-set is equally false. An extreme example would be Enron, where fraud cost thousands

of employees their jobs and retirement savings. In less serious instances, fraud can damage the bottom line and do considerable harm to the organization's viability. This was illustrated in the massive Tyco International fraud case of the early 2000s, when the company's former chief executive, Dennis Kozlowski, was convicted of looting the company and committing securities fraud and other major crimes. The company's survival was seriously threatened; it took several years to restructure Tyco and return it to long-term viability.

In the financial services sector, the 2007 collapse of two major hedge funds run by Bear Stearns employees after they had assured investors that their investments were safe was enough to trigger the firm's demise just before its acquisition by JPMorgan Chase. The two fund managers, whose investors lost \$1.6 billion due to the collapse of the subprime mortgage securities market, were indicted for mail fraud and conspiracy.

Remember

Fraud, while usually not serious enough to destroy a financial services firm, often is much more than just a necessary cost of doing business.



► Review Points

- Statistical picture of fraud. The numbers do not lie: Fraud is a *huge* worldwide problem—for all organizations.
- Financial services fraud. Seventy-one percent of financial institutions experienced attempted payments fraud (check fraud, ACH fraud, or credit card fraud).
- Definitions of fraud. The broad definition of fraud is illegal activity representing either theft or deception or a combination of both.
- Myths about fraud. It is easy to become complacent about fraud, but doing so can be very costly. Fraud *does* occur in every organization, and it *is* potentially serious enough to cause major long-term damage.
- Main types of fraud. Countless varieties of fraud threaten financial institutions. Fraudsters are constantly thinking up new ways to target financial services institutions.

► Chapter Quiz

True or False:

1. The majority of public companies investigated by the Securities and Exchange Commission (SEC) for fraud subsequently suffer a substantial (50 percent or more) decline in stock price.
 - True False
2. It takes an average of 36 months for a fraud to be detected.
 - True False



3. Only 5 percent of large-organization executives say they have no documented investigative policies or procedures for fraud, and 50 percent have no incident response plan.
 - True False
4. Organizations that implement entity-wide fraud awareness training cut fraud losses by 52 percent.
 - True False

Circle the correct answer to the following questions:

5. Between 2005 and early 2009, the percentage of nonperforming real estate loans on FDIC-insured institutions' books exploded from approximately:
 - a. 0.1 percent to 0.9 percent
 - b. 0.6 percent to 1.4 percent
 - c. 0.6 percent to 2.8 percent
 - d. 0.4 percent to 3.2 percent
6. In the mortgage industry, "stated-income" loans are synonymous with:
 - a. Adjustable-rate mortgages
 - b. Liar's loans
 - c. Brokerage loans
 - d. Teaser rate mortgages
7. A major reason mortgage lenders in the 1990s lowered the standards for approving mortgage applications was that:
 - a. Borrowers had high credit scores
 - b. Unemployment was very low
 - c. Home prices were expected to continue rising indefinitely
 - d. Interest rates were extremely low
8. The most common types of fraud affecting the financial services industries include all EXCEPT:
 - a. Corruption
 - b. Theft of cash
 - c. Fraudulent financial statements
 - d. Ponzi schemes

Fill in the blank:

9. Regardless of whose definition of fraud you accept, all incidents of financial wrongdoing fall into one or both of the following categories: theft and _____.
10. In the area of payments transactions, the incidence of check fraud is much greater than that of _____ fraud.
11. The most common form of employee-level fraud is _____.

For the answers, please turn to Appendix A.