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Find Fraud Before It Finds Your Credit Union

Presented by:
Joseph A. Zito, CPA, MBA
Shareholder



Michigan • Texas • Florida • North Carolina

Insight. Oversight. Foresight. SM

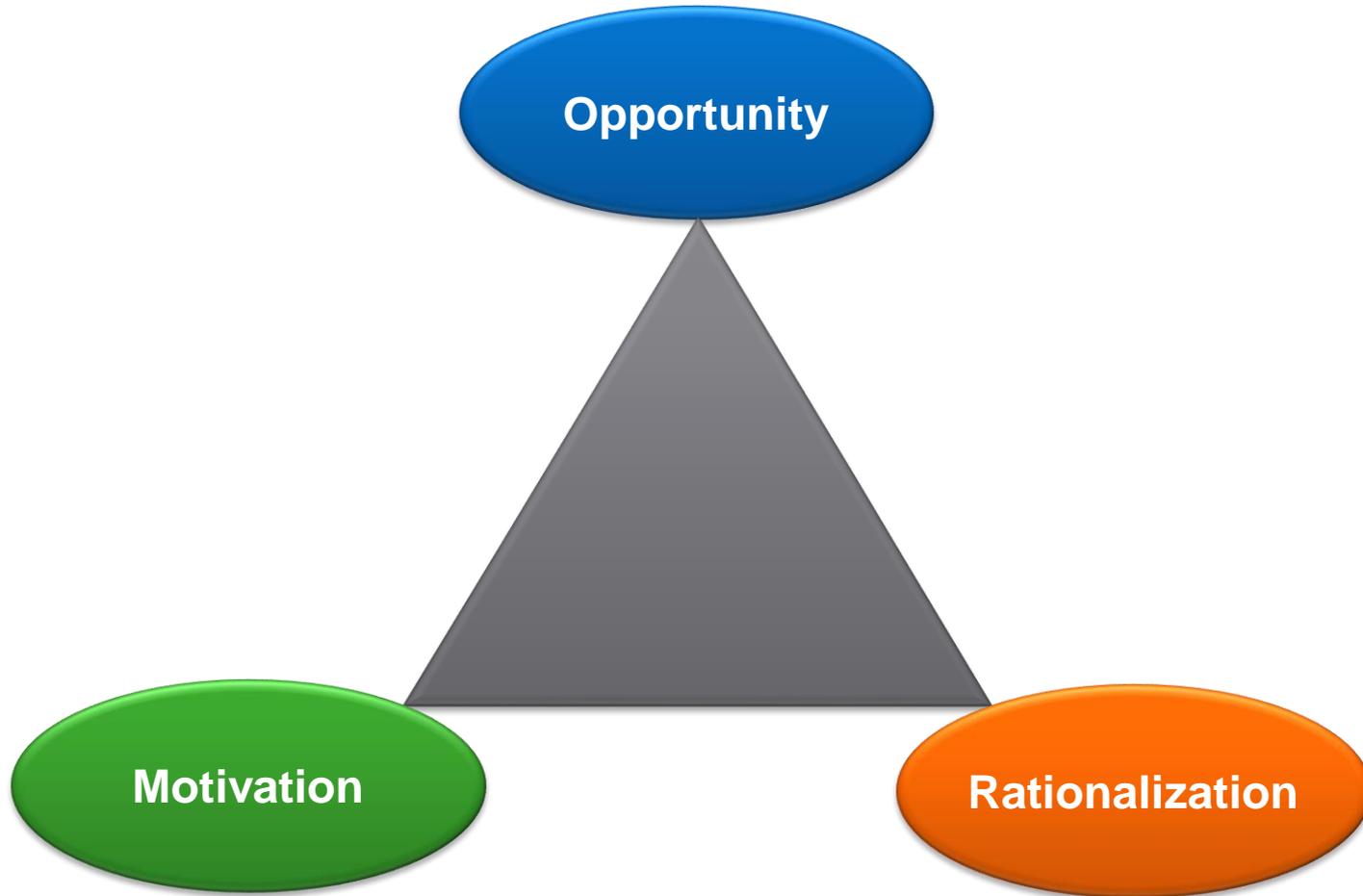
- The environment of fraud
- Internal controls
- Roles and responsibilities
- Examples of control breakdowns
- Tools to detect now and in the near future
- Questions

1. Pressure to maintain the business numbers
2. Culture of fear and silence
3. A “bigger than life” supervisor and awe-struck direct reports who won’t go against their leader
4. A weak board of directors
5. A practice of conflicts of interest
6. A belief that the organization is above the law
7. **That goodness in some areas (such as corporate giving) atones for evil in others**

Excerpt: “The Seven Signs of Ethical Collapse” by Marianne Jennings

The Association of Certified Fraud Examiners' Fraud Triangle

Financial Institutions
Group





"We've considered every potential risk, except
the risks of avoiding all risks."

Internal controls: What they are and what they can do



What is Internal Control?

Before we discuss what you can do...what are internal controls?

- A process, effected by an entity's **Board, management, and other personnel**, designed to provide reasonable assurance regarding the achievement of objectives in:
 - Effectiveness and efficiency of operations
 - Reliability of financial reporting
 - Compliance with applicable laws and regulations

Preventative: prevent undesirable “activities” from happening; deter the instance of errors or fraud

- Segregation of duties
- Authorization
- Documentation
- Security

Detective: identify undesirable "occurrences" after the fact

- Key control activity is reconciliation
- Activity reports (masterfile changes)
- Physical counts

Corrective: make appropriate changes to errors identified by detective controls

- Procedures to remediate errors
- Training staff on existing procedures that are not functioning at desired success level
- Progressive discipline for repeated procedural errors

Internal controls help an entity:

- Achieve performance and profitability targets
- Prevent loss of resources
- Ensure reliable financial reporting
- Ensure compliance with laws and regulations

Management

- CEO
 - Ultimately responsible and should assume “ownership” of the internal control system
 - Sets the “tone at the top”
- Senior management
 - Effectively a chief executive of his/her area of responsibility

Board of Directors/Supervisory or Audit Committee

- Provides governance, guidance, and oversight
- Should be objective, capable, and inquisitive

Internal auditors

- **Independently** evaluate effectiveness of control systems
- Often has significant monitoring role
- Provide **unbiased** insight to leadership regarding effectiveness of existing controls

Other management and staff

- To some degree, the responsibility of everyone

Limitations of Internal Control

- Judgement
 - Human error in decision making process or execution
 - Management biases
 - Based on information available at the time and usually within a limited time frame
- Breakdowns
 - Lack of effective or sufficient controls
 - Carelessness, distraction, being asked to focus on too many tasks / Volume
 - Complexity/Training
 - Misunderstanding of instructions by staff (communication)

Limitations of Internal Control

- Collusion

- Individuals acting together to perpetrate and conceal an action from detection
- Between two or more employees, or between employee and outside party (customer/member, vendor or other related party)
- This breakdown can also occur without fraudulent intentions. For example, an employee signing as the dual control when they were not actually present so that everything “looks right”
 - Signing off as reviewed but not understanding what to review

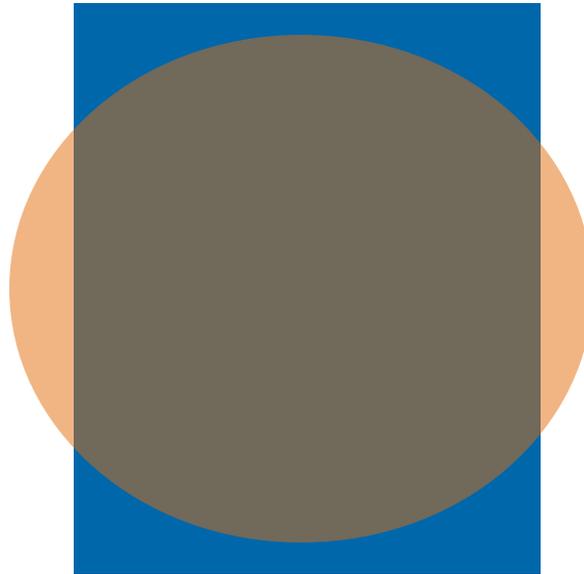
- Management override
 - Internal control only as effective as individuals responsible for its functioning
 - Overriding policies/procedures for illegitimate purposes with the intent of personal gain or enhanced presentation of performance
 - Frequent overrides performed to speed up processes can also be an issue. If a control is regularly being bypassed, it cannot function as designed or intended

Limitations of Internal Control

Circle/Square Concept

Circle: Your internal control procedures

Square: What the employees really do



Breakdown Example

Wire Transfer Controls

- For wires taken by phone, a typical control is a secure callback to a number on file
 - If this callback cannot be completed, how often does management override the control?
 - Instances of large losses due to fraudulent wires sent after override of this control
- Validation of identity
 - Provide security data in the effort to help in member service



Being on the lookout...

It's a puzzle



Insight. Oversight. Foresight. SM

Two Types of Internal Fraud

- Financial misstatement
 - Financial reporting fraud: not as prevalent...but could have disastrous consequences
 - Prior economic downturn resulted in an unusual “spike”
- Embezzlement
 - Employee fraud: some new “approaches” and some traditional “favorites”
 - Receiving more attention through “revamping” internal controls, internal audit and “whistleblower” provisions

Only one part is truly controllable

Motive/Pressure

Opportunity

Rationalization

- What can we do in respect to pressure/motivation?
 - Monitor employee accounts for over-limit activity, negative balances, excessive fees, and check-kiting indicators
 - In most instances, the information is available to us to identify this piece of the formula prior to the occurrence of fraud
 - Provide resources to employees identified as experiencing financial pressure
 - Budgeting help
 - Financial counseling
 - Environment of support (happy employees provide superior service)

- Lending
 - There are many variations
- Branch operations
 - Whether one branch or 10
- Accounting
 - Reconciliations are the key
- System access
 - Who can do what?
- Member accounts
 - Are they protected?
- Credit union assets
 - Easy to sell these days
- Off the wall
 - Getting creative



- Reconciliation issues
 - Conversion
 - Training / turnover
 - Theft
- Aggressive / unrealistic goals
 - Incentives
 - Performance



Types of Lending Fraud

- Fictitious loans
- Indirect lending arrangements
- Credit card loans
- Business lending (MBL) abuse
- Repossession and foreclosure schemes
- Insider deals



Fictitious Loans

- How are the loans created?
- How are the loans maintained?
- How are the loans paid off...and are they?
- What control weaknesses allow this?

Fictitious Loans

How They Happen

- A long-tenured employee experiencing financial pressure knows the system, changes the address on a seldom used account and funds a fictitious loan
 - This scheme can continue to grow as the employee uses proceeds from additional fictitious loans to pay off previous loans
- A member, in collusion with an employee, submits falsified information to obtain approval
- An individual impersonates another member to obtain funds under someone else's name

Fictitious Loans

Preventing and Detecting

- Do we have effective controls in place to **prevent**?
 - Approval requirements
 - Documentation requirements
 - Dual control over approval and disbursement/proper segregation
 - Segregation from collection efforts/file maintenance
- Do we have effective controls to **detect** them should they occur?
 - Monitoring first payment defaults
 - Regular review of approved loan sample by QC and/or IA

- These result in “indirect” losses
- The risk is big...but where is it?
- Two main types of indirect loan programs
- The dealers...their role...and “kickbacks”
- What control weaknesses allow this?



Indirect Lending Arrangements

How It Can Happen

- High-pressure, fast-moving environment; dealers want loans funded quickly and financial institutions compete for business
- Employees with approval authority enter into scheme with dealerships submitting applications and receive kickbacks for approval
- Dealers take advantage of leverage in having multiple funding sources and credit union's desire for loan growth to push loans with high negative equity or excessive back-ends
- Dealerships learn where corners can be cut in documentation requirements

Indirect Lending Arrangements Preventing and Detecting

- Preventive controls
 - Approval process for new dealer arrangements
 - Dealer relationship maintenance – site visits
 - Proper underwriting and approval
- Detective controls
 - Dealer monitoring – activity levels and loan performance
 - Review of “add-ons” at dealership level
 - Regular review of approved loan samples by QC and/or IA

- Often an “island” by themselves
- Tough area to control requiring special expertise
- Often serviced by third parties (separate system)
- What control weaknesses allow for abuse?
- What do the fraudsters gain?



Credit Card Loans

How It Can Happen

- As with all loans, an approval can be given where the applicant or employee grossly overstates income
- Employees colluding with applicants for kickbacks or a share of what will eventually be reported as fraudulent transactions - segregation
- Employees taking advantage of their access to obtain credit card numbers

Credit Card Loans

Preventing and Detecting

- Preventive controls
 - Approval process for new credit cards
 - Setup and ordering of new cards
- Detective controls
 - Monitoring of fraud activity/charge-backs
 - Can increased levels of fraud be traced back to a single approver or processor?
 - Regular review of new credit card sample by QC and/or IA

- Fairly new area of concern
- Tough area to control requiring special expertise
- Data system...often separate from core system
- Incentives to grow the business?
- What control weaknesses allow for abuse?
- Is it “fraud” or “negligence” or both?
- Preventing and detecting



- These result in real losses
- Tough area to control requiring special expertise
- Repo - then fix (if needed) - then sell
- Are there checks and balances?
- Internal issue plus dealers
- What control weaknesses allow this?
- Preventing and detecting



- Traditional area of concern
- Special treatment beyond what members receive
- Not always just loans
- Abuse of trust – they think they're special
- Vendors and kickback schemes
- What control weaknesses allow this?



Insider Deals

Preventing and Detecting

- Preventive controls
 - Does vendor selection process for significant purchases require proper vetting and multiple levels of approval?
 - Staff training
 - Annual independence acknowledgements by senior leadership and Board
- Detective controls
 - Review of approved contracts and loans
 - Accounts payable audit

- Why are **branches vulnerable**?
- Away from main office – proper controls?
- Are losses at branches “limited”?
- What about securing member information?
- **Reputation risk** more significant than lost cash
- Can be perpetrated by members or employees



Branches: Examples

- Theft of cash
 - Teller “borrowing” from drawer; vault custodians taking advantage of trust
- Elder abuse
- Fraudulent / Fictitious loans
 - Branches can be isolated. Are appropriate controls in place to compensate for the increased risk?
- Instant issue / Control of plastic cards
- Member information
 - Are sensitive documents properly secured during the day and at close?

- Safe Deposit boxes
 - Access controls, procedures for drilling unpaid / dormant boxes and subsequent custody of assets
- Staff training and awareness
 - Does staff have proper training and reporting channels for reporting of unusual activity by fellow employees?
 - Are staff comfortable reporting this information and aware of the whistleblower hotline?

- Certain member accounts are vulnerable to theft
 - Elderly, dormant, members not receiving statements
- Member education and information
- Reputation risk immense
- What control weaknesses allow for abuse?



Member Accounts

Preventing and Detecting

- Preventive controls
 - Dual control over new account process
 - Identification requirements
 - Proper override / dual control requirements for dormant account transactions
- Detective controls
 - Monitoring file maintenance activity is critical
 - Address, name changes
 - ACH changes (notice of change)
 - Regular review of dormant account activity
 - Regular review of new accounts by QC and / or IA

- An open door to fraud “opportunity”
- Could result in cover up of cash or check diversion
- Restrict access to certain functions in data system
- Who has “Administrator” rights?
- Access levels to systems “as needed”
- Control over “terminated” employees



System Access Preventing and Detecting

- Preventive controls
 - Ensuring user roles are administered by the appropriate employee(s) and require proper approval
 - Policy / procedures limit access rights to minimum required
 - Termination process includes removal of all system access
 - Rights for employees transitioning roles are properly changed; new rights are not simply added to existing rights
- Detective controls
 - Regular review of user roles in all systems

- Computers, monitors, cables, supplies, etc.
- Theft or diversion often goes undetected
- Poor purchasing and inventory controls
- Who can get away with this?
- Need education for all employees in technical inventory awareness



Credit Union Assets

Preventing and Detecting

- Preventive controls
 - Inventory of assets
 - Process for disposal of unused / outdated assets
 - Segregation of duties in purchasing approval, payment and receipt
 - Staff training
- Detective controls
 - Periodic verification of recorded inventory
 - Review sample of executed invoices
 - Purchasing / Accounts payable audit

- For the areas discussed, are proper channels in place for management to take prompt and effective corrective action if an error is detected?
 - Effective communication
 - Escalation procedures
 - Staff training and awareness
 - Disciplinary procedures documented in policy and implemented by management
 - Responding to and tracking of audit findings

- Fake employees lead to fake salary
- Is overtime and salary rate accurate?
- Expense reimbursement for “non-expenses”
- Insurance proceeds for fake and real claims
- Preventing and detecting



Tools to Assist in Fraud Identification

- Continuous audit concepts
 - Use by management, internal audit, external audit, examiners
- Artificial intelligence
 - Increased scope capability; 100% transaction review
 - Pattern and micro-pattern identification
 - Financial transactions are assessed with multiple coded risk profile characteristics on each general ledger transaction
 - Enhanced audit capability to isolate anomalies with massive speed and efficiency
- Block chain – wire authentication/reconciliation

Thank You!



Joseph A. Zito, CPA, MBA
Shareholder
Office: (248) 244-3068
Cell: (586) 291-4311
Email: zito@doeren.com

- External audit
- IT assurance
 - General controls/GLBA
 - Vulnerability assessments
 - Penetration testing
- Mergers and acquisitions consulting
- Internal audit
- Regulatory compliance auditing
- BSA and BSA validation
- ALM validation
- Loan reviews
 - Member Business Loan
 - Real Estate
 - Consumer