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Fraud in banks

ARE YOU KEEPING OCCUPATIONAL FRAUD UNDER CONTROL?

BUILDING YOUR CORE DEPOSITS FOR THE LONG TERM

HOW TO MANAGE COMMERCIAL REAL ESTATE RISK IN THE POST-PANDEMIC ERA

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ARE YOU KEEPING OCCUPATIONAL FRAUD UNDER CONTROL?

Willie Sutton, when asked why he robbed banks, famously replied, "Because that's where the money is." So, it's no surprise that banks are prime targets for fraud. According to the Association of Certified Fraud Examiners (ACFE), the banking and financial services industry consistently tops the list of industries most frequently affected by occupational fraud.

ACFE conducts a biennial survey and publishes the results in its reports on occupational fraud. Survey participants include certified fraud examiners (CFEs), internal auditors, accounting and finance professionals, compliance and ethics professionals, law enforcement, and other fraud investigators around the world. In the most recent edition, *Occupational Fraud 2022: A Report to the Nations*, banking and financial services again had the most occupational fraud cases (351 of the 2,110 cases studied). The average loss was approximately $1.74 million and the median loss was $100,000.

Important caveat: A high number of fraud cases may or may not mean that the banking and financial services industry experiences more fraud than other industries. It also might indicate that the industry employs more fraud investigators than other industries do — or it's more heavily regulated. Either way, fraud is a significant problem.

CATEGORIES OF FRAUD

ACFE classifies occupational frauds into the following three categories:

1. Asset misappropriation. These schemes involve employees who steal or misuse the employing organization's resources. Examples include theft of company cash, false billing schemes or inflated expense reports.

2. Corruption. These schemes involve employees who misuse influence in a business transaction in a way that violates their duty to the employer in order to gain a direct or indirect benefit. Examples are schemes involving bribery or conflicts of interest.

3. Financial statement fraud. This happens if an employee intentionally causes a misstatement or omits material information in the organization's financial reports. For example, a dishonest employee might file a fraudulent expense report claiming personal travel or nonexistent meals.

In the banking and financial services industry, the majority of occupational frauds (84%) involve asset misappropriation, while corruption occurs in 46% of cases and financial statement fraud happens in 11% of cases. Note that while financial statement fraud is relatively infrequent, it tends to produce the largest losses.

COMMON SCHEMES

The most common asset misappropriation schemes in banking and financial services are:

- Check and payment tampering (14% of cases),
- Theft of cash on hand (14%),

- Cash larceny, where an employee steals an incoming payment after it's recorded on the bank's books and records (11%),
- Noncash misappropriation, including theft or misuse of confidential customer information (11%),
- Skimming, where an employee steals an incoming payment before it's recorded on the bank's books and records (10%), and
- Billing schemes, which happen when an employee creates a shell company, bills the bank for fictitious services or personal items, and then submits a false invoice to the bank for payment (10%).

Keep in mind that these are only the most common *occupational* fraud schemes. Banks also may be victimized by a variety of external fraud schemes, such as check fraud, vendor fraud and cybercrimes.

INTERNAL CONTROLS

A strong system of internal controls is an excellent fraud prevention measure. For example, background checks, segregation of duties, dual authorization and management review are some of the most effective tools for preventing fraud.

Indeed, ACFE's survey found that many frauds occur because of the lack of internal controls (29%), the override of existing controls (20%) or the lack of management review (16%). Although deterring fraud is the best strategy, despite your best efforts, fraud may still occur. Have controls in place to detect fraud and put a stop to it before it gets out of hand. (See "Antifraud controls and percentage of fraud reduction," at right.)

DETECTION METHODS

According to the ACFE, the most common way frauds are initially detected is through tips (42%). Most often, tips are from employees, but they also may come from customers, vendors and others. It's a good idea for banks to set up hotlines where people can report suspected fraud via phone, email or online forms (preferably all three).

ANTIFRAUD CONTROLS AND PERCENTAGE OF FRAUD REDUCTION

The following table summarizes the antifraud controls that were most effective in terms of reducing fraud losses and duration, according to *Occupational Fraud 2022: A Report to the Nations.*

Antifraud control	Loss reduction	Duration reduction
Job rotation/ mandatory vacations	54%	50%
Surprise audits	50%	50%
Hotline	50%	33%
Proactive data monitoring/analysis	47%	56%
Antifraud policy	45%	33%
Formal fraud risk assessments	45%	44%
Fraud training for employees	45%	33%
Code of conduct	40%	33%

Regardless of which mechanisms your bank uses, you should allow for anonymous reporting. The ACFE reports that around 16% of tips were anonymous. In addition, frauds are commonly detected through internal audits (16%), management review (12%) and document examination (6%).

EVALUATE YOUR RISK

Each institution is different, so it's a good idea to conduct a formal risk assessment to identify your bank's specific vulnerabilities to fraud. Such an assessment will help you develop an antifraud program designed to mitigate those vulnerabilities and protect your bank from fraud. ■

BUILDING YOUR CORE DEPOSITS FOR THE LONG TERM

In the current unpredictable and volatile economy, community banks need to stay at the top of their game to maintain both stability and profitability. To that end, banks have many technological, regulatory and digital factors to consider. Among the most basic factors is attracting and sustaining the bank's core deposits.

TAKE THESE STEPS

Here are some steps your bank can take to grow core deposits, while keeping costs under control:

Avoid short-term fixes. It's important to recognize that building core deposits is a long-term strategy — there are no quick fixes. Offering above-market interest rates, for example, may attract new customers in the short term, but it's unlikely to support sustainable deposit growth. That's because customers who're attracted to higher rates are more likely to abandon you when a better rate comes along. In the long run, it's better to focus on customers who value service over interest rates.

Recognize the importance of branches. A recent J.D. Power banking satisfaction study offers insights into the value of branches. According to the study, although 28% of retail bank customers are now digital-only, they're among the least satisfied. The most satisfied customers are "branch-dependent digital customers" — those who take advantage of online or mobile banking but also visit a branch two or more times during a three-month period.

Interestingly, the satisfaction gap between branch-dependent customers and more "digital-centric" customers was most pronounced among Millennials and Generation Xers. This is a bit surprising, since it's commonly thought that younger customers eschew branches. It's still the case that most customers, including younger generations, prefer to open accounts at a branch — with personalized guidance — because they find it confusing to do online.

Focus on service. According to J.D. Power, weaker performance in the areas of communication and advice, new account openings, and products and fees caused lower satisfaction levels among digital-only customers. To attract and retain engaged customers and grow core deposits, banks need to improve communications and provide quality, personalized advice and other services consistently. It's key to make these strides across both digital and branch channels.

In addition, community banks that specialize in particular industries or types of banking are often able to attract customers who value specialized services over interest rates. The right niche — whether it's health care, professional services, hospitality, agriculture or some other industry — depends on the bank's history and the needs of the community.

CONSIDER RECIPROCAL DEPOSITS

A provision of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018 created an opportunity for community banks to boost deposits by taking advantage of reciprocal deposits. A bank receives these deposits through a deposit placement network in exchange for placing matching deposits at other banks in the network. One advantage of these networks is that they enable banks to attract large-dollar, stable, local depositors by offering them insured deposits beyond the $250,000 FDIC threshold. (Insurance coverage is increased by spreading deposits among several network banks.)

The 2018 law made it easier for banks to take advantage of reciprocal deposits by providing that these deposits (up to the lesser of 20% of total liabilities or $5 billion) won't be considered "brokered deposits" if specific requirements are met. Brokered deposits are subject to various rules and restrictions that make them more costly than traditional core deposits.

KEEP REFINING YOUR METHODS

Competition between community banks has never been higher. Your bank has to find ways to differentiate itself from the crowd. In the end, retaining customers requires a multifaceted effort, and focusing on attracting core deposits is key. ■

HOW TO MANAGE COMMERCIAL REAL ESTATE RISK IN THE POST-PANDEMIC ERA

Community banks, by their very nature, tend to have higher concentrations of commercial real estate (CRE) loans than larger institutions. Any concentration in certain types of loans, borrowers or collateral exposes banks to heightened risks, so your bank needs to be proactive in managing CRE concentration risk. This is particularly critical today, because a confluence of recent trends has elevated CRE risks for many banks.

CRE TRENDS

The following three key trends are affecting community banks' CRE risks and will likely continue to do so in the foreseeable future:

1. Remote work. In the wake of the COVID-19 pandemic, many businesses have shifted to fully remote or hybrid work arrangements (for instance, two days per week in the office, three days remote). As a result, many office building tenants are reducing their office space or electing not to renew their leases. This can make it difficult for commercial property owners to repay loans and potentially decreases collateral values.

2. Rising interest rates. Higher interest rates expose banks to maturity/refinance risks. As fixed-rate CRE loans mature over the next year or two, some borrowers may struggle to make payments when faced with significantly higher interest rates — in some cases double the rates they had previously locked in.

3. Inflation. The costs of operating commercial buildings have increased dramatically in the last few years. Borrowers are faced with increasing costs for labor, insurance, utilities, maintenance, taxes and other items, which affect their income and, therefore, their ability to repay loans.

In light of these trends, it's more important than ever for banks to shore up their risk management programs for CRE concentrations, particularly in the office sector.

RISK MANAGEMENT STRATEGIES

In assessing a bank's risk management program, it's helpful to consult the federal banking agencies' 2015 joint *Statement on Prudent Risk Management for Commercial Real Estate Lending*. Among other things, the statement urges banks with high CRE concentrations to:

- Establish adequate and appropriate loan policies, underwriting standards, credit risk management practices, concentration limits, lending strategies and capital adequacy strategies,
- Conduct global cash flow analyses based on *reasonable* assumptions regarding rental rates, sales projections and operating expenses,
- Stress test their CRE loan portfolios,
- Assess the ongoing ability of borrowers and projects to service debt, and
- Implement procedures for monitoring volatility in the CRE industry and reviewing appraisal reports.

Valuable guidance can also be found in the agencies' Supervision and Regulation (SR) Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate*. That guidance outlines the key elements of a robust risk management framework, including: 1) a strong management information system to identify, measure, monitor and manage CRE concentration risk; 2) market analysis, which allows banks to determine whether their CRE lending strategy and policies continue to be appropriate based on changes in market conditions; and 3) clear and measurable credit underwriting standards that facilitate evaluation of all relevant credit factors. Other elements discussed in the letter include board and management oversight, portfolio management, portfolio stress testing, sensitivity analysis and the credit risk review function.

IT'S MORE IMPORTANT THAN EVER FOR BANKS TO SHORE UP THEIR RISK MANAGEMENT PROGRAMS FOR CRE CONCENTRATIONS, PARTICULARLY IN THE OFFICE SECTOR.

RISKY BUSINESS

CRE lending has become riskier in recent years. You can manage this risk, however, if your bank monitors its CRE portfolio, keeps abreast of changing market conditions and implements sound risk management practices. ■

BANK WIRE

NEW INTERAGENCY GUIDANCE ON MANAGING THIRD-PARTY RISK

The Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Federal Reserve have finalized their "Interagency Guidance on Third-Party Relationships: Risk Management," which was proposed in 2021. The new guidance promotes consistency in the agencies' supervisory approach to third-party risk management. (Previously, each agency had its own guidance.)

The guidance maps out the third-party risk management life cycle — planning, due diligence and third-party selection, contract negotiation, ongoing monitoring, and termination — and describes risk management principles applicable to each stage. The guidance also clarifies that a bank's risk management program should focus on critical activities, while noting that not all third-party relationships are equally critical or present the same level of risk to a bank's operations. ■

WATCH OUT FOR "DIGITAL REDLINING"

Various federal laws and regulations protect consumers from unfair and discriminatory practices by banks. They include the Equal Credit Opportunity Act, the Fair Housing Act and the Dodd-Frank Act, which authorizes the Consumer Financial Protection Bureau to prosecute "unfair, deceptive, or abusive acts or practices."

Federal banking regulators are particularly concerned about redlining. This is a form of illegal disparate treatment whereby a lender provides "unequal access to credit, or unequal terms of credit, because of the race, color, national origin, or other prohibited characteristic(s) of the residents of the area" in which the credit seeker lives or the mortgaged residential property is located. A bank may expose itself to allegations of "digital redlining" if, for example, it offers more favorable credit terms for products offered through certain channels — such as websites or social media platforms — that are less likely to be used by minorities. Banks should review their marketing materials and online activities with this in mind. ■

DOING BUSINESS WITH MARIJUANA-RELATED BUSINESSES: HANDLE WITH CARE

As an increasing number of states legalize marijuana for medical or recreational use — or both — the marijuana business is booming. For community banks, lending to or accepting deposits from marijuana-related businesses (MRBs) represents a lucrative opportunity, but it can also be risky. Marijuana continues to be classified as a controlled substance under federal law, so banks that do business with MRBs may risk being charged with aiding and abetting a federal crime.

The U.S. Department of Justice and the Financial Crimes Enforcement Network have issued guidelines that offer some comfort to banks. For example, the guidance states that banks won't be prosecuted if they conduct thorough due diligence on MRBs, monitor them for money-laundering activities and comply with certain other requirements. However, many banks will understandably be wary of doing business with MRBs until federal legislation is enacted that normalizes relations between state-licensed MRBs and financial institutions. Stay tuned. ■

acxell ("acxell") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to other firms, acxell provides internal audit, regulatory compliance, BSA/AML, information technology, SOX/FDICIA and enterprise risk management review services and software. acxell is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

acxell's uniqueness is characterized by its experienced staff and partners. Their hands-on involvement on each engagement provides our clients with a wide range of skills, experience and industry expertise. We employ the use of Subject Matter Experts — designated individuals performing audits in their specific field of expertise. The use of such professionals provides a unique value-added approach that is both efficient and productive.

We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

We pride ourselves in our ability to provide effective and practical solutions that are commensurate with our clients' needs by emphasizing high-quality personalized service and attention. Our services are truly customized.

For **Solutions** *to your risk management needs, please contact our service coordinators at (877) 651-1700, or log-on to www.acxellrms.com to learn more.*

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