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Being aware of the fraud risk

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Editorial

On 19-21 November 2009, the Bank of Greece co-organized with the Bank of Albania the 3rd Annual South-Eastern European Economic Research Workshop held at its premises in Athens. The 1st and 2nd workshops were organized by the Bank of Albania and took place in Tirana in 2007 and 2008, respectively. The main objectives of these workshops are to further economic research in South-Eastern Europe (SEE) and extend knowledge of the country-specific features of the economies in the region. Moreover, the workshops enhance regional cooperation through the sharing of scientific knowledge and the provision of opportunities for cooperative research.

The 2009 workshop placed a special emphasis on three important topics for central banking in transition and small open SEE economies: financial and economic stability; banking and finance; internal and external vulnerabilities. Researchers from central banks participated, presenting and discussing their work.

The 4th Annual SEE Economic Research Workshop was organized by the Bank of Albania and took place on 18-19 November 2010 in Tirana. An emphasis was placed upon the lessons drawn from the global crisis and its effects on the SEE macroeconomic and financial sectors; adjustment of internal and external imbalances; and the new anchors for economic policy.

The papers presented, with their discussions, at the 2009 SEE Workshop are being made available to a wider audience through the Special Conference Paper Series of the Bank of Greece.

Here we present the paper by Elsa Kristo (Raiffeisen Bank) with its discussion by Elsida Orhan (Bank of Albania).

February, 2011

Altin Tanku (Bank of Albania)
Sophia Lazaretou (Bank of Greece)
(on behalf of the organisers)

BEING AWARE OF THE FRAUD RISK

Elsa Kristo
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ABSTRACT

Fraud is a concept that is generally understood, but whose characteristics are often not recognized until it is too late. The potential damage, financial and reputational, means that this risk cannot be ignored. Combating fraud requires an understanding of how and why it occurs and the way by which it can be minimized. As the pressure on management to maintain income and earnings increases, the incentive to commit fraud is higher. The above issues are the main subject of the paper. Its most interesting part refers to real fraud cases that have occurred in the Albanian banking system. These cases reveal the causes leading to fraud. Finally, the paper asks how the risk of fraud can be prevented.

JEL classification: K42, M42

Keywords: fraud, counterfeit, prevention

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1. Introduction

Fraud is a global problem. Fraud can occur in any organization at any time; fraud is dynamic. Significant frauds are now increasing as the global financial crisis has taken hold. Most fraudulent acts are perpetrated by employees who understand the internal operations at their workplace and take advantage of internal control weaknesses. But what does fraud really mean?

Fraud can be considered any falsification or misrepresentation by customer, employee or any third party with the intention to gain undeserved benefit. Generally speaking, an act is considered fraud when losses occur, whilst the gain from this act is not simply about money. Any type of advantage is a gain. What do people often steal or gain? It can be cash, equipment, and intellectual property, information for personal gain, name or reputation.

Under the Albanian Law, credit fraud (i.e. the most common type of fraud) is defined as a fraud performed through the presentation of false information, involving or obtaining a loan unrightfully by, for example, registering fictitiously mortgage properties that do not exist, claiming inflated prices for properties, or using a property that belongs to someone else. The loan application is made with the intent not to repay the loan (see articles 146, 186, 287 of the Penal Code, pp.78, 94, 135).

2. Classifications of Fraud

Incidents of fraud can be classified into the following categories:

- Based on the relation of the perpetrator to the bank, fraud is classified as external (perpetrated by a customer or other third party) or internal (perpetrated by staff or management). In the case of collaboration of internal and external parties, fraud is classified as internal.
- Based on the objective and intention, it is classified as credit (the objective is to obtain financing; the intention is not to pay) or theft (the objective is to steal; the intention is never to pay).

- Based on the number of fraud cases per perpetrator or group of perpetrators, fraud is classified as single (one fraud per perpetrator; no relation to other frauds) or multiple (organized attack; several frauds linked to one perpetrator).

Based on the scheme used, the following types of fraud are recognized:

- A. Falsified information or forgery meaning falsehoods or false information. Forgery is used to gain a benefit, which would otherwise not be reached. In most cases, the false information presented to the Albanian banks with the aim of being granted loans, is the declaration made by the employer of the salary earned by the applicant, when the customer gets the salary in cash and not through the bank.
- B. Identity theft. That is when hiding one's own identity by using the identity of somebody else through a nominee (white horse). In most cases in Albania, it is the birth certificate that is counterfeit; currently, new IDs card are being issued.
- C. Collateral (price and/or other) manipulation. Namely, any manipulation with collateral such as inflated price, multiple mortgage, sale, non-existent collateral, 'bubble' financing, corrupted resale, etc. Appraisal companies that evaluate the collateral usually engage in this kind of fraud.
- D. Theft of financial assets, namely stealing monetary funds belonging to the bank, such as cash, deposits, bonds, etc.
- E. Theft of non financial assets, i.e. stealing non-monetary property of the bank (fixed assets, e.g. cars, etc).
- F. Electronic fraud, i.e. unauthorized access, manipulation or disruption of systems, infrastructure or data, including denial of service attacks.
- G. Plastic fraud. Card fraud or plastic fraud includes: all lost and stolen, counterfeit, not received mail, third party application fraud, invalid cards, etc.

The last two categories of fraud are seldom met in Albania. However, there have been some cases so far. The fraud schemes have been ranked by their frequency of occurring in Albania.

3. Who commits fraud? A typology of fraudsters

When people are asked about the risk of fraud, they naturally tend to think of the risk posed by third parties. In fact, the worst frauds are carried out by insiders - employees, or even worse, management - many of whom have been with the company for many years and are in position of trust and authority. A person that perpetrates fraud may be involved in a situation that is so insurmountable that the person cannot see any other way out (e.g. gambling, abusing alcohol/drugs, family pressure or targets pressure). The worst case may be the insatiable desire for financial gain.

Internal fraudsters usually work their crimes alone, by exploiting weaknesses in internal controls to cover up their crimes. They have ready access on-the-job to cash or its equivalents. The way that such people justify their act of fraud is by viewing it not so much as a criminal act, but as a case of borrowing the money until they are able to pay back (see Uline 2007, pp.5-6).

4. Albanian banking fraud cases

The banking system in Albania was still developing in late 1990s and, as a result, the concept of fraud was synonymous with the theft of money. Currently, fraud (in banks) is performed in different ways, from a simple theft to more sophisticated means, from third party (external) fraud to the internal fraud or collusion between internal and external.

Based on data from internal sources, as well as the Albanian court publications, in most cases, fraud in the Albanian banks takes the form of credit fraud, meaning that customers, or rather 'fake customers', use counterfeit documents or identities (i.e. ID, collateral property certificates, salary declarations, payment utilities invoices, etc) with the aim of being granted a loan or an overdraft.

Referring to the 'credit fraud' cases brought to the courts, it can be seen that credit fraud is proliferating from 2005 onwards. Thus,

- In 2005 – one fraud case in the amount of \$40 million, by presenting in two Bulgarian banks a fake Letter of Guarantee from an Albanian bank and fake documents issued from the Albanian Ministry of Finance.
- In 2007 – two fraud cases amounting to \$22,000 and EUR 36,585. The two cases involved the presentation of falsified collateral ownership documents.
- In 2008 – two fraud cases amounting to EUR 61,000. The two cases involved the use of fake ID documents. One case was performed by third parties in collusion with bank employees in the position of Personal Banker.
- In 2009 – eleven fraud cases amounting to EUR 218,341. Three ‘credit fraud cases’ are still in process, three other ‘credit fraud cases’ involved presenting falsified documentation with regard to collateral ownership blocked in favour of the bank, whilst five other fraud cases involved the use of fake ID documents.

The following fraud cases both internal and external fraud risk cases were performed in the Albanian banking system:

Case 1

The branch manager (of a bank) initiated an application for an overdraft without customer’s knowledge, being aware that the customer had a deposit, to be used as cash collateral. Additionally, the Personal Banker password was known so as to proceed with the application. After the overdraft was made available in the customer account, the branch manager compiled a transfer order, counterfeiting the signature of the customer, for transferring the amount of the overdraft into another customer account to whom the branch manager had obligations. The transaction was easily performed by the Back Office based on the transfer document with the counterfeited customer’s signature. At the maturity date of this overdraft, the branch manager started another overdraft application with the scope of closing the previous one. The transaction was performed by using the password of the Personal Banker (for the overdraft application) and of the Customer Service (to transfer the amount) since the branch manager had no right to perform the above transactions. Then, to close the second overdraft, the branch manager again

performed unauthorised transactions from another customer's account. The fraud was discovered when the last customer presented at the bank to withdraw the money and close the account.

Case 2

A customer service employee performed unauthorised transactions from a customer's account by transferring amounts of money to his personal account (knowing that some of the customers were no longer alive). The transactions could be easily performed since no authorisation was needed in the banking system up to a defined limit. Furthermore, some of these accounts were dormant and for their activation an override was required, which was formally given by the supervisor.

Case 3

The customer service employee had previously been in a Teller position. Since his teller ID was still active (whereas it should have been deactivated), he performed fictitious cash transactions in his favour by debiting the customer account (i.e. a cash withdrawal transaction) and crediting his account (i.e. a cash deposit transaction).

Case 4

A private company pays its employees' salaries through the bank. Based on an agreement between the company and the bank, if the salaries are paid through the bank, the company employees will be granted loans. To this end, the salaries of the company employees are credited through the bank twice (for two consecutive months) in order for the employees to be eligible for granting loans. After the loans are approved, the employer, in collusion with the bank employees, signs the loan contracts (by counterfeiting the employees' signatures) and withdraws the loan amounts disbursed.

Case 5

A real customer applies for a loan, the loan is approved, but the customer is refused by the branch and the bank employee steals the funds.

Case 6

A fraudster fabricates written request of a customer to terminate deposit and then withdraws the customer's money.

Case 7

A real customer repays the loan before the schedule. The cashier issues the payment document, prints it out and gives it to the customer. Afterwards, the transaction is not confirmed and is cancelled at the branch level.

Case 8

A cashier in conspiracy with the customer service employee perform foreign exchange transactions by using money from a customer's accounts and then depositing it back. When the core banking system is not yet online, the transactions are performed manually (or in excel format) and the staff compiles false order withdrawals on behalf of the customer, not registering them in the customer's file or card. Then, they correct (i.e. manipulate) interest accruals by increasing them fictitiously. Hence, the customer's deposit is debited (i.e. the money is used for foreign exchange transactions) and the interest accrued (i.e. the liability side) is credited. The fraud was revealed by one of the employees. After an audit was performed, a considerable number of customer deposits had been found to be being used in this fraud.

Case 9

A non-material fraud case occurred, that is no bank losses occurred. Due to the target pressure for credit card products, bank employees started applications for credit cards on behalf of customers without customer awareness. They attached in the application system copies of the photocopied ID documents stored in the existing files of the customers' current account, in order to have risk approval for the card limit. The 'fraud' was revealed when risk analysts interviewed the customers *via* phone. Even if the credit card limit had been approved, no loss would have occurred since the customers were unaware that they had been issued a card.

Case 10

A customer came to a bank to deposit a certain amount of money. Since the teller told him that the system was down, he gave the money on trust and came to the bank the next working day in order to sign the deposit slip. When the customer came to the bank, he noticed (verifying on the ATM) that the amount left on trust had only partly been deposited in his account. The customer asked for an explanation from the teller, who declared that she had his funds and immediately booked the difference. While the teller booked the difference into the account of the customer, she did not have all the funds in the cash box (she had used a part of them for personal purposes). Hence, the teller performed a withdrawal transaction from the account of another customer to cover the difference.

Case 11

A person, by presenting to the bank an authorizing document from a private company, retrieves a cheque-book on behalf of the company administrator. The document had the stamp of the company and the signature of the administrator. The teller accepted the authorization and delivered the cheque-book. Another person, in another branch (rather than the one where the cheque-book was issued) presents a cheque from the company in order to withdraw a certain amount of money. The cheque has on it the stamp and the

signature of the company and the administrator, which however were counterfeited. Hence, the customer withdrew the money. The fraud was noticed when the company administrator required an explanation from the bank of why a considerable amount of money had been withdrawn from his company account.

Case 12

The administrator of a company (i.e. the supplier) had signed an agreement with a contractor. Since he did not fulfil the contract terms within the deadline, the contractor sequestrated the guarantee of the provider. In order to be granted a loan, the administrator asked his insurance company to be his guarantor by showing the contract, without however informing the insurance company that the contract had not been executed. The bank and the insurance company failed in their verification performed.

Based on the above cases and those due in court, we can draw the conclusion that the Albanian banks are ‘victims of credit fraud’. Usually, the customers submit to the bank counterfeit documents such as birth certificates (ID documents), company (employer’s) data, including contact phone numbers, address and administrator’s signature, customer data, including mobile phone and home address, customer salary declarations, insurance and tax office documents, rent agreements and property registration certificate. It is particularly difficult even for trained verifiers and underwriters to detect the false documents, the hidden relationship between different customers, or between different customers and the same employer, the same phone number, the same address, the same contact person or the same guarantor for different customers. Furthermore, in the absence of a unique identification number, security elements in ID documents (currently new ID cards are being issued), a blacklist database or a national address and landline database along with a significant informal economy and a high level of migration, it is very difficult to investigate customers. Hence, the approval process exhibits some weaknesses, which leads to the ‘bad’ loans approval.

Internal frauds are also increasing. Due to gaps in the process, including lack of control over transaction authorisation, a breach of bank internal operational procedures (for cash and noncash transaction) and a breach of password policy, along with the

absence of the four eyes principles, bank employees take advantage and perform fraud. All the above cases suggest that if proper control had been in place and performed at the end of each working day, fraud would have been detected.

Since the Albanian banks are now aware of the fraud risk, they involve immediately the Fraud Risk Officer. Moreover, fraud detection in Albania is supported by the Credit Bureau (exposures and current applications in the domestic banking system), the election list (identity double check), whistle blowing and mystery shopping.

5. Fraud figures & fraud surveys

Different fraud surveys were performed during 2009 and the conclusion suggested is that in a time of a global crisis, companies all over the world are experiencing increased fraud risk. As the economic downturn persists, management faces tougher challenges than ever before.

To the question ‘Do you expect corporate fraud to increase or decrease in the next few years?’ the surveys reveal that 55% believe that fraud will increase significantly or slightly; 27% expect no change; 8% expect a slight or significant decrease; and 10% answered that they do not know. For many companies, this comes at a time when survival rather than growth is the primary focus (see Ernst & Young 2009, p4). The results of the fraud surveys are consistent with the situation in the Albanian banking system.

6. Fraud management process in the banking system

Expressing concern over rising incidents of fraud in loans and in operational activity, the banks are even more focused on the fraud prevention and management function.

The fraud management process involves three steps: (1) fraud prevention; (2) fraud detection; and (3) fraud investigation. The best to fight fraud is to prevent it. Prevention is mostly about improving the key risk processes.

For a bank, it is important that when dealing with customers, employees must ensure that they know the identity of the customer, what business they do with the bank and why they are undertaking each activity. It is the personal responsibility of every member of staff to ensure that they are aware of and that they can competently identify activities which may constitute fraud, can identify signs of suspicious behaviour by customers or staff and to know how they should report any concern regarding fraud, and to whom.

All bank employees (specifically those in relevant positions) should be provided with the adequate and appropriate fraud prevention and awareness training. Fraud risk must also be analysed during the development of all new products within the bank to ensure that the product structure will help prevent possible fraudulent attempts.

Banks' main activity is lending activity, which bears the greatest external and internal fraud risk. As a result, the approval process should be strictly considered from the fraud point of view. The bank should have a third party acquisition and monitoring policy in place which must include fraud related actions. The granting of loans or credit limits should be made only after considering the fraud risk as well as the credit risk associated with the applicant, the co-applicant and the guarantor.

A bank should have in place a fraud response plan, which manages and reduces instances of fraud committed by employees/agents (internal fraud) or by third parties (external fraud) of the bank and thus minimizes incurred losses. The purpose of a fraud response plan must be clearly communicated to the employees. As a minimum, the fraud response plan should have been devised to define initial action and responsible persons once a fraud has been reported and restrict further losses to the company, review the reasons for the incident, advice on measures required to prevent future fraud, recommend actions that will strengthen future responses to fraud and, lastly, recover any actual losses.

The above steps should be defined in a fraud policy, which is a written statement recording the company's attitude to fraud. It may be included within a more general ethics statement or code of conduct that records the way in which the company deals with its customers and staff. The fraud policy has to be supported by the company's directors,

who in turn must comply. The staff should be required to indicate their awareness of and compliance with the fraud/ethics policy on an annual basis. In particular, the policy should make clear that fraud is unacceptable and that all instances of suspected fraud will be treated seriously.

Noting that the steps taken by banks in investigating fraud and identifying the fraudsters have not been adequate, the central bank should advise the commercial banks or impose regulations on them with the aim of fraud prevention.

7. Conclusion

Fraud is a concept that is generally understood but whose characteristics are often not recognized until it is too late. The incidence of fraud has been rising during the global crisis all over in the world as well as in Albania itself. Most fraudulent acts are perpetrated by employees who understand the internal operations at their workplace and take advantage of internal control weaknesses. The type of fraud mostly common to the Albanian banks is the credit fraud.

In common with any crime prevention strategy, the key to minimizing the risk of fraud lies in understanding why it occurs; in identifying business areas that are at risk and implementing procedures addressing vulnerable areas. Combating fraud risk should therefore be a two-pronged approach. First, ensuring that the opportunities do not arise and, second, ensuring that the fraudster believes that he will be caught and that the potential rewards do not make the consequences of being caught worthwhile. With the aim of preventing fraud, the central bank should consider imposing regulations on the banks by enforcing their framework for fraud risk protection.

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Discussion

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The paper by Elsa Kristo gives us a general description of the fraud concept and the associated risk when a fraud event occurs. The paper is organized as follows. First, it presents a theoretical definition and understanding of fraud. A classification of fraud, namely types and fraudsters, are developed further, especially those that are related to the banking services and products, as well as the reasons why fraud exists and which is its impact on the respective banking business. Finally, fraud surveys conducted for European countries are presented and some Albanian fraud cases are briefly discussed.

1. What does ‘fraud’ really mean?

As the author notes, fraud can be considered any falsification or misrepresentation by customer, employee or any third party with intention to gain undeserved benefit. Generally speaking, fraud is considered when losses occur, whilst gain is not simply about money. A major reason why people commit fraud is because they are allowed to do so. Fraud risk is a component of operational risk and compiling reliable statistics around fraud is not an easy task. Fraud is mistakenly considered a victimless crime-social but it really has psychological effects.

2. Classifications of fraud

Incidents of fraud are classified in the following categories:

Based on the relation of the perpetrator to the bank:

- **External** (perpetrated by a customer or other third party) or
- **Internal** (perpetrated by staff or management).

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In the case of collaboration of internal and external parties, fraud will be classified as internal.

Based on the objective and intention:

- **Credit** (the objective is to obtain financing; the intention is not to pay), and
- **Theft** (the objective is to steal; the intention is never to pay).

Based on the number of fraud cases per perpetrator or group of perpetrators:

- **Single** (one fraud per perpetrator, no relation to other frauds);
- **Multiple** (organized attack, several frauds linked to one perpetrator).

3. Who commits fraud: A typology of fraudsters

When one asks people thinking of the fraud risk, they tend naturally to think of that posed by third parties. In fact, the worst frauds are carried out by insiders - employees, or even worse management - many of whom have been with the company for many years and in position of trust and authority. However, a person which perpetrates fraud may have the following characteristics:

- He usually works their crimes alone
- He tends to be compulsive (gambling, abusing alcohol/drugs)
- He spends money freely (their own)
- He rationalizes his thefts by thinking he is merely borrowing or the money is owed to him
- He tends to repeat and escalates his crime
- He exploits weaknesses in internal controls to cover up his crimes
- He has ready access on-the-job to cash or its equivalent

4. Banking fraud case studies (Albanian cases as well)

The banking system in Albania has been developing lately in 1990s; hence the fraud as a concept has been known only as a theft of money. Currently, fraud (in banks) is performed in different ways; from a simple theft to more sophisticated ways and from third parties (external) fraud to internal fraud. Fraud which is often performed in the Albanian banks is the credit fraud (referring to Albanian courts publication), meaning that the customer or better the ‘fake customers’ use false documents or identity (i.e. ID, collateral property certificate, salary declaration) with the scope of being granted a loan or an overdraft.

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