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The Detection, Investigation and Prevention of Insider Loan Fraud: A White Paper

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INSIDER LOAN FRAUD

Fraud poses substantial risks, both to individual institutions and the financial system. This interagency guidance focuses on insider[1] loan fraud and ways that financial institution examiners can identify, research, and document suspected activities. Though intended to heighten examiners' awareness and encourage flexible approaches to this problem, **direction provided herein is not meant to over-ride or replace current examination policies and practices. Examiners should only use these procedures contained in this document when warning signs that warrant expanded procedures are present and in consultation with their supervisors.**

The initial narrative portion discusses various issues related to prevention, detection, and documentation. In addition, a series of appendices contain warnings signs, procedures and other guidance designed to be separated for examiner use. The first narrative section, Control Environment Assessment, concentrates on infrastructure that reduces the risk of insider loan fraud. The second portion, Insider Loan Fraud Detection, identifies avenues of review that might reveal anomalous items requiring additional research. The last section, Researching Suspicious Circumstances, while discussing the importance of additional procedures, also highlights the critical nature of interviewing skills and appropriate documentation. The associated Appendices include an inventory of warning-signs specific to insider loan fraud and a group of procedures that can be used to research suspected activities, as well as other reference materials. **Examiners should use these appendices in conjunction with the applicable narrative sections and in consultation with their supervisors.**

Factors Conducive to Fraud

Fraud is often defined as: "[a] knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."[2] There are several common psychological and environmental conditions that foster the occurrence of fraud. The fundamental element that must exist is awareness of a control weakness that can be exploited for financial gain. Further, whether committed individually or in collusion, fraud frequently arises when an instigator(s) develops a financial need that he or she cannot share with anyone. Examples include addictive behaviors, family medical problems, romantic entanglements, financial hardships, or similar

[1] The term "insider" is intended to mean an institution-affiliated party, such as an officer, director, employee, agent, consultant or any other person who participates in the affairs of a financial institution.

[2] *Black's Law Dictionary* p. 670 (7th ed. 1999).

situations. Finally, the instigator(s) develops a rationalization that makes the act acceptable in his or her personal ethical code.

Since the tone set by executive management tends to permeate the entire organization, a strong ethical tenor at the top of an organization will help establish a principled attitude throughout. Absent that, it is not unusual for lower level employees to follow the lead of any top managers who may be engaging in fraud or perceived as such. Even without illegal activity at the top, lax management and weak internal controls can produce a similar effect.

Environmental aspects such as weak internal controls and an inadequate audit program present the motivated insider with the opportunity to engage in improper behavior. Active, strong controls reduce the opportunities available to those who find themselves in the circumstances referred to above. In the absence of a satisfactory control environment, the following elements can help to counter-balance structural deficiencies:

- Increased attention to an institution's operations and staff when examiners are on-site,
- A skeptical attitude on the part of examiners and auditors geared toward early fraud detection, before the level of damage imperils an institution, and
- Visible, credible adverse consequences, such as a high probability of detection, administrative enforcement, and criminal prosecution.

Examples of Insider Loan Fraud

The following list, while not all-inclusive, illustrates various insider loan fraud situations typically found in financial institutions:

- Nominee loans[4] and similar transactions that are constructed to circumvent laws, regulations, and institutions' internal limits or internal policies;
- Conflicts-of-interest that go beyond laws governing insider interests;
- Bribes and kickbacks arising from lending activities;
- Loans tied to favors for friends and family, including non-monetary consideration;
- Fictitious loans;

[4] A "nominee loan" is one in which the borrower named in the loan documents is not the real party in interest, i.e., the party that receives the use or benefit of the loan proceeds.

- Manipulation in the sale and purchase of loan pools,
- OREO sold through preferential contracts that include favorable financing or are not at arms length,
- Inappropriate or fraudulent loan arrangements used to purchase capital stock, which inflates the capital base.

When insider loan fraud does occur, the federal regulatory agencies may be able to penalize the offender, protect the financial system from the offender, and deter similar offences by other insiders by pursuing civil enforcement action. The agencies may have the authority to pursue certain enforcement actions against an insider who has committed loan fraud, regardless of whether the insider is criminally prosecuted. These possible actions include assessing civil money penalties; ordering insiders to reimburse, make restitution or indemnify losses; or prohibiting insiders from participating in the affairs of insured institutions.

CONTROL ENVIRONMENT ASSESSMENT

Insider loan fraud prevention, like other forms of fraud prevention, is a frame of mind. An institution's control environment, including management's attitude, may contribute significantly to windows of opportunity for insiders to commit loan fraud. Not only do control weaknesses provide the opportunity for an insider to commit loan fraud; some insiders may even seek out weaknesses to exploit. Examiners and institution management should be alert to all possibilities.

The control environment should be examined with healthy skepticism. Different facets of the institution's structure and culture should be examined using your agency's risk assessment approach to examinations. Certain tools can be used to determine if windows of opportunity are open and to determine the need for additional resources and time to be allocated to an on-site examination to help close these windows.

Although it is not possible to avoid all instances of insider loan fraud, financial institutions can better manage such risk by creating a control environment that promotes honest and open corporate behavior. It is far more cost effective to prevent insider loan frauds than to investigate and prosecute them. A strong control environment hinders an insider from dominating the institution and circumventing restrictions. Strong *employment practices* prevent people with questionable reputations from entering the financial services industry. Essential elements of a strong control environment include *code of conduct*, *employment practices, loan review system*, *independent audit*, and *internal controls*.

Code of Conduct

An essential preventive element against insider loan fraud is a clear statement by the institution's board of directors of its ethical position, such as a code of business principles.[5] A code of conduct, which is expressed strongly and applied vigorously, gives all employees a way to resolve ethical conflicts and positions the institution as one that does business fairly and honestly. Compliance must include the entire institution: directors, management, employees, and institution-affiliated parties. The code of conduct should be impartially enforced and include sanctions.

People have a tendency to view fraud as a crime which is committed by outsiders rather than intimates. As a result, insider loan fraud is sometimes not fully considered in the development and enforcement of codes of conduct and business principles. It can be seen by management as a negative feature in a code extolling positive corporate principles such as teamwork, trust, and respect. Ignoring this potential risk is a lost opportunity. Financial institutions, which successfully promote high standards of ethical conduct in all situations, have a lower incidence of fraud and find out about incidents earlier.

Consider the following questions when assessing the adequacy of an institution's code of conduct:

- Does the code of conduct address conflicts of interest and self-dealing that could lead to fraud?
- Does the code of conduct define acceptable behavior, encourage ethical conduct, and establish mechanisms to monitor and enforce the policy?
- Does the institution have a system to validate compliance with its code of conduct?
- Does the institution have an ongoing program to educate and raise the awareness of the entire institution regarding its code of conduct?
- Does the institution provide an independent avenue, such as a whistle blower policy, for reporting suspicious activity directly to the board of directors?

[5] Refer to agency guidelines for specific guidance regarding appropriate code of conduct and conflicts of interest policies.

- Does the code of conduct or loan policy define the term "related interests" and include provisions for proper disclosure of all related interests?

Employment Practices

An essential defense against insider loan fraud is the use of proactive hiring procedures. Employees engaging in frauds often fit a profile. As stated earlier, they may be involved with drugs, alcohol, gaming, or personal relationships creating extraordinary financial needs, or may be experiencing personal financial hardships that are otherwise unknown to their employer.

Ongoing monitoring and awareness of all employees' immediate situational factors is essential. Many of the most scandalous insider loan frauds have been generated by persons of "impeccable" social background with no previous record of dishonesty. In essence, this lack of a prior history of insider abuse and self-dealing led to a false sense of security and contributed to the ability of such insiders to participate in large frauds.

Consider the following questions when determining whether an institution's employment practices are proactive deterrents for insider loan fraud:

- Are comprehensive background checks performed for all new personnel, including directors? While such a program should be tailored to the size and complexity of the institution, the protocol could include evaluation of handwriting and fingerprint samples by law enforcement authorities, verification of educational transcripts, analysis of credit reports, reference validation, and public records searches? Institutions should ensure legal requirements for above items, such as credit reports, are observed.

- Are there procedures in place to check employment references with other financial institutions with respect to prospective employee's suitability? For example, are references reviewed to determine if there has been involvement in potentially unlawful activities? (Section 355 of the USA Patriot Act).

- Are there appropriate procedures to ensure that the institution has an ongoing screening program to monitor and detect changes in its employees' and directors' lifestyles, behaviors, and actions? Do these procedures include periodic credit reports and public records searches?

The extent to which employment practices are implemented may differ due to the size and complexity of the institution;

however, compensating controls should be in place. Examples of compensating controls could include some of the following:

- Periodically reviewing the financial statements and tax returns of insiders with outstanding loans,

- Reviewing an annual questionnaire in which insiders identify their related interests, and

- Reviewing insiders' deposit and loan accounts on a routine basis to determine the reasonableness of transactions.

Independent Loan Review

The complexity and scope of a loan review system will vary based on an institution's size, type of operations, and management practices. However, an effective loan review function can expose insider loan fraud and self-dealings at an early stage.

Consider the following questions when trying to determine the effectiveness of an institution's loan review system relative to insider loan fraud:

- Is the loan review function independent of the credit administration and loan approval processes? Are loan review findings reported directly to the board of directors or board level committee?

- Are procedures in place to review insider loans within a reasonable time period after origination?

- Is the loan review timely, thorough, and comprehensive? Does it ensure that loan samples include loans originated by all lending officers and is representative of all lending types?

- Are procedures in place to ensure the prompt identification of loans with well-defined weaknesses and relevant lending patterns that may potentially be indicative of fictitious or fraudulent activity?

- Are procedures in place to identify multiple extensions, renewals, or rewrites that are exceptions to policy?

- Are procedures in place to assess the adequacy of and adherence to established lending and conflict of interest policies?

- Does loan review substantiate appraisal values for real estate properties and make adequate reviews of appraisals?

- Do loan review personnel have the knowledge and confidence to challenge transactions that look suspicious, especially if the transactions have been executed by an executive officer or board member?

Audit

Deterring dishonest insider lending practices may be achieved by increasing an insider's perception of the risk of credible adverse consequences – namely, detection and prosecution. A comprehensive independent audit function provides a significant deterrent on both accounts. The institution should have a reliable accounting function and internal control system, as well as an appropriately staffed audit function that has sufficient authority and resources to perform its function. The audit function should be independent and report findings directly to the board of directors.

Consider the following questions when assessing the adequacy of an institution's audit function as a viable deterrent against insider loan fraud:

- Does the scope of the audit include review of compliance with the code of conduct, employment practices, loan review systems, and internal controls?

- Are there specific audit procedures to target insider loan fraud?

- Are confirmations of loan balances performed frequently enough with proper controls?

- Does the audit include a review of general ledger suspense accounts, such as loans in process; employee accounts and other transactions, such as wires, performed by employees; and charged-off loans for insider involvement?

- Are auditors willing to challenge any transaction that looks suspicious, especially those involving an executive officer or board member?

Internal Controls

The potential for insider loan fraud is greatly increased in an environment where internal controls are lax, arbitrary, or non-existent; where management and others are exempt from policy and procedures; where nepotism is allowed but not acknowledged; and where the authority to act does not accompany responsibility for results.

Consider the following issues when assessing the effectiveness of an institution's internal control system:

- Does the institution perform a risk assessment relative to insider loan fraud? Are anti-fraud policies and procedures in effect?

- Does the institution routinely assess the effectiveness of controls with the ultimate test: would its system of checks and balances identify actions of a dishonest insider committing loan fraud?

- Does the institution's control environment and organizational structure allow one employee or director to dominate or undermine lending decisions, or dominate senior management and the board?

- Does the institution require rotation of duties and schedules without notice?

- Is there sufficient segregation of duties? It should not be possible for a single individual to complete all aspects of a transaction. Authorization for a transaction, custody of the asset, and ability to effect accounting entries should not be concentrated in one person.

- Is the institution's vacation policy strictly enforced for all employees? What are the consequences of policy violations?

- Does the board monitor and supervise the actions of the institution's loan officers to determine that they are executing their duties and loan authority in accordance with the loan policy and delegations of authority granted by the board?

To summarize, as examiners assess the complete control environment in relation to insider loan fraud, a "no" answer to any of these questions indicates that the institution may have a heightened exposure to insider loan fraud. Although not a certainty, a negative response to a single issue is a window of opportunity for insider self-dealing, abuse, or fraud. A one page recap of the above tips is provided in Appendix A for detachment and use in the field. In addition, many of these concepts can be applied to the detection, not just the prevention of insider loan fraud.

INSIDER LOAN FRAUD DETECTION

<u>Experience</u> and <u>common sense</u> are key elements in the identification of potential insider loan fraud. If something

does not look right or does not seem to make sense, further analysis is usually needed. In addition, communicating your concerns to the examiner-in-charge early on is critical to alerting other examiners to look for similar patterns or circumstances.

This section identifies common sources of information that may contain warning signs of possible insider loan fraud. In reviewing documentation from these sources, examiners need to be mindful of the ease with which fraudulent documents can be created. Photocopies may not be representative of the original documents. Inconsistencies between what should be identical information contained in one document and another may indicate that one, or both, of the documents may be forgeries. The examiner should always request original documents in these situations.

The following are examples of instances where examiners discovered information that did not seem to make sense, and their perseverance uncovered material insider loan frauds.

- Over a three-year period, an institution's quarter-end past due loan ratio was consistently around one percent. Closer review by examiners revealed that the chief executive officer was refinancing loans and extending loan payments to maintain a low past due loan ratio.

- While reviewing a loan trial balance, an examiner noticed several real estate secured loans to different borrowers on the same street with consecutive house numbers. The examiner also noticed that the loan balances did not appear to be amortizing. Research of public records disclosed that the borrowers did not own the real estate pledged as collateral.

These are just a couple examples of examiners taking a step back and looking at the big picture to see if things just make sense.

Analysis of Electronic Loan Data

It is common practice for financial institutions to provide regulators with an electronic download of the institution's loan data, which is used primarily to determine the loan review scope for an examination. Many of the data fields contain information that, when properly analyzed, may be early indicators for potential insider loan fraud. Often the data is in a spreadsheet format, which enables examiners to perform calculations and data sorts.

Although the guidelines in Appendix B are based on data fields that are common to loan processing systems, not all institutions will maintain each of the data fields discussed below. In those instances, and especially where insider loan fraud is suspected, examiners should consider alternative information sources such as reviewing system generated reports.

Board Minutes and Board Reports

The content and informative value of board of directors' minutes and board level reports varies from institution to institution. It is just as common for some institutions to maintain detailed board minutes as it is for others to record only basic information. Management may be able to successfully conceal indications of fraud by generating voluminous board packages rife with minute detail as easily as by omitting key information. Board reports should be reviewed carefully to determine the accuracy, adequacy, and appropriateness of information reported to the directorate.

Discussions with Employees

Formal and casual discussions with employees may reveal irregularities, anomalies, or suspicious behavior. Employees who are very guarded in answering examiner questions may have something to hide. They may have personal knowledge of questionable loan transactions and are looking for an opportunity to inform examiners. Some employees may seek out examiners with known situations. Other employees may unknowingly reveal information through casual discussion that should be pursued by examiners. An additional discussion of interviewing is included in the section - **RESEARCHING SUSPICIOUS CIRCUMSTANCES**.

Insider and Borrower Financial Statement Analysis

Analysis of insiders' and borrowers' financial statements can reveal several points of interest. Statements that contain accumulated assets or liabilities that are in excess of an insider's income generation capabilities can be a significant indicator of suspicious activity. Additionally, review of a borrower's financial statements can reveal borrowing or business relationships between an insider and other institution customers.

It is important that a institution's internal analysis of insider financial statements occur in the ordinary course of business under the established credit granting regimen. This would include verification of assets and liabilities, particularly if the financials are unaudited. Lack of verification of financial statement items can be a warning sign that merits further examiner review.

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Loan File Review

If warning signs are present, examiner loan file review should include a review of the financial institution's policies and procedures, loan files, and committee minutes to determine existence of anomalies. A synopsis of key policy parameters prepared by a member of the examination team can aid file review examiners by providing a ready reference for assessing policy compliance. Inconsistencies with policies and procedures should trigger more intense scrutiny.

In summary, suspicion of insider loan fraud may arise from a variety of sources or from a just single source. The key is to question inconsistencies or information that does not make sense until the issues are resolved. Researching issues can be accomplished through a number of avenues that are discussed in the following section. A detailed list of warning signs is provided in Appendix B.

RESEARCHING SUSPICIOUS CIRCUMSTANCES

Standard examination procedures are not designed to test routinely for fraud, particularly in a risk-focused environment. This section and related appendices provide possible procedures to use when examiners suspect insider abuse or fraud, as well as guidance for interviewing and documenting findings. Some of these procedures include tracing loan payments and proceeds, reviewing insiders' deposit account activity, analyzing general ledger reconcilements and suspense account activity, and researching public records for relevant information.

- Tracing loan payments and proceeds can provide details on the transaction originator(s) or identify additional participants, as well as reveal the path of funding flows, and the final destination of funds. This information can be used to substantiate evidence of intentional misconduct.

- Reviewing insiders' deposit account activity and official checks can also help establish the flow of funds; identify previously unknown, related parties to transactions; accounts at other institutions; and other lending relationships,

- Review and tracing of reconciling items can reveal items that are not cleared properly or are re-aged to hide irregularities. Fraudulent lending activity is sometimes hidden in reconciling items of general ledger accounts.

- Researching public records will supply a wide variety of information related to lien filings, ownership of assets, relationship of different parties, previously unidentified related interests, etc.

A more extensive list of potential procedures is provided in Appendices C and D, which can be detached for field use. These are not intended to be all-inclusive, but rather are designed to stimulate the thought process about procedures that can be applied depending on the circumstances. Furthermore, each of these steps would not be appropriate in all instances. The nature of the suspected fraud will dictate the avenue of inquiry. Many of these items can also be used in detection of fraud.

If a special inquiry appears to be indicated, examiners should consult with their supervisors, fraud specialists, subject matter specialists, and legal staff in planning and executing fraud detection or research procedures. The review should be conducted in an objective manner and proceed in a way that does not raise the defenses of the insider(s). It is important to proceed in a way that does not reveal the examiner's suspicions too early, as the insider may destroy records to protect his or her position. It is usually desirable to request a larger group of records than the specific documents that may reveal the precise fraud. This puts the evaluation in a broader context and helps cover the anti-fraud purpose of the review. The examiner should also carefully consider the timing as to when the anti-fraud purpose of the review is revealed. Generally, the examiner should wait until all applicable records have been obtained and copied or until all leads have been exhausted with no further avenues to pursue before discussions with personnel.

In addition, examiners may consider other actions to follow-up on suspected insider loan fraud. For instance, in accordance with the agency's policies and procedures, the examiner may recommend the issuance of an order of investigation. The order of investigation empowers the agency to issue subpoenas and take depositions. This provides a means of obtaining evidence from sources that are outside of the institution. Another option to consider is a recommendation that the institution engage a third party to investigate the suspected offenses, such as a financial institution consultant, forensic accountant, or private investigator.

Interviewing

Information gathering through discussion or interview is a standard examiner tool employed on every examination. While interviews conducted when fraud is suspected contain some of the same methods employed in standard examinations, additional techniques are necessary for maximum effectiveness. The nature of the interview is different and a more tactical approach is necessary. **An examiner should not conduct these types of**

interviews alone, but should take another examiner as a witness and to help with taking notes.

Since preparation is critical to success, it is important for the interviewer to review existing documents and known information. Initially, the examiner should determine the information he or she needs to have from the interview. A strategy needs to be developed that leads the interview from general information toward the specific details that the examiner needs to reveal. It is important not to script the interview with specific questions, but rely on a list of key discussion points. The interviewer needs to ensure that the interview subject does not glean too much information from the nature of the questions asked and discern the purpose of the interview too early.

A good interviewer needs to be skilled at human interaction and able to easily establish rapport in the interview. Efforts should revolve around setting the interviewee at ease and making him or her feel comfortable about volunteering information. Helpful techniques include conducting the interview in an informal manner without the use of accusatory language. It is important that the interviewee not feel at risk at this stage. Maintain eye contact with the subject as much as possible, but avoid showing excitement in regard to specific answers. This can reveal the direction of your research at an inopportune time. Asking for his or her help frequently helps to create a non-threatening atmosphere. The use of clear and concise open-ended questions can expedite the gathering of information. It is also important for the interviewer not to try to impress the subject with an abundance of knowledge about the topic of the interview. This may limit the flow of information. Above all, the interviewer must adopt an unbiased approach with a demonstrated commitment to fairness for all involved.

Although an interviewer needs to take notes, the examiner should not try to write everything down during the interview, but should note only the pertinent facts. It is important to avoid impeding the pace of the interview just for note taking. As stated above, there should always be two examiners in an interview of this type. It is common for one to focus on note-taking while the other takes the lead in the conversation. Each interviewer’s notes should then be expanded into as much detail as possible, immediately after the interview, and compared for accuracy and completeness. Avoid making notes regarding your overall opinions or impressions of a witness during the interview as this can also prematurely signal the examiner’s concerns or direction of the research.

Focusing on inconsistencies between various statements and documentary evidence is a useful tactic. These could be differences between individual subjects’ statements on the same topic or question, differences between subjects' statements and documented evidence, differences between statements made by a subject and statements made by other staff about the same topic or question, or a variety of other situations. The examiner should continue to question institution employees and officers about these inconsistencies until satisfactory answers are obtained. If the answers do not make sense, keep asking questions until they do. Once clear evidence of wrongdoing has been documented, this information should be discussed with your supervisor regarding the appropriate steps to take. In addition and in consultation with your office, the information should be provided to the highest level of authority at the institution that is not suspected in the fraud for the institution's own follow-up investigation. In many cases, this would be the board of directors. However, since directors are sometimes involved in insider frauds, care must be taken to approach parties not believed to be involved in the fraud scheme.

Documentation

Examiners must properly document insider loan fraud in order for the regulatory bodies and law enforcement to pursue appropriate civil or criminal enforcement action. While the decision to criminally prosecute an insider suspected of fraud is outside the control of the agencies, law enforcement officials may be more inclined to pursue a well-documented case. Regardless of whether a criminal prosecution is pursued, insider loan fraud cases will likely involve activity that is subject to civil enforcement action by the agencies, such as civil money penalties ("CMP"); restitution, reimbursement, and indemnification orders; and prohibition orders.[6] The success of a civil enforcement case is highly dependent on the quality of the examiner's documentation. Examiners should consult with their supervisors, fraud specialists, and legal staff to ensure insider loan fraud cases are properly documented. The following paragraphs contain some basic guidelines on documentation that examiners should keep in mind when looking into possible insider loan fraud.

At a minimum, the examiner must document that the insider engaged in an "actionable" offense, i.e., that he or she violated a law or regulation, engaged in unsafe and unsound practice, or breached a fiduciary duty. However, just documenting the existence of an offense is not enough. The examiner must also determine and document the effects of the insider's offense

[6] For U.S. banks and agencies of foreign banks, federal branches, and savings associations, see 12 U.S.C. § 1818(i) (civil money penalty); 12 U.S.C. § 1818(b)(6) (restitution, reimbursement, or indemnification order); and 12 U.S.C. § 1818(e) (prohibition order). For federally insured credit unions, see 12 U.S.C. § 1786(k) (civil money penalty); 12 U.S.C. § 1786(e)(3)(A) (restitution, reimbursement, or indemnification order); and 12 U.S.C. § 1786(g) (prohibition order).

(e.g., whether there was gain to the insider, unjust enrichment to the insider, or loss to the institution) and the culpability of the insider (e.g., whether the insider acted knowingly, willfully, or recklessly in engaging in the offense). These elements are important in determining the type of enforcement action that can be pursued.[7]

To help ensure complete documentation, prepare a written description of the insider's actionable offense, and then determine whether you have documents or records to support each statement of "fact" set forth in that description. A sample memo is provided in Appendix E. This process will assist in identifying gaps in documentation, as well as instances where the examiner's initial perception of the "facts" is not supported by the documentation.

The following tips may aid the examiner in gathering documents in a condition that will support an administrative, civil, or criminal action:

- Examiners should document whether and how the insider's activities strayed from established policies, procedures, and practices that were in effect at the time of the insider's transactions. This comparison is important in demonstrating the insider's culpability. Accordingly, examiners should retain, where appropriate, <u>complete</u> copies of the institution's loan policies, loan authorization limits, loan approval procedures, ethics or conflicts of interest policy, samples of routine loan presentation/approval packages, etc.

- Sometimes it is important to document the absence of an occurrence. For instance, the fact that a loan to an insider was not presented to the board for approval may be relevant to a case against the insider. Examiners should document the lack of board approval by retaining <u>complete</u> copies of full board and board committee minutes for all relevant time periods.

- If relevant information is contained in a certain document or file, retain a copy of the <u>entire</u> document or file, not just the pages that include the relevant information. This will

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[7] As an example, to support a tier II CMP for a recklessly engaged in unsafe and unsound practice, the documentation must show that the insider acted or failed to act and that:

1) Those acts or omissions were contrary to normal financial institution practices,
2) Those acts or omissions placed the institution, its depositors or its shareholders/members at an abnormal risk of loss,
3) The insider knew or should have know of the associated risk, yet failed to heed such risk, and the insider benefited or the institution incurred losses as a result of those acts or omissions.

Consult with your agency's enforcement area for specifics to your agency.

protect against the insider adding or deleting information to or from those documents at a later date.

- Copy both sides of records such as checks, notes, and general ledger tickets. The information on the reverse sides of these records may be relevant to the case. Moreover, copying both sides of these records will protect against subsequent counterfeits by the insider or others. When on-line processing systems are used to post debits and credits, screen prints showing trace and batch numbers for both sides of these records should be obtained.

- Examiners should **not** write on or make marks on the face of any of the documentation. Such writing or marks could jeopardize the integrity, authenticity, and admissibility of those documents as evidence.

- At the time of receipt, examiners should document the date they acquired a record and the name and title of the person from whom they obtained the record.

- Use flowcharts and other graphics in documenting the case. Use of flowcharts and graphics will help others, including agency attorneys, other examiners, opposing counsel, law enforcement, and administrative law judges, visualize the transactions and gain a better understanding of the case. A sample flow chart is included as Appendix F.

- Make sure copies of documents and records are readable.

- Examiners should label, date, and index all documentation. The organization of documents should mirror the flow of events they support.

- When in doubt, make and retain a copy of the record. This will help minimize the time spent going back to the institution to obtain necessary documentation. Furthermore, it may protect against subsequent destruction of relevant records.

- When examiners suspect the possibility that institution records could be destroyed or altered, consider sealing those records or requesting the institution to place special controls over those records. Consult with your supervisor and legal counsel before taking steps to seal or control institution records.

In summary, use these methods to research and document a case once suspicious behavior has been identified. The techniques included in this section and the appendices are just a starting point to examine suspicious insider loan activity. The assortment of possible procedures are as numerous and varied as the array of events to be investigated.

CONCLUSION

This document is not intended to be an all-inclusive guide to detecting and investigating fraud. It is intended to be thought provoking and to provide the field examiner with tools to utilize when fraud is suspected. Remember the primary responsibility for preventing and detecting any type of fraud—not just loan fraud--lies with the financial institution and the system of internal controls they establish. There should be an infrastructure in place that promotes a system of controls that mitigates the risk of fraud. The role of the examiner is to ensure that these controls are in place and working. However, if this is not the case, the examiner should take additional steps to investigate the potential for fraud, as well as researching and documenting occurrences that point to fraud.

Appendix A

CONTROL ENVIRONMENT ASSESSMENT
QUICK REFERENCE GUIDE

- **IS THERE A STRONG CODE OF CONDUCT THAT IS STRICTLY ENFORCED?**
- **ARE EMPLOYMENT PRACTICES PROACTIVE?**
- **IS THE LOAN REVIEW SYSTEM EFFECTIVE?**
- **IS THERE A COMPREHENSIVE AUDIT?**
- **ARE INTERNAL CONTROLS EFFECTIVE?**

OPPORTUNITY

A "NO" TO ANY OF THESE QUESTIONS COULD MEAN AN OPEN WINDOW FOR INSIDER LOAN FRAUD.

Employment Practices

- Are comprehensive background checks performed for all new personnel, including directors? Do hiring protocols include handwriting and fingerprint samples, verification of educational transcripts, credit reports, reference validation, and public records searches of all new hires?
- Are there procedures in place to attempt to check employment references with other financial institutions with respect to prospective employee's suitability? For example, involvement in potentially unlawful activities committed (Section 355 of the USA Patriot Act).
- Are there appropriate procedures to ensure that the institution has an ongoing screening program to monitor and detect changes in its employees' lifestyles, behaviors, and actions? Do these procedures include periodic credit reports and public record searches?

Audit

- Does the scope of the audit include review of compliance with the code of conduct, employment practices, loan review systems, and internal controls?
- Are there specific audit procedures to target insider loan fraud?
- Are verifications of loan balances performed frequently and properly controlled?
- Does the audit include a review of general ledger suspense accounts, such as loan in process; employee accounts and other transactions (wires) conducted by employees; and charged-off loans for insider involvement?
- Are auditors willing to challenge any transaction that looks suspicious, especially those involving an executive officer or board member?

Code of Conduct

- Does the code address fraud, define acceptable behavior, encourage ethical conduct, and establish mechanisms to monitor and enforce the code?
- Does the institution have a system to validate compliance with its code?
- Has the institution established an ongoing program to educate and raise the awareness of entire institution regarding its code of conduct?

Internal Controls

- Does the institution perform a risk assessment relative to insider loan fraud? Are anti-fraud policies and procedures in effect?
- Does the institution routinely assess the effectiveness of controls with the ultimate test: would its system of checks and balances identify actions of a dishonest insider committing loan fraud?
- Does the institution's control environment and organizational structure allow one employee or director to dominate or undermine lending decisions, or dominate senior management and the board?
- Does the institution require rotation of duties and schedules without notice and ensure that two or more persons or departments are involved in any loan transaction?
- Is the institution's vacation policy strictly enforced for all employees? What are the consequences for policy violations?
- Does the board monitor and supervise the actions of the institution's loan officer to determine that they are executing their duties and loan authority in accordance with the loan policy and delegations of authority granted by the board?

Loan Review System

- Are procedures in place to review insider loans within a reasonable time period after origination?
- Is the loan review timely, thorough, and comprehensive? Does it ensure that samples include all lending officers and is representative of all lending areas?
- Are procedures in place to ensure the prompt identification of loans with well-defined weaknesses and relevant lending patterns that may potentially be indicative of fictitious or fraudulent activity?
- Are procedures in place to assess the adequacy of and adherence to established lending and conflict of interest policies?
- Does loan review substantiate appraisal values for real estate properties and make adequate reviews of appraisals?
- Is loan review afraid to challenge transactions that look suspicious, especially by an executive officer or board

Appendix B – Detectable Warning Signs

The following table, while not all inclusive, contains a wide range of items that would prompt additional review. Please note that the same type of indicator can be found in assorted reports, but in different forms. For example, if an insider is advancing due dates on loans, it may be discovered through various source points. Use this list in conjunction with the narrative section on detection beginning on page 9.

ANALYSIS OF ELECTRONIC LOAN DATA		
Data Analysis	**Warning Signs**	**Potential Problems**
Reconcile download data to board reports, call report data, and institution's systems generated reports.	A large discrepancy between the number and dollar amount of past due and nonaccrual loans from the loan data download and information reported to the board of directors.	There may be an attempt to conceal problem or fraudulent loans from board of directors.
Analyze fields containing past due loan counters by using search criteria to identify loans with chronic past due loan histories.	Loans with chronic past due loan histories are reported as current and do not appear on the institution's problem loan list.	An insider may be hiding problem or fraudulent loans by manually adjusting due dates or using proceeds from nominee loans to keep loans current and off management monitoring reports.
Establish criteria to identify loans with multiple payment extensions.	Loans with excessive number of payment extensions.	A repayment source does not exist because the loan is to a nominee or is fraudulent
Establish criteria to identify loans with multiple renewals and an outstanding loan balance that exceeds the original loan amount.	Loans with excessive number of renewals and increasing loan balances.	An insider may have created a fraudulent loan or may be receiving bribes or kickbacks from a borrower who cannot repay the loan. Accrued interest may be capitalized.

ANALYSIS OF ELECTRONIC LOAN DATA		
Data Analysis	**Warning Signs**	**Potential Problems**
Identify loans with partial charge-offs.	Loans with partial charge-offs that do not appear on the institution’s problem loan list.	These could be nominee or fraudulent loans where part of the balance was charged off to keep the loan balance below the minimum loan amount subject to routine review.
Determine reasonableness of accrued interest in relation to loan type, repayment terms and payment status.	Accrued interest is too high in relation to delinquency status.	There may be an attempt to conceal problem or fraudulent loans by manually changing payment due dates.
Establish criteria to identify loans significantly paid ahead.	Paid ahead status is inconsistent with loan type and terms.	There may be an attempt to conceal problem or fraudulent loans by manually changing paid-to-date fields.
Identify loans to different borrowers with the same mailing address but different customer identification numbers.	Multiple borrowers with the same mailing address and different customer identification numbers.	There could be loans to a straw borrowers or fraudulent loan.
Identify loans to different borrowers with the same social security number or taxpayer identification number and different customer identification numbers.	Different borrowers with identical social security or taxpayer identification numbers.	This could indicate a fictitious borrower.
Identify loans with similar names or forms of the same name. Also identify addresses that are similar or the same.	Relationships exist that are not identified by social security numbers and/or addresses.	This could indicate fictitious borrowers and or undisclosed related borrowers.
Generate a list of loans, by loan officer, with a post office box mailing address or hold mail notation.	The financial institution is unable to contact or notify customer by mail.	The borrower does not exist or borrower has no knowledge of loan. There could be a nominee or fictitious loan.
Identify loans by loan officers who may have been terminated or left the institution.	These accounts may not be grouped by loan officer and monitored for activity.	Possible kiting of payments from one account to another. Borrowers may not exist.

ANALYSIS OF ELECTRONIC LOAN DATA		
Data Analysis	**Warning Signs**	**Potential Problems**
Identify loans that are associated with a loan officer who has a substantial portfolio or whose portfolio has experienced rapid growth.	Senior management and subordinates may not question the loan officer due to high production or profitability of the portfolio.	Loans could be fictitious.
If the institution recently raised additional capital, determine if insider loans or total loans increased substantially around the same time.	A significant increase in loan originations occurring on or about the date the institution received capital funding.	These could be insider or shareholder loans granted to fund stock purchases.
Identify loans with comparably low interest rates.	Preferential interest rates.	There could be low interest rate used to minimize cash flow required to service a fraudulent loan.

BOARD MINUTES AND BOARD REPORTS		
Warning Signs	**Potential Problems**	**Ways to Detect**
An institution changes loan review personnel or firm without apparent valid reasons.	Frequent changes in loan review personnel may prevent them from becoming familiar with the institution's lending practices to identify insider schemes. Also, they may be close to uncovering an insider loan fraud and have been dismissed for this reason.	Review board, audit committee or loan committee minutes. Engage in discussions with management and employees.
An insider inappropriately suggests or resists changes in appraisers.	Collusion between the insider and the appraiser to falsify appraisals.	Review board minutes. Engage in discussions with management and employees.

BOARD MINUTES AND BOARD REPORTS		
Warning Signs	**Potential Problems**	**Ways to Detect**
Insider receives compensation incentives or bonuses based on new loan volumes without compensating controls.	To maximize compensation, insider may camouflage poor quality loans with forged, altered, or fraudulent documents, or originate loans to fictitious borrowers.	Review board minutes and compensation plans. Engage in discussions with management.
The insider is a defendant in a lawsuit alleging improper handling of a transaction.	A particular insider may be prone to engage in dishonest or unethical behavior.	Review board minutes and litigation summaries.
A past due loan report does not include an itemized list of past due loans.	An attempt to conceal identity of delinquent borrowers to avoid board scrutiny.	Compare board reports to system generated and departmental reports.
Insider's loans appear on past due loan reports.	An insider's financial condition may be strained and provide a motive to engage in loan fraud.	Review board and system generated reports.
Delinquent loans to insiders are omitted from a past due loan report.	Loans may be omitted to conceal insiders' strained financial positions and avoid board scrutiny.	Compare board reports to system generated and departmental reports.
The board does not receive an itemized list of charged-off loans.	Insider attempting to conceal charged-off fraudulent loans.	Review board reports and request supporting detail or internal institution workpapers.
New loan report provided to the Board does not reconcile to that generated from the loan system.	All new loans are not being reported to the Board.	Review board and system generated reports for differences.
Report providing a list of loans made as exceptions to policy is not provided.	Inadequate monitoring of policy exceptions.	Review board reports and discuss the existence of policy exceptions with examiners reviewing loan files.

DISCUSSIONS WITH EMPLOYEES		
Warning Signs	**Potential Problems**	**Ways to Detect**
An insider appears to receive special favors from borrowers or shows unusual favoritism toward certain customers.	An insider may be involved in a kickback scheme where loans are granted in exchange for personal benefits or cash.	Engage in discussions with employees. Observe employee and officer behavior.
An insider will not allow employees to talk to examiners about loans.	Employees may have knowledge of irregular loan transactions.	Insist on sufficient verifiable objective information to resolve discrepancies. Engage in informal discussions with employees, if possible.
A dominant insider exerts influence or intimidates without restraint.	An insider with this level of control can force alteration of institution records to his or her benefit	Engage in informal discussions with employees to the extent possible. Review board and committee minutes and comparative departmental records for inconsistencies.
High turnover of lending personnel.	Might signify working conditions or ethical compromises that employees are unwilling to accept.	Engage in discussions with employees. Review personnel records.
An insider's life style is inconsistent with income.	Insider may be booking fictitious loans or involved in a kickback scheme.	Engage in discussions with employees. Review insider's financial statements, income tax returns, and credit reports.
Disregard for or significant disagreement with regulatory authorities.	Insider may be trying to discourage or impede in depth review of institution records.	Review prior exam reports. Arrange discussions with management and examiners. Insist on corroborating information for management's views.

DISCUSSIONS WITH EMPLOYEES		
Warning Signs	**Potential Problems**	**Ways to Detect**
An insider dictates that different loan departments are audited at different times.	An insider attempting to control access to records, which gives him the ability to shift and manipulate data to cover loan fraud.	Engage in discussions with internal audit staff. Review internal audit schedule. Review records of loan transfers or sales near the time an audit is scheduled to start.
Insider frequently takes loan papers out of the institution for customer signature, personally handles disbursement of loan proceeds, routinely cashes loan proceeds checks for borrower, and insists on personally handling certain past due accounts.	Indicates possible existence of fictitious loans and insider manipulation of loan status to hide irregularities.	Engage in discussions with employees. Conduct an internal control review.
An insider involved in undisclosed silent trusts, partnerships, or shell corporations that borrow from the institution.	Loan purpose or insider's involvement is concealed to circumvent institution's legal lending limits.	Engage in discussions with employees. Search for undisclosed related interests in state incorporation records and investments listed on the insider's financial statement. Review the insider's financial statements and those of any undisclosed related interest's for intercompany borrowings. Conduct a loan file review.
An insider lending personal funds to or borrowing from customers, which may or may not be disclosed on insider's or borrower's financial statements.	An insider may have violated a fiduciary duty by placing his or her own interest above that of the financial institution. An insider may be applying borrowed funds to conceal fraudulent loans.	Engage in discussions with employees. Review customers' financial statements.

DISCUSSIONS WITH EMPLOYEES		
Warning Signs	**Potential Problems**	**Ways to Detect**
An insider purchases assets from customers.	An insider may extend preferential treatment to a customer in exchange for kickbacks or a reciprocal arrangement.	Engage in discussions with employees. Review insider's financial statements and loan files.
An insider refuses to fully answer questions or provide relevant records.	An insider could be concealing information relevant to uncovering lending irregularities.	Conduct discussions with insider and examiners.
An insider making payments on a customer's loan.	Nominee, straw borrower, or fictitious borrower.	Engage in discussions with employees. Trace loan payments and original loan proceeds.
An insider is responsible for resolving loan confirmation exceptions.	An insider can conceal exceptions and fraudulent loans.	Engage in discussions with employees. Consider conducting loan confirmation as part of the examination
Insider has access to both the loan system and the general ledger system. Insider has control over both loan receipts and disbursements and the recording of these transactions.	Insider can divert loan payments/proceeds or post/alter institution records.	Determine whether there is proper segregation of duties. Review user profiles for the various information systems to determine if insiders have access to system not needed to perform their daily function.

INSIDER AND BORROWER FINANCIAL STATEMENT ANALYSIS		
Warning Signs	**Potential Problems**	**Ways to Detect**
An insider's financial statement discloses significant indebtedness in relation to disclosed income sources. There may also be a poor credit score.	An insider may have a motive to commit loan fraud.	Review the insider's financial statements, credit reports, income tax returns. Obtain compensation information for human resources.

INSIDER AND BORROWER FINANCIAL STATEMENT ANALYSIS		
Warning Signs	**Potential Problems**	**Ways to Detect**
An insider's financial statements show large or unusual fluctuations. Net worth cannot be reconciled with disclosed sources.	An insider may have financial difficulties and be motivated to engage in fraudulent lending activities.	Review the insider's financial statements.
Rapidly appreciating assets not supported with independent valuations.	An insider knowingly accepting unreliable financial information in order to grant loan approval. There may be financial incentive or reciprocal favors.	Review financial statements.
Commingling of business assets on personal financial statement without disclosure of business liabilities.	An insider knowingly accepting unreliable financial information in order to grant loan approval. Financial incentives or reciprocal favors may be involved.	Review financial statements.
A financial statement fails to disclose debts reported on credit bureau report.	An insider knowingly accepting unreliable financial information in order to grant loan approval. Financial incentives or reciprocal favors may be involved.	Review financial statements and compare to the credit report.
Undisclosed contingent liabilities such as personal guaranty of debt to a related interest.	Insider may be unable to service debt to the institution if required to repay related interest's debt.	Review financial statements.
An insider's related interest is not disclosed or reported.	Circumvention of an institution's legal lending limits. Masking of true financial condition.	Review financial statements.

LOAN FILE REVIEW		
Warning Signs	**Potential Problems**	**Ways to Detect**
Loan files are missing.	Borrowers do not exist; loans are to fictitious borrowers or nominees.	Employees are unable to provide loan file requested by examiners.
An insider conceals noncompliance with lending policies, guidelines from management and the board, regulatory policies, or violations of laws.	An insider is involved in kickback or a fraudulent loan scheme. Blackmail may be involved.	Loan file review.
The loan amount exceeds loan officer's lending authority.	An insider attempting to conceal a questionable or fraudulent loan, policy exceptions, or legal lending limit violation.	Review loan file, loan approval form, and lending authorities.
Loan terms are different from terms approved by loan committee or board of directors.	Fraudulent transaction.	Loan file review. Compare loan documents to loan approval form or board/loan committee minutes.
Collateral inspections or valuations are missing.	Collateral is inadequate or does not exist.	Employees unable to provide the required information at the examiner's request. Conduct a loan file review.
Documents used to verify borrower's identification are missing.	Loan is to a nominee or straw borrower.	Employees unable to provide the required information at the examiner's request. Conduct a loan file review.
An insider keeps "shadow" files or omits certain documents from loan files reviewed by examiners.	An insider attempting to conceal documentation, underwriting, or collateral problems. Loan transaction may be fraudulent.	Conduct a loan file review. Engage in discussions with employees.
Insider maintains signed, blank notes in personal or customer loan files.	Documents may be used for fictitious loans.	Conduct a loan file review. Engage in discussions with employees.

LOAN FILE REVIEW		
Warning Signs	**Potential Problems**	**Ways to Detect**
Insider loans do not comply with lending policies and exceptions are not authorized.	Insider circumvents controls to receive preferential treatment or prohibited transaction.	Review loan file, loan approval form, and board and loan committee minutes.
Insider loans with unusual or preferential terms, interest rates, or collateral.	Insider collusion involving possible kickbacks, bribes, or other fraudulent schemes.	Review loan file, loan approval form, and board and loan committee minutes.
Appraisals for insiders' loans contain deficiencies or values appear overstated and are not adequately supported.	An insider influencing an appraiser to conceal inadequate collateral position. This may involve a kickback scheme.	Review appraisal report and appraisal regulations.
Purpose of loan is not recorded or proceeds are not used for stated purpose.	Purpose does not comply with lending policies or violates the law. True purpose may be to pay accrued interest other loans to borrower.	Review loan file, payment history, and paid loan disbursement checks. Trace loan proceeds.
Insider makes or approves loans to himself or herself, family members, or related interests.	Self-dealing. Concealment of loans that do not meet policy guidelines. Violation of code of conduct.	Review loan file and loan approval form.
Insider loans not approved by the board or board committee.	Self-dealing. Fraudulent loan transaction.	Review loan file and loan approval form.
Loan funded prior to approval.	Fraudulent loan transaction.	Review loan file. Compare date of loan proceeds check to date loan was booked and loan approval date. Debit to loans in process or suspense account for amount of loan proceeds.
Loan documents appear altered or forged.	An insider knowingly accepting or preparing forged or falsified documents.	Compare loan documents to minutes

LOAN FILE REVIEW		
Warning Signs	**Potential Problems**	**Ways to Detect**
Credit reports with no or very limited credit history and absence of letters from landlords, utility companies, etc. stating satisfactory payment record. Earnings statements appeared altered.	Fraudulent transaction. Borrower's true credit history may be concealed by using fictitious social security number to generate credit report. Forged letters and forged earnings statements.	Credit history is inconsistent with borrower's financial information. Various loan files contain similar documents.
Files without documentation to identify how loans were funded, such as official checks, deposit tickets, funding sheet, etc.	True beneficiary of funds may be hidden.	Trace loan funds as described in Appendix D.
Borrower's financial statements are prepared by an insider.	False information used as basis for loan decision.	Verify with information provided by borrower/ compare to credit reports.

INTERNAL REPORTS AND ACCOUNTING RECORDS		
Warning Signs	**Potential Problems**	**Ways to Detect**
Loan disbursement checks are presented for payment before loan is booked.	Insider using loan proceeds for personal benefit, hiding problem loans, or lending limit violation.	Review loan disbursement account reconcilements. Compare new loan report with loan check register.
Insiders or related interests have frequent overdrafts or appear in suspense account item listings.	Insider having financial difficulties and motive to commit fraud.	Review overdraft reports, suspense items, and suspense account reconcilements.
Adversely classified loan paid off or paid down just prior to or during the examination.	Insider attempting to conceal fraudulent loans.	Compare previously classified or problem balance to current balance.

INTERNAL REPORTS AND ACCOUNTING RECORDS		
Warning Signs	**Potential Problems**	**Ways to Detect**
An insider loan is paid off prior to or during the examination.	Insider attempts to conceal lending limit violations, delinquency or fraudulent loans.	Review recently paid off insider loans
Customer loan proceeds disbursed by wire transfers to institution secrecy haven countries.	Loan proceeds not used to stated purpose. Fraudulent transaction.	Review wire transfer activity.
High level of loan losses.	Charge-off of fraudulent loans. A loan officer directed by senior officer or director to grant loans that normally would be declined. There could be financial incentives or reciprocal benefits involved.	Review charged off loan files and payment histories. Be alert to an unusual level of charge-offs resulting from loans originated by a particular loan officer.
No review of inactive or dormant accounts.	Insider using dormant or inactive accounts for fraudulent lending activities. Possible use of customer information to generate fictitious loans could be involved.	Review dormant and inactive account reports. Cross check with loan trials to determine if a large number of dormant account holders also have loans.
Cash disbursement of loan proceeds.	Insider receiving kickbacks or bribes.	Internal control review. Copies of transaction tickets in loan file should trigger further research. Trace loan proceeds, if appropriate.
Insider changes loan payment due dates, renews loans, or grants loan extensions.	Conceal delinquent or fraudulent loans.	Loan file system maintenance reports.
Internal debits/credits (noncash transactions) posted to insider or customer’s loan/deposit accounts.	Fraudulent transactions. Insider receiving kickbacks from loan customer or embezzling loan proceeds or funds from deposit accounts.	Review deposit and loan account histories for noncash transaction codes. Trace transactions.

INTERNAL REPORTS AND ACCOUNTING RECORDS		
Warning Signs	**Potential Problems**	**Ways to Detect**
Rapid loan growth.	May be partially attributable to fraudulent lending transactions.	Comparative analysis of balance sheet accounts.
No reconciliation of loans-in-process and disbursement accounts.	Fraudulent loan activity may be processed within these accounts.	Perform reconciliations of these accounts.

Appendix C – Research Procedures

The following is a list of procedures that may aid in researching suspicious circumstances. To maximize the effectiveness of such a review, the examiner should read the sections on interviewing and documentation starting on pages 13 and 14 prior to using these procedures.

Procedure	Uses
Trace the flow of funds – e.g., use of loan proceeds, source of loan payments, source of funds used to purchase cashiers checks or money orders, debits or credits to dormant accounts, debits or credits to accounts for which the institution holds the monthly statements, etc. **Appendix D provides detailed procedures for tracing loan transactions.**	Tracing loan proceeds and payments and other funding flows can help in identifying fictitious or nominee loans, or insiders' undisclosed interests in borrowing entities.
Review demand deposit account statements of insiders. Obtain and analyze copies of significant or unusual debits or credits.	By reviewing the activity in insiders' demand deposit accounts, examiners may be able to identify insiders' undisclosed financial interests, undisclosed borrowings, or other similar irregularities, or accounts at other institutions.
Review paid official checks (official checks can include money orders, cashiers checks, loan disbursement checks, etc.)	A review of paid official checks might reveal unauthorized diversion of institution funds to insiders or their related interests. Be alert to payees that seem inappropriate or unusual.
Reconcile general ledger accounts or review institution's internal reconcilement. Review reconcilements over a period of time to observe fund flows in and out. Trace suspicious items between accounts.	Account reconcilements can uncover debit or credit entries used to offset fraudulent transactions.
Review reconciling items.	Reconciling items may represent debit or credit entries used to offset fraudulent loan transactions.
Review safe deposit box access records.	Insiders might store fraudulently obtained cash in safe deposit box.

Procedure	Uses
Review wire transfer activity.	A review of wire transfer activity might reveal unauthorized diversion of institution funds to insiders or their related interests.
Review insiders' lists of related interests.	These lists provide names of insiders' businesses that may have loans or deposits accounts at the institution, or have received proceeds of official checks.
Review suspense accounts for several consecutive days or periods	Suspense accounts may include debit or credit entries used to offset fraudulent loan transactions.
Review loan trial balance reports for anomalies or unusual activity, e.g., loans paid in advance, negative amortization, etc.	Accrued interest that is more than the delinquency status indicates could be a sign of manipulation of the borrower's performance status or misapplication of funds. This can also help in identifying fictitious loans.
Review credit reports on file at the institution.	Low credit scores for insiders with large loan balances at the institution should trigger additional investigation.
Review deposit and loan account statements that the institution holds for customers for several consecutive months.	Fictitious deposit and loan accounts are sometimes used to receive and hold funds misappropriated by insiders. Holding the deposit statements for customer pickup allows the insider to control that statement. Statements mailed to post office boxes can also be used in a similar fashion. Tracing of loan proceeds could lead to these accounts.
Review dormant accounts activity.	Inadequately controlled dormant accounts are a natural place to hide fraudulent activity.
Review accounting for charged-off loans.	Payments received on charged-off loans can be diverted to insider's accounts.
Send or request institution's auditors to send positive loan or deposit confirmations. Review accounts of customers who do not respond. This may identify loans for which proceeds should be traced.	Confirmations are useful in identifying fictitious borrowers or depositors, or unexplained differences in account balances or payment histories.

Procedure	Uses
Visit real estate collateralizing loans.	Visits can reveal whether real estate collateral truly exists, or exists in the condition described in the loan documentation.
Obtain Dun & Bradstreet ("D&B") or similar service reports on borrowers and insiders' related interests	D&B reports can reveal insiders' undisclosed financial interests in borrowers or other entities. Further, lien filings included in the D&B reports can reveal the existence of undisclosed business relationships between borrowers and insiders' related interests.
Search internet and public records on insiders, insiders' related interests, and other borrowers, as warranted. These could be recorded deeds; lien searches; corporation, limited liability company and partnership filings; news articles; lawsuits, etc.	Public records can contain significant relevant information about insiders and borrowers, related or affiliated business entities, the lien and title status of collateral, etc. Consult with your supervisor and legal counsel before conducting subscription-based searches of public records.
Search SAR and CTR databases.	SAR and CTR data may indicate that insiders, their related interests, or other suspect borrowers were the subjects of SAR or CTR filings at other institutions.
Consult with agency subject matter specialists.	Fraud or other subject matter specialists can provide suggestions on types of records to be examined.
Be alert to situations where the loan officer of record does not appear to be the officer who actually handles the loan.	In these situations the "true" loan officer may have benefited from the loan, and the loan may have been assigned to another loan officer to avoid suspicion. In addition, it could indicate a loan placed in the institution by the CEO, control owners, or board members
Be alert to loan terms or conditions that are inconsistent with the loan purpose or normal institution practice.	Changes in rates, abnormal rates, and repayment terms that are inconsistent with use of loan proceeds may represent transactions warranting closer scrutiny.
Be alert to unusual events or activity anywhere within the institution.	Casual discussions with institution staff can both yield clues of insider abuse and enable staff to approach examiners with information. An insider's public lifestyle (e.g., expensive cars, clothing, etc.) beyond apparent means might indicate insider fraud. Document conversations with staff.

Procedure	Uses
Communicate with examiners working on other areas of the financial institution.	Aspects of loan fraud may involve other non-lending areas of the institution. Examiners working on those other areas of the institution should be alert for transactions or activity that may be involved in the suspected fraud.

Appendix D – Loan Tracing Procedure Detail

The following steps can be used to trace loan proceeds or payments.

Procedure	Use
For the sample loan identified, obtain a payment history on the loan selected. Maintain a copy of the loan history for examination workpapers.	The transaction history will show all advances, payments, and charges to the loan.
Select either the advance or payment to be traced.	An advance on the loan will reveal where funds went and a payment will reveal the source of the funds.
Find the general ledger debit (advance) or credit (payment) ticket for the selected transaction. Look for the proof transaction number located on the back of the ticket and retain a copy of the ticket (front and back) for the examination workpapers.	This provides the source document for data entry onto the accounting system.
Go to the proof tape for the day of the transaction and find the transaction number for the debit/credit ticket. Identify the corresponding entry. (TIP: Credits are usually listed before debits on the proof tape. Also, some institutions can use their optical system to identify transactions rather than physical general ledger and proof tapes.)	This shows the entry of the data onto the accounts of the institution.
Use microfilm, microfiche, or optical equipment to find a picture of the items(s). Retain a copy of the items, front and back, for the examination workpapers.	The credit should show the disposition of the loan proceeds and the debit the source of funds for payment.

Appendix E

The following excerpts are from a sample insider fraud write-up referencing supporting documentation and a documentation index.

The evidence presented here suggests that $75,000 of the proceeds of the Institution's loan to Smith was used for the economic benefit of Vice President Jones in the form of a one-third interest in the underlying investment.

Mr. Smith is the principal shareholder and officer of XYZ Inc., a local manufacturer. On October 12, 20X0 the institution made a $225,000 unsecured loan to Mr. Smith, due May 11, 20X1 (Exhibit A-2). Vice President Jones was the lending officer (Exhibit A-2). The loan file memorandum, prepared by Vice President Jones, states that the proceeds were used to purchase real estate for investment purposes in AnyState (Exhibit A-3). The full proceeds were wire transferred to the ABC Bank (Exhibit A-4). On May 31, 20X1 the $225,000 loan was renewed, due April 10, 20X2 (Exhibit A-5). On May 31, 20X2, interest accrued through the April 11, 20X2 maturity of the $225,000 note totaling $33,971.93 was paid by check # 3056 in the amount of $33,971.93 drawn on Smith's demand deposit account #999-888-7777 (Exhibit A-6). However, on this same day Vice President Jones drew two checks on his demand deposit account at the Institution # 111-222-3333 in the total amount of $11,323.97 (one third of the amount of interest on the Smith loan) payable to John Robert (Exhibit A-9). These checks were deposited in Mr. Robert's account # 444-555-6666 on June 8, 20X2 (Exhibit A-10 and A-11). On the same day, Mr. Robert drew check # 5500 on his account # 444-555-6666 in the amount of $11,323.97 payable to Mr. Smith (Exhibit A-12). On June 10, 20X2 check # 5500 on Robert's account was deposited to Smith's account #999-888-7777 (Exhibit A-13).

Mr. Smith's personal financial statement dated March 31, 20X2 reflect a $150,000 investment in AnyState real estate rather than a $225,000 investment. (Exhibit A-14). Vice President Jones' signed personal statements dated December 31, 20X1 and March 31, 20X2 list an "AnyState investment property partnership," acquired in 20X0 at a cost of $75,000 (Exhibit A-15 and A-16). A corresponding debt to finance this acquisition does not appear on Mr. Jones' financial statement or Regulation O form dated June 24, 20X2. Furthermore, AnyState Secretary of State partnership records show Vice President Jones and Mr. Smith are both general partners in Green Acres Partnership ("GAP") (Exhibit A-17). According to the AnyCounty real estate title records, GAP is the owner of 60 acres of real estate in Any County, AnyState (Exhibit A-18).

* * * *

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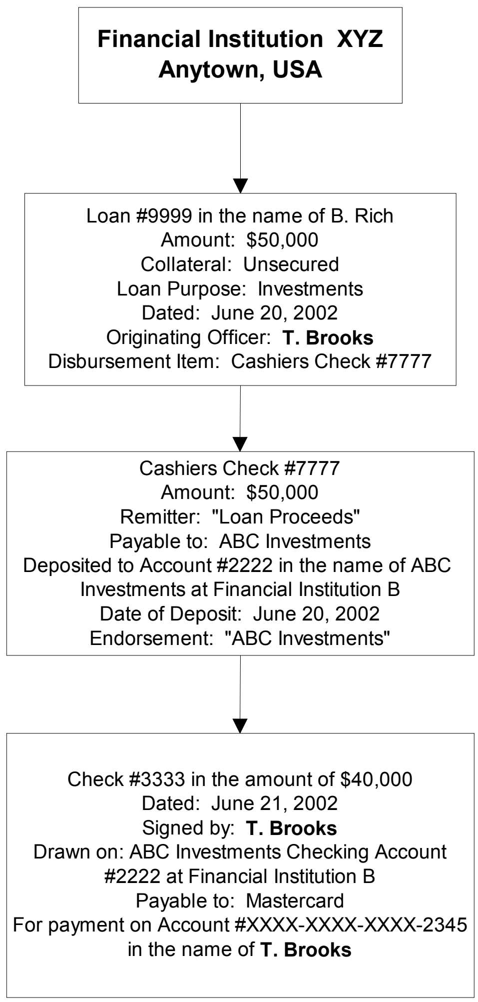
Exhibit A-1	-	Flowchart of transactions
Exhibit A-2	-	Copy of $225,000 note to Mr. Smith dated October 12, 20X0
Exhibit A-3	-	Copy of Smith loan file memorandum dated October 3, 20X0
Exhibit A-4	-	Copy of wire transfer instruction dated October 12, 20X0
Exhibit A-5	-	Copy of $225,000 renewal note to Smith dated May 31, 20X1
Exhibit A-6	-	Copy of cancelled check #3056 drawn on Smith account # 999-888-7777 (front and back)

Appendix F

Flowcharts

Flowcharts can be used to simplify complex movement of money and highlight the involvement of key insiders or loan officers. A brief example is shown below.



Note: In this situation, loan officer T. Brooks made a $50,000 ficticious loan in the name of B. Rich, deposited the proceeds in an account he contro lled and then used $40,000 to pay his Mastercard bill which had become excessive due to habitual online gambling. The full $50,000 is deemed to benefit Mr. Brooks due to the fact that all the money was deposited to an account he controlled.

Appendix G

The following list of websites is included for your reference

Search Engines

www.alltheweb.com
www.nbci.msnbc.com
www.ixquick.com
www.allonesearch.com
www.excite.com
http://webfile.com
www.google.com

Fraud Sites

www.fraud-report.org
www.fraud.org/info/contactnfic.htm
  National Fraud Information Center

Public Records

www.searchsystems.net
  Public Records in US
www.archives.gov
  National Archives & Records Admin

Government Sites

www.fdic.gov
www.federalreserve.gov
www.fedworld.gov
  Locate government information
www.fincen.gov
www.irs.ustreas.gov
www.gao.gov/special.pubs/soi.htm
  Investigators Guide to Sources of Information
www.usps.gov/websites/depart/inspect
  Postal Inspection
www.ncua.gov
www.occ.treas.gov
www.ots.treas.gov
www.state.gov

Law Enforcement

www.usdoj.gov
  Click on Organization Chart under "About DOJ"
www.fbi.gov
www.dea.gov
www.irs.treas.gov

Click on sitemap; click on Criminal Investigation under "About IRS"

www.ustreas.gov

Click on Law Enforcement under "Key Topics"

www.leolinks.com

www.officer.com

Police information

www.usss.treas.gov

www.usmarshals.gov

www.customs.treas.gov

Legal Information Sites

http://uscode.house.gov/usc.htm

Researching US Code

www.findlaw.com

Miscellaneous

www.cfenet.com

www.bankersonline.com

www.asc.gov

Check appraiser license or for disciplinary action

www.classified3.com/

Dig up dirt on anybody doing anything

www.cybercrime.org/

National White Collar Crime Center (large listing of investigative resources)

www.whowhere.lycos.com