CASE STUDIES & LESSONS FROM THE FIELD
COMMUNITY BANKS—FOLLOW THE MONEY TO FRAUD

Community bank assets are the target of internal and external fraud schemes on a daily basis. This presentation will teach you the red flags of community bank fraud through case studies and will describe methods to detect fraud and prevent it from bringing down your community bank.

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Sheri Knope is a Certified Public Accountant, a Certified Internal Auditor, a Certified Fraud Examiner, and is Certified in Financial Forensics with over 15 years of banking experience and an in-depth focus on internal audit, risk management, fraud prevention/detection, and bank management.

Her background includes substantial experience in all facets of financial institutions, including but not limited to developing, implementing, and monitoring risk management functions in a financial institution setting.

Prior to forming PKC Consulting, LLC, Sheri was an Internal Audit manager for WIPFLI, a regional CPA firm; the CFO for a DeNovo community bank with $150 million in assets; a CFO for a SEC reporting community bank with over $180 million in assets; and an internal auditor for a bank holding company with over $2 billion in assets. Sheri has a unique perspective; she has worked on both sides of an audit as the auditor and as the auditee. Sheri states, “I’ve been in the shoes of senior management and have lived firsthand the increasing role regulation and fraud have played in the complexity and risk of both small businesses and financial institutions.”

“Success is not final, failure is not fatal: it is the courage to continue that counts.”
-Winston Churchill

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Sheri is a member of the American Institute of Certified Public Accountants (AICPA) and the Wisconsin Institute of Certified Public Accountants (WICPA). She serves as the Accounting Careers Committee Co-Chair for the WICPA with the hope of promoting, educating, and exciting students about a CPA’s changing role and unlimited career opportunities.

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A Regional Bank—$2 Billion in Assets
Take a town with a population of around 500,000, a lender from a prominent family, and add the following ingredients:

- Relatives and school friends
- High-school sweetheart wife, daughter of ex-NFL player
- Brother-in-law who is a real estate appraiser
- Mother who is the heir of old wealth
- Builders of commercial and residential real estate
- Star real estate agent/real estate developer
- Connections to a local slum lord
- Deals with bankrupt commercial developer who uses his mom’s assets to secure loans
- Wealthy trusting friend who is a prominent orthopedic doctor
- High-school friend who sold his lucrative temporary employment company to fund deals
- Financial institution in a rapid growth pattern with top concerns being efficiency and loan growth
- Staff turnover to less experienced employees (100 percent in less than 18 months)
- New President of Region is the prior Chief Operating Officer of region
- Prior President “JJ” (efficiency zar) advanced to second in command of the bank holding company
- Prior President JJ tells new president to give “TL” plenty of room to make loans. He is a rainmaker. Prior president had verbally given TL the same lending limit JJ was assigned, thus verbally overriding the lending limits set by the board of directors.
- TL was poor at details and had been under review by the holding company audit and compliance departments multiple times (JJ had been faced with terminating TL twice, and both times chose not to despite thr audit
department’s repeated recommendation to terminate
TL.)

- “S,” the whistleblower
- What events led to discovery of eventual loan losses?
  - TL makes deals on a regular basis with same
core group of individuals by creating multiple
LLCs
  - Used his brother-in-law “DD” as his sole loan
appraiser
  - Prominent orthopedic doctor, local slum lord,
star realtor for national firm, multiple builders,
and others to be named later
  - TL’s related parties would not have been
unwound if not for S, the whistleblower. S knew
and proved there was much more than poor
documentation occurring.
  - S worked under TL as head teller before moving
to the audit department, where she learned red
flags and how to uncover the paper trail. She
also had inside information on prior audit
department concerns with TL.
  - S knew the parties and the paperwork eventually
proved the lender was a liability to the bank.
  - S took concerns to new regional president.
  - S, along with the audit department, researched
more. Audit Director and new President met
with TL to discuss their findings. TL almost
convinced them he did nothing wrong.
  - TL was put on administrative leave.
  - A few days passed, and upon S’s arrival to the
bank for a meeting with the President and the
Internal Audit Director, TL’s wife was seen by
S leaving the bank branch with a large stack of
manila files. It turned out that his loyal loan
processor gypsy had let her into his office without notifying anyone.
- Loyal gypsy eventually left bank and continued helping TL with his books on his continued deals.
- TL began L financial group. Through this account, he moved money between parties whom he had in his shell games. He had his rich friends lend him money to invest in big deals. In reality, he was covering up some of his mess at the bank by paying off LLC notes that were probably links back to his kickbacks or some other scheme.
- TL was pursued by the FBI for a period of time. Then a person robbed a local branch of the bank. The FBI was tied up in that and it took priority. No one was willing to tell the FBI that TL took kickbacks, so the FBI basically removed itself. The bank pursued civil actions after writing off large dollars.
  * Interesting piece of information came out from Carey, the slum lord’s girl for hire. She told a lender trying to collect on her car payment after TL was gone that she was friends with the person who robbed the branch.
  * I would not put it past these people to have put some poor girl who had a drug problem up to this so that the heat was removed from them long enough to regroup.
  * Some other people who provided information to S about TL borrowing money from their bank accounts without permission did the following. One was a large business owner and the other was a former large business owner. They were friends. The
former large business owner was very wealthy at one point, but lost it all gambling and messing around on his wife. Therefore, his house was foreclosed upon. The first large business man bought the now broke business man’s house at a sheriff’s sale so the broke business man could continue living there with his two young children from his drug-addicted mistress 30 years his minor.

* Suddenly, the wealthy business owner is under criminal investigation by the IRS. The poor business man’s house suspiciously burns down around Christmas. Everyone is safe, but all of his records are destroyed in the fire, and the wealthy business man makes money on the deal through the insurance settlement.

- Know relationships to understand related parties. Understand senior management can and does override controls frequently in community banks. Understand that community bank boards often are on the board just for the appearance or prestige it brings to them in the community. Many do not understand banking or the many regulations that exist. They rely on senior management to lead them down the path of information. Therefore, many community bank boards function as rubber stamps.

- Also, community bankers or fraud examiners should look at these three reports regularly to uncover suspicious transactions and to follow the money in bank fraud.
  - Overdraft list
  - Renewal loan report
  - Past due report
  - Last orphan debit report on official bank checks
• Discuss why each report is important and what can be uncovered.

Finally, this former lender is now head of human resources at a private business. He sent letters to S four years after he was put on leave. He had finally uncovered the fact that she was the whistleblower. He played the role of the wronged soul in the letter. He was convinced that he had done nothing wrong and just wanted to know why she persecuted him and ruined his banking career.

A $200 Million, Three-Location Bank Case Study

- 80 percent of senior management turned over in the last two years.
- Why? The board pressured to achieve too high of an income to pay out high dividends to shareholders.
- The Board pressure made the President fear for his job because he couldn’t make the numbers. Therefore, he felt it necessary to alter the board minutes that were kept on the bank electronic network. All employees were not assigned a unique network password. He went undetected after hours and changed the board minutes on the amount of approved loan charge-offs. Unfortunately for him, a board member noticed the discrepancies in his review of prior-month to current-month board meeting minutes.
- This president was fired and eventually barred from the banking industry by regulators. Once he was gone, the bank found more income producing shortcuts he had taken. He had negative amortizing loans on the books. He had the loans starting as amortizing notes, but then lowered payment amounts without proper loan documents. Just a small quarter-page extension form was used to rewrite the terms of the note. How did he learn to play with the system and to go undetected in
this scheme? He learned tricks of the trade as an ex-FDIC examiner.

- So what steps did the bank take to verify that the assets (loans) were recorded appropriately on the core operating system? It had the regulators and bank staff confirm balances on just the now-former president’s portfolio. Given that the president oversaw all lending and had the ability to override controls, the bank should have confirmed the whole portfolio. Interesting results would have been found—items that are now just being empirically proven, such as 300 extensions done on a portfolio of 1,200 loans in one year. However, if one dug deeper, he would find that lenders were not only extending payments—they were modifying the terms of these notes as to payment arrangements and rate changes. Numerous problems occurred due to this behavior.

- Since the ex-president’s dismissal, the bank has had several payouts on fraud cases. One former fidelity bond company refused to reinsure the bank when its policy came due.

- Main causes of fraud cases:
  - The retail bankers turned over three times in one year.
  - No long-term retail lenders or loan processors.
  - Only two people remained consistent over the last 24 months. The Senior Lender and the internal auditor. Even the long-term CFO/CIO/COO left within a year after the newest president was hired. Overworked and disillusioned by the ethics within the company . . . She exited the banking industry.

- Other frauds that occurred at this bank were as follows:
  - One large floor plan loan with a reputable dealership. The father was always overdrawn. The CFO at the time felt this would all be cleared up with the father’s life insurance money. He was
right. It cleared up all past dues and paid down a chunk of the loan.

- However, the bank did not exercise proper controls over the floor plan. No surprise audits were completed despite the board’s approval, which had been predicated on monthly floor plan inspections. The dealership sent via fax a list of inventory for the bank to audit when it was scheduled to audit the floor plan.

- One day the bank called up the owners due to overdrafts and told them it wanted to meet and discuss the financial situation of the dealership. They came in the next day and confessed they had been supplying inaccurate information to the bank on their floor plan. The bank ended up losing half a year’s net income, and the brothers went to jail for a few years.

- Three other costly frauds occurred next at this bank. These frauds occurred due to the bank not obtaining or requesting borrowing resolutions and current signature cards. Also, a lender was notarizing documentation without the signing parties being present. These three frauds against the bank involved the office manager of a manufactured homes business and the office person of two separate not-for-profit organizations. Each person at these businesses funneled money off of the respective organization’s books and went to the bank to turn their money into a money order made out to themselves or to petty cash. One of the three schemes cost the bank over $300K. The largest of the three is still in pending outcome in litigation. Two others have already been sentenced to jail time.
Currently at this bank, the auditor has returned to auditing loans. She notes questionable findings. However, she is not totally trained on how to go about determining if these are isolated events or if these are larger systemic problems. Her current findings are:

- Poor collateral on a large credit. Write-ups showing values that were not substantial.
- Collateral exceptions to the loan policy.
- Loans made at no interest and low payments for 10 years because the customer had been written a fraudulent check.
- A HELOC loan that was a UTMA account. Despite the minor having attained legal age prior to renewal... the lender did not receive her signature on the note or right of recession. The loan was in default, but the bank was now in a poor position to pursue legal action due to the failure to obtain all required signatures.
- All of this information has led the interim CFO to tell the internal auditor to query the loan portfolio for all notes that were renewed more than two times in the past 12 months and then to just randomly pick a few renewed notes on the list to research the paperwork beneath the renewals. Most had been modified with an extension.
- The interim CFO wanted the audit department to watch the overdraft list. A common pattern is to follow the overdrafts to new notes, which get extended and then get charge-offs or repossession.
- The interim told the internal auditor to also determine the number of single pay notes in the portfolio and to determine the current loans by purpose code that fell within the guidelines of trouble debt restructuring.

After all the information was gathered and exceptions and extensions were determined to be the norm... The interim CFO and internal auditor talked to the supervisor of the
loan processing area. The loan processing supervisor wanted to know if it was normal to have note terms not match the computer terms. The interim CFO said no, that should not occur, because the bank would be misstating its loan interest income on the financial statements. The loan processing supervisor said most of the bank’s milk assignment dependent notes had inaccurate single maturity due dates input to the computer system. Therefore, rather than monthly due dates as stated on the signed notes, the system had a single pay note set up for the term of the original note. If a missed payment occurred, no mechanism was in place to report and track the missed payments.

- This board or even the loan committee should be reviewing the renewed or extended loan reports that no one currently reviews.

- Extensions should be approved by the president and reported through the standard core system reports that should be sent to the board for their review monthly.

- What is wrong with doing this volume of extensions?
  - Past due management is prolonging write-offs of loans in the portfolio.
  - Would the bank be able to enforce its collateral position or its claims to money due based on e-mails from lenders to change terms?
  - Would courts find an extension form stating it was approved per phone conversation as a written agreement to repay the original note?

A Chicago Bank

Bank client (JN) was ill with cancer. Bank client JN’s business manager, PD, was living a lifestyle beyond his means. PD paid all invoices. PD reconciled all accounts. PD used JN’s signature stamp on checks to pay invoices. JN died of cancer. His wife received notice of past due payroll taxes and didn’t know what to do. She contacted long-time JN friend Nal. He came to visit her and dug into
the possible cause for past due payroll taxes. Nal began to question PD, who didn’t answer forthright enough for Nal. He fired JN and learned from staff how possessive he had been within the accounting arena.

PD paid multiple personal bills on personal credit cards using company funds and JN’s signature stamp. Occasionally, he would go to the company’s community bank, with which JN had been a customer for a few decades. PD convinced the bank personnel that JN had made PD a business partner due to his illness and that the bank needed to allow PD to sign on notes for the business and to negotiate JN’s business checks into bank cashier’s checks payable to PD or to PD’s credit card companies.

When Nal started looking through the books, he noticed many payments of JN’s business checks to “Chico,” a local mechanic, and to credit card companies. He also saw the trend of converting checks into cashier’s checks. He began to determine that the widow’s money had been swindled for personal use of PD instead of being available to fund payroll tax payments. Since PD did all of the accounting and JN’s wife was dealing with a medical crisis, all went undiscovered for a long while. The bank was eventually sold off to another financial institution due to a cease and desist order. Therefore, JN’s wife and Nal wanted to know if they could sue the bank for its failure to exercise due diligence prior to converting JN’s business checks into cashier’s checks payable to PD. They were unable to do so for various reasons, and the wife took a substantial monetary loss.