Managing Fraud Risk: First, Second, or Third Line of Defense Responsibility?

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• Any organization of which the speaker is a member

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However, we invite you to participate in the discussion today and later on.

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Outline

Introduction
Ownership of Fraud Risk
  • When it comes to fraud, there are no winners
  • Three lines of defense
Fraud Risk Management
  • Prevention
  • Risk Assessment
  • Detection
  • Fraud Case Management
  • Repair and Remediation
Conclusion
Outline

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BNP Paribas Fortis, a Belgian bank with international reach

October 2011
BNP Paribas Fortis: A Belgian bank with international reach

The No. 1 bank in Belgium
- A comprehensive offer of financial services
- to private and professional clients, wealthy individuals, corporate clients, public entities and financial institutions
- through a multi-channel network

Clients
- 3.7 million retail customers in Belgium (1 Belgian out of 3)
- 1 million in Turkey
- over 400,000 in Poland
- 300,000 in Luxembourg
- 35,000 corporate clients

Staff*
- Total: 27,870 FTEs
- 16,940 in Belgium
- 4,570 in Turkey
- 2,600 in Poland
- 2,070 in Luxembourg
- Present in 15 other countries

Strong credit ratings
- Standard & Poor's: AA
- Fitch Ratings: A+
- Moody's: A1

Ownership
- BNP Paribas (74.93%)
- Belgian State (25%)
- Minorities (0.07%)

Market positions
- In Belgium: #1 in deposits, #2 in consumer lending
- Leader in Private Banking in Belgium, No.2 in Luxembourg
- Market leader in Commercial and Corporate Banking in Belgium
- European player in Corporate & Transaction Banking
- Strong positions in renewable energy, trade finance and cash management
- Challenger in Poland and Turkey

Community focus
- Sponsoring of sports (RSC Anderlecht since 1981-82, tennis federations) and culture & film (Queen Elisabeth International Music Competition, Film Days, et al)
- Corporate philanthropy via BNP Paribas Fortis Foundation, to combat poverty and social exclusion
- Doing business in a sustainable way and reducing our environmental footprint
BNP Paribas Fortis: part of BNP Paribas, A world player with extensive geographical reach

More than **200,000** employees in **83** countries - **68%** working outside France

- Sizeable operations in North America (also in retail banking),
  Asia, the Mediterranean and in Central Europe
- 18th place (and number 3 bank) in the Fortune Global 500 company rankings

*Of which BNP Paribas Fortis: 17,150*
BNP Paribas: An integrated business model
### Key financial figures of the Group in 2010 (in EUR billion)

#### BNP Paribas Group:
- **Sustained business growth across all the operating divisions**

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>43.9 (+9.2%)*</td>
<td>40.2</td>
<td>27.4</td>
</tr>
<tr>
<td>Operating income</td>
<td>12.6 (+48.1%)*</td>
<td>8.5</td>
<td>3.2</td>
</tr>
<tr>
<td>Net profit</td>
<td>7.8 (+34.5%)*</td>
<td>5.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,998</td>
<td>2,058.0</td>
<td>2,075.6</td>
</tr>
<tr>
<td>Employees (’000 FTE)</td>
<td>205.3</td>
<td>202.3</td>
<td>173.2</td>
</tr>
<tr>
<td>Cost/income ratio</td>
<td>60.4%</td>
<td>58.1%</td>
<td>67.2%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>12.3%</td>
<td>10.8%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Tier 1 ratio</td>
<td>11.4%</td>
<td>10.1%</td>
<td>7.8%</td>
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#### BNP Paribas Fortis: pursuing sales and marketing drive; reaping benefits of restored franchise

- Fast-paced growth in mortgages and upswing in demand from small businesses
- Good asset inflows into sight deposits and savings accounts; decrease in term deposits
- Successful cross-selling with CIB for midcaps (syndicated loans, acquisition finance, bond issues)
- Limited rise in operating expenses (continued business development plan and IT investments)
- BeLux Retail Banking’s pre-tax income of EUR 688 million (double the 2009 level)
- Assets under Management of Private Banking Belgium rose 13.2% compared to 2009

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*S Change from 2009

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**Sustained business activity thanks to the Group’s active role in financing the economy:**

- Successful integration of Fortis taking the Group to a new dimension: synergies reevaluated at EUR 1.2 billion (+33%)
- Decline in cost of risk (-42.6% vs. 2009) in an improved economic environment
- Profit-generation capacity reinforcing solvency organically: 2/3 of net income reinvested
2010 Net Income fifth highest in the world

Net income attributable to equity holders*

EUR m**

13,144

8,791 8,181 7,959 7,843

13,144

J.P. Morgan  Wells Fargo  Santander  Citi  BNP Paribas

Net income that reflects BNP Paribas’ position in the banking industry

*Source: banks; ** Average exchange rate for 2010
Market Capitalization: BNP Paribas

Market capitalization on 5 September 2010

BNP Paribas = 64 billion euros

Ranking

World # 12
Europe # 3
Eurozone # 2
France # 1

Source: Bloomberg
In summary BNP Paribas + BNP Paribas Fortis: a strong and reliable bank

- A leading Eurozone bank of international standing
- A diversified and integrated business model
- Solid ratings
- A healthy solvency and liquidity position
- Centering on local relationship and presence for the customer
- Very broad offering of skills and expertise
- Integration gives customers better access to financial services on European and world scale
- BNP Paribas Fortis remains a Belgian bank, with a strong investment of BNP Paribas Group to foster development in Belgium
**BNP Paribas:**
A model based on hybrid brands

<table>
<thead>
<tr>
<th>BNP PARIBAS PERSONAL FINANCE</th>
<th>BancWest BNP PARIBAS GROUP</th>
<th>BGL BNP PARIBAS</th>
<th>BICIG GROUPE BNP PARIBAS</th>
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<td>UKRSIBBANK BNP PARIBAS GROUP</td>
<td>УКРСИББАНК BNP PARIBAS</td>
<td>BNP PARIBAS NAJMAM</td>
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<tr>
<td>TEB BNP PARIBAS JOINT VENTURE</td>
<td>BNP PARIBAS EQUIPMENT SOLUTIONS</td>
<td>First Hawaiian Bank</td>
<td>A BNP PARIBAS company</td>
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Department of Justice

Office of Public Affairs

FOR IMMEDIATE RELEASE

Eight Former Senior Executives and Agents of Siemens
Charged in Alleged $100 Million Foreign Bribe Scheme

WASHINGTON – Eight former executives and agents of Siemens AG and its subsidiaries have been charged for allegedly engaging in a decade-long scheme to bribe senior Argentine government officials to secure, implement and enforce a $1 billion contract with the Argentine government to produce national identity cards, announced Assistant Attorney General Lanny A. Breuer of the Justice Department’s Criminal Division, U.S. Attorney Preet Bharara for the Southern District of New York and Ronald T. Hosko, Special Agent in Charge of the FBI, Washington Field Office’s Criminal Division.
Outline

Introduction

Ownership of Fraud Risk
  • When it comes to fraud, there are no winners
  • Three lines of defense

Fraud Risk Management
  • Prevention
  • Detection
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  • Repair and Remediation

Conclusion
When it comes to fraud…

Who does what?

• In practice: No one likes fraud
  • A Fraud Examiner is always the bearer of bad news.
  • Fraud detection routines only prove that the system of internal control is functioning as intended.

• In theory: Two overall approaches
  • Fraud control is just like any other internal control.
    – Management responsibility
  • Fraud risk is too specific to leave it in the hands of a layman.
    – Responsibility of a dedicated department

…there are no winners
Three lines of defense...in general

First line of defense—Operational management
  • Ownership, responsibility, and accountability for assessing, controlling, and mitigating risks

Second line of defense—Risk management/compliance
  • Facilitates and monitors the implementation of the framework
  • Assists the risk owners in reporting

Third line of defense—Internal Audit
  • Provides assurance to the organization’s board and senior management
What About Fraud?
Outline

Introduction
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Conclusion
Definition of *Fraud*

Every book, magazine, and jurisdiction appears to have its own definition of *fraud*.

Most definitions encompass the following three key elements:

- Misconduct or abuse
- Deception
- Enrichment/benefit
Cost of Fraud

Financial impact
- Direct losses
- Indirect losses
- Increased credit risk
- Cost of Fraud Management and recovery

Reputational impact
- Reliability
- Ethics

Psychological impact
Why do people commit fraud?

Some people are honest all of the time.
Some people are dishonest all of the time.
Most people are honest some of the time.
Some people are honest most of the time.

–Tommie Singleton, PhD, University of Alabama
Fraud Risk Management

- Prevention and Early Detection
- Fraud Case Management
- Repair and Remediation
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Conclusion
Yet another policy?

ZERO TOLERANCE

Some important messages…

• What do we consider as fraud?
• How do we expect management and staff to deal with fraud risk?
• Who is responsible for managing fraud risk?
• What do we do in case of a fraud suspicion?
• What are the consequences of fraudulent behavior?
Talking About Fraud

Issues

• No one likes to talk about fraud

• They don’t know how to talk about fraud

• There are business targets to be reached
Learning to Talk About Fraud

- The real and possible impact
- Words to talk about fraud
- An appropriate framework to cover the entire range of fraud possibilities

Fraud Risk Categories

- Internal Fraud (Occupational fraud)
  - Economic Extortion
  - Abuse of Powers and Authority (Corruption)

- External Fraud
  - Fraudulent Disbursements
  - Asset Misappropriation
  - Fraudulent Financial Statements
  - Non Financial Assets
  - Financial Assets
  - Fraudulent documents
Learning to Talk About Fraud

Learning to know fraud

• Part of a training path for newcomers and new managers
  • Integrated in product training
  • Cross-product
• Other trainings and road shows
• E-learning

If you don’t know fraud, you won’t be able to:

• Recognize it in your daily operations
• Prevent it when designing processes
• Detect it when performing control tasks
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Assessing Fraud Risk

Issue: The first response

• Incidents that are part of the business as usual
• Incidents that have occurred recently
  – Within the own entity
  – With the neighbors
Assessing Fraud Risk

Why?

• Focusing limited resources on most risky areas
  • Frequency/impact
• Creating awareness
• Thinking outside the box

Nice side effect

• Putting fraud on the agenda
Fraud Risk Assessment

Preliminary
- Get an overall starting point
- Objective “Yes/No” questions
- Covers the entire fraud universe

Assessment
- Discussion with Line Management, based on preliminary questionnaire
- Inherent and controlled risk
- Fraud awareness maturity

Wrap Up
- Compare the outcome of the different assessments
- Action plan
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Fraud Detection

The hay

• 70,000 new mortgage loans
• 450,000,000 transfers
• 3,800,000 checks
• 600,000 physical coupon payments
• 17,000 staff members
• 1,300 branches
• …
Fraud Detection

• What are we looking for?
  • Kerviel, Madoff, Leeson?
  • The great train robbery?
  • The one big hit?

• Remember:
  • Fraud can occur anywhere, anytime.
  • Big fraud schemes usually start small.
  • Errors, anomalies, etc., indicate weaknesses.
Fraud Detection

Risk-based approach

• How will a typical fraud scheme appear in your systems?
• Determine risk factors.
• Isolate high-risk transactions by means of data mining.
Fraud Detection

Example: Mortgage fraud

• Modus operandi
• Risk factors
  • New customers
  • Increase sales
  • Renovation
  • Distance between the branch and the residence
• Score
• Analysis
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Managing Fraud Cases

Independent and objective inquiry

• To find out what actually happened
• To clearly define losses and responsibilities
• To maintain legal evidence
• To avoid cover up
  • By the fraudster or an accomplice in an internal fraud case
  • By someone who made a mistake and thus facilitated an external fraud
Repair and Remediation

Cleaning up the mess…
- Accounting
- Loss collection
- Reimbursing customers
- Recovery
- Legal action
- Disciplinary action

…and avoiding reoccurrence
- Lessons learned
- Revise and update controls in place
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Three lines of defense…and fraud

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Third line of defense—Internal Audit
  • Provides assurance to the organization’s board and senior management
First line of defense—Operational management

• Ownership, responsibility, and accountability for assessing, controlling, and mitigating risks

Training on how to recognize fraud

Tone at the top

Detective controls

Investigate incidents

Training on how to react when confronted with fraud

Preventive controls

Learning organization

Mr./Mrs. Anti-Fraud
Three lines of defense…and fraud

Second line of defense—Risk management/compliance
- Facilitates and monitors the implementation of the framework
- Assists the risk owners in reporting

Policy setting

Set the example

Proposing detective controls

Independent view

Knowledge center

Oversight

Methodology

Give advice
Three lines of defense…and fraud

Third line of defense—Internal Audit
• Provides assurance to the organization’s board and senior management
Three lines of defense…and fraud

Quis custodiet ipsos custodes?

*Juvenalis*, Satire VI, lines 347–8
## Conclusion

<table>
<thead>
<tr>
<th>Prevention and Early Detection</th>
<th>Investigation of Fraud Cases</th>
<th>Fraud Repair and Remediation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Culture of fraud risk awareness</td>
<td>Fraud alert Line</td>
<td>Accounting entries and register losses</td>
</tr>
<tr>
<td>Fraud awareness training</td>
<td>Process for fraud case management</td>
<td>Reimburse customers</td>
</tr>
<tr>
<td>Fraud risk in risk assessment process</td>
<td>Investigate fraud cases in a professional and objective way</td>
<td>Disciplinary action</td>
</tr>
<tr>
<td>Fraud preventive and detective controls</td>
<td></td>
<td>Improve internal control</td>
</tr>
<tr>
<td>Oversight on fraud risk Management</td>
<td>Report on fraud risk exposure</td>
<td>Post-mortem analysis and recommendations to line management</td>
</tr>
<tr>
<td>Guidance, advice, and recommendations on fraud risk Assessment methodology</td>
<td></td>
<td>Monitoring fraud risk exposure</td>
</tr>
<tr>
<td>Knowledge center on fraud risk Develop fraud detection controls</td>
<td></td>
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<tr>
<td>Provides assurance to the organization’s board and senior management</td>
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Conclusion

• Managing fraud risk is more than managing fraud incidents
• A fraud risk management framework, adapted to the needs of your organization
• Make sure that all aspects of fraud risk management are allocated somewhere
  • Role of management
  • Fraud Detection
    – A statistical approach
    – Looking into your systems
  • Let audit play its role
• Ensure coherence with the overall roles of risk and control governance
  • Create a second line function to maintain oversight

Questions?