

**INTRODUCTION**

The early detection of apparent fraud and insider abuse is an essential element in limiting the risk to the FDIC's deposit insurance funds and uninsured depositors. Although it is not possible to detect all instances of apparent fraud and insider abuse, potential problems can often be uncovered when certain warning signs are evident. It is essential for examiners to be alert for irregular or unusual activity and to fully investigate the circumstances surrounding the activity. Examiners should not restrict concern to internal crimes, but should also be alert to any attempts by outsiders to defraud financial institutions.

This section is organized by separate subject areas with each providing a summary of potential problems, a listing of warning signs of possible fraud and insider abuse, and suggested action for investigation. The lists are not all-inclusive but rather cover only those areas in which fraud and insider abuse occur most frequently. This section is designed to help alert examiners to possible fraudulent activity and insider abuse. It is intended to serve as a reference source during examinations and should be used as a supplement to standard examination procedures on an "as-needed" basis.

Any important situations should be commented on in the Report of Examination. Appropriate comments should be included in the Examination Conclusions and Comments schedule and in any other report pages as applicable.

Note the restrictions on disclosing irregular transactions in examination reports. This is more fully explained in the Report of Examination Instructions.

Any apparent criminal activity should be investigated thoroughly and reported on the Interagency Criminal Referral Form. The procedures for reporting apparent criminal violations are included in the Criminal Violations Section, Part IV.

**SUBJECT AREAS**

Included under each of the following subject areas is a summary of potential problems, a listing of warning signs of potential fraud and insider abuse and suggested action for investigation.

1. Corporate Culture/Ethics
2. Insider Transactions
3. Loan Participations

4. Real Estate Lending
5. Secured Lending
6. Third Party Obligations
7. Lending to Buy Tax Shelter Investments
8. Linked Financing/Brokered Deposits
9. Credit Cards and ATM Transactions
10. Advance Fee Schemes
11. Offshore Transactions
12. Wire Transfers
13. Money Laundering
14. Securities Trading Activities
15. Miscellaneous

**CORPORATE CULTURE/ETHICS****Potential Problems**

Complete dominance of an institution's policies and administration by one or a few directors may lead to inept management at lower levels. Absence of a written code of conduct may make it difficult to discipline directors, officers or employees who may be involved in questionable activities and may cause problems for directors, officers, employees and agents under the Bank Bribery Statute (18 U.S.C. 215). The code of conduct should identify allowable nonbank activities and acceptable gifts or gratuities received in the normal course of business.

**Warning Signs**

1. Absence of a code of ethics.
2. Absence of a clear policy restricting or requiring disclosure of conflicts of interest.
3. Absence of a policy restricting gifts and gratuities.
4. Lack of oversight by the institution's board of directors, particularly outside directors.
5. Absence of planning, training, hiring and organizational policies.

6. Absence of clearly defined authorities and lack of definition of the responsibilities that accompany the authorities.
7. Lack of independence of management in acting on recommended corrections.
8. CEO controls internal and outside auditors.
9. Lax control and review of expense accounts.
2. Insider involvement in silent trusts or partnerships and/or shell corporations.
3. Insider appears to receive special favors from institution customers or shows unusual favoritism toward certain institution customers.
4. Insider purchases assets from the institution, directly or indirectly, and there is no evidence of independent appraisal of the assets.

**Suggested Action**

Review the institution's code of conduct. Determine if there is a policy covering conflicts of interest and if prohibited practices are clearly stated along with the consequences for failure to refrain from these practices. Determine whether all insider interests are accurately reported to the institution's board of directors. Closely review the minutes of the board of directors' meetings and note the reporting of insider interests and the dominance of any director(s) in discussion of policy matters and administration. Also note the discussion of insider transactions and see if there are any directors who frequently or consistently vote against insider transactions in general or against those of one or more insiders in particular. Attempt to determine the reason for the dissent. If directors, officers and employees are required to report gifts and gratuities from present or potential customers, review the report to see if the gifts or gratuities conform to the institution's guidelines.

**INSIDER TRANSACTIONS****Potential Problems**

Insider fraud has accounted for over one-half of all bank fraud and embezzlement cases closed by the FBI during the past several years. Insiders are in a position of trust and can abuse that trust for their own personal benefit. Insider abuses include failure to disclose their interests that borrow from the institution or otherwise have business dealings with the institution; diverting assets and income for their own use; misuse of position by approving questionable transactions for relatives, friends and/or business associates; abuse of expense accounts; acceptance of bribes and gratuities; and other questionable dealings related to their positions at the institution. Insider abuse undermines confidence in institutions and often leads to failure.

**Warning Signs**

1. Insider lending personal funds to customers or borrowing from customers.
5. Insider is responsible for clearing up audit exceptions on loan balance confirmations.

5. Insider has apparent reciprocal lending arrangements with insiders of other institutions and his/her institution has correspondent relationships with those institutions.
6. Insider is involved in a business that arranges its financing through the institution.
7. Insider "perks" include use of expensive institution-owned automobiles, boats, airplanes, housing, etc., where the institution's earnings do not appear to support such extravagance.
8. Insider heavily indebted and debt service appears to require most, if not all, of the insider's salary.
9. Insider financial statements show large or unusual fluctuations. Net worth cannot be reconciled from disclosed sources of income.
10. Insider is financing large purchases (home, auto, etc.) through private, nonbanking sources that may have a business relationship with the institution.
11. Insider financial statement reflects heavy concentration of high-risk investments and speculative ventures.
12. Insider sells personal assets to third party and the institution provides financing without benefit of an independent appraisal.
13. Insiders or their interests frequently appear on transaction suspense item listings or on computer-generated past due loan lists, but do not appear on the "updated" version presented to the board of directors or to examiners.
14. Insider "unofficially" guarantees loans and/or loan participations.

16. Insider "forgets" to process credit entry for official bank checks causing the account to be out-of-balance because checks are sometimes paid (debited) before the credit is posted, sometimes several days later.
17. Insider conducts a cash transaction over \$10,000 but "forgets" to have the institution file a Currency Transaction Report or asks an employee to "structure" the transaction to avoid filing a Currency Transaction Report with the Internal Revenue Service.
18. Insider's stock in the institution is pledged to secure loans obtained from sources other than financial institutions. If true, what is the purpose of the loan and are payments current?
19. Insider conducts personal business from the institution using equipment, supplies, employees, etc., and/or spends most of their time out of the institution on business unrelated to the institution.
20. Insider has substance abuse problems or is known to associate with people who have these problems.
21. Insider is known to associate with "high rollers".
22. Insider suggests that institution change servicers or vendors even though there appears to be no problem with the current servicers or vendors.
23. Insider abruptly suggests changes in outside auditors or legal counsel.
24. Insider loans increase dramatically at about the same time as the institution is recapitalized.
25. Insider's major assets are parcels of real estate that appear to increase in value at a rate that is not consistent with market conditions.
26. Insider sells his stock to an Employee Stock Option Plan (ESOP), sometimes arranging for the ESOP to obtain a loan to purchase the stock.
27. Insider's interests have a direct business relationship with the institution and compensation for services is not commensurate with the level of services provided.
28. Insider agrees to buy fixed assets from the institution with the understanding that the institution will repurchase the fixed assets at some future date.
29. Insider receives incentive pay or "bonuses" based on volume of loans generated.
30. Insider buys a home from a builder whose development project is financed by the institution.
31. Insider is involved in "churning" of the institution's securities portfolio.
32. Insider arranges sale of EDP equipment at book value in connection with the conversion to a new data processing servicer. Also check "side" deals.
33. Insider authorizes ORE related expenses such as landscaping, remodeling, etc., when such expenses do not appear justified. (May be making improvements or repairs to personal residence.)
34. Insider makes frequent trips at the institution's expense to areas where the institution has no business relationships.
35. Insider will not allow employees to talk to examiners.
36. Insider keeps an unusual number of customer files in his/her office.
37. Insider is making payments on other borrowers' loans.
38. Insider's loan is being paid by someone else.
39. Insider receives commissions on credit life insurance premiums and those commissions are not properly adjusted in cases where the insurance company gives rebates for the borrower's prepayment of the loan or gives refunds to borrowers for premium overcharges.
40. Insider sells some of his/her personal stock of the institution to borrowers (as a condition for approving loan) and buys more stock from the institution at about the same time that the institution is under pressure to increase capital.
41. Insider purchases investment securities for his personal portfolio through the institution but "forgets" to reimburse the institution until a few days or weeks later, and then only if the investment has increased in value. In spite of the increase in value, the insider only pays the original purchase price to the institution.
42. Insider's accounts at the institution are frequently overdrawn. Deposits to cover overdrafts come from loans or some undisclosed source.

43. Insider maintains total control over the institution and does not allow other officers and employees to make independent decisions.
44. Insider has past due loans at other financial institutions.
45. Insider maintains signed, blank notes in personal or customer loan files.
46. Insider is rumored to have financial problems due to divorce, business failure, gambling losses, etc.
47. Insider maintains several personal accounts outside of his/her own institution.
48. Insider frequently takes loan papers out of the institution for customer signatures; personally handles the disbursement of the loan proceeds; routinely cashes checks for customer loan proceeds; and insists on personally handling certain past due accounts as a "special favor" to certain customers.
49. Insider insists that different audit firms audit different divisions or departments. (Hopes there will be no comparison of findings between firms.)
50. Insider insists that different departments be audited at different times. (Makes it easier to hide fraudulent inter-departmental transactions.)

**Suggested Action**

Review all insider transactions to see if they comply with policy and applicable state and federal regulations. Follow up on any exceptions. Any nonconforming transactions should be discussed with the institution's board of directors. Apparent fraudulent activities should be referred to the proper authorities.

**LOAN PARTICIPATIONS****Potential Problems**

Loan participations can lead to substantial losses if not documented properly and if not subjected to the same credit standards and reviews as direct loans. Participations purchased as an accommodation to affiliated institutions often do not receive the same scrutiny as those purchased from non-affiliated institutions. Informal repurchase agreements between participating institutions may be used to circumvent legal lending limitations and could subject institutions to substantial undisclosed contingent liabilities.

Participations may also be used to disguise delinquencies and avoid adverse classifications.

**Warning Signs**

1. Excessive participation of loans between closely related institutions, correspondent institutions and branches or departments of the lending institution.
2. Absence of any formal participation agreement.
3. Poor or incomplete loan documentation.
4. Investing in out-of-territory participations.
5. Reliance on third party guaranties.
6. Large paydown or payoff of previously classified loans.
7. Some indication that there may be informal repurchase agreements on some participations.
8. Lack of independent credit analysis.
9. Volume of loan participations is high in relation to the size of the institution's own loan portfolio.
10. Evidence of lapping of loan participations. For example, the sale of a loan participation equal or greater than, and at or about the same time as, a participation that has matured or is about to mature.
11. Disputes between participating institutions over documentation, payments, or any other aspect of the loan participation transaction.
12. Formal participation agreements are missing; therefore, responsibilities and rights of all participating institutions may be unclear.
13. Participations between affiliated institutions may be "placed" without the purchasing institution having the benefit of reviewing normal credit information, particularly where there is dominant ownership and a "rubber stamp" board of directors.
14. Payments that are not distributed to each participant according to the participation agreement may indicate preferential treatment; or where the participants are affiliated, it may indicate an attempt to disguise the delinquent status of the loans in the weaker institutions.
15. Informal guaranties by insiders may be one method of disguising insider transactions.

16. There is some indication that the credit information contained in the selling institution's files is not the same as the credit information in the purchasing institution's files.
17. Be aware of reciprocal arrangements in the sale/purchase of participations. For example, Institution A sells a 100% participation in a loan to an insider of the selling institution to Institution B which, in turn sells a 100% participation in a loan to one of their insiders to Institution A.
18. There are a number of outstanding items in correspondent accounts just prior to or during an examination or audit which relate to participations purchased or sold.
19. There is some indication that payments on participations purchased are being made by the selling institution without reimbursement from the borrower.

**Suggested Action**

Where possible, determine the current status of participations at each participating institution. Make special note of any disputes between participating institutions and follow up. Review any debits or credits related to participations posted to the correspondent institution accounts just prior to or during the examination. Follow up on any exceptions. Attempt to determine if the participation has been adversely classified by examiners at any participating institution. Look for any indication of any informal repurchase agreements.

**REAL ESTATE LENDING****Potential Problems**

Real estate lending abuses have been given a lot of publicity due to the problems encountered by financial institutions that have suffered substantial losses from problem real estate loans. These problems have not been confined to any particular area of the country. Many of the problems revolve around inflated appraisals, land flips (interparty transactions), fraudulent sales contracts, forged title documents, misapplication of loan proceeds, financing of nonexistent properties, loans in the name of trustees, holding companies and offshore companies to disguise the true identity of the actual borrowers and fraudulent loan applications from purchasers, including false income statements, false employment verifications, false credit reports and false financial statements. In many cases, important documentation is missing or is intentionally deficient in an attempt to conceal material facts.

**Warning Signs**

1. An unusually large number of loans in the same development are exactly equal to the institution's maximum loan-to-value (LTV) ratio for real estate mortgages.
2. The institution has an unusually high percentage of "No Doc" loans. (A "No Doc" loan is one in which extensive documentation of income, credit history, deposits, etc., is not required because of the size of the downpayment, usually 25% or more. Theoretically, the value of the collateral will protect the lender.)
3. Borrower has never owned a home before and does not appear to have the financial ability to support the size of the downpayment made.
4. Property securing loan has changed ownership frequently in a short period of time. Related entities may be involved.
5. Insured value of improvements is considerably less than appraised value.
6. Appraiser is a heavy borrower at the institution.
7. Appraisal fee is based on a percentage of appraised value.
8. Borrower furnishes his/her own appraisal which is a photocopy of an appraisal signed by a reputable appraiser.

9. Use of "comparables" which are not comparable.
10. Appraisal is based on an estimated future value.
11. All comparables are new houses in the same development that were built by the same builder and appraised by the same appraiser.
12. An unusual number of "purchasers" are from out of the area or out of state.
13. Credit history, employment, etc., are not independently verified by the lender.
14. Large number of applicants have income from sources that cannot be verified, such as self-employment.
15. The value of the home the applicant desires to purchase is not in line with the applicant's income. For example, the applicant makes \$90,000 per year and only wants to purchase a \$90,000 home.
16. The applicant's credit history is incomplete. For example, the applicant is 45 years old, but credit history only dates back five years.
17. The institution's normal procedure is to accept photocopies of important documents rather than to make their own copies of the originals.
18. If copies of income tax returns are provided, columns are uneven and/or do not balance.
19. Appraiser is from out of the area and not likely to be familiar with local property values.
20. A close relationship exists between builder, broker, appraiser and lender.
21. Construction draws are made without visual inspections.
22. All "comparables" are from properties appraised by the same appraiser.
23. Generally, housing sales are slow, but this development seems unusually active in sales.
24. There seems to be an unusual number of foreclosures on 90% to 95% loans with Private Mortgage Insurance on homes in the same development built by the same builder. (Sometimes it is cheaper for the builder to arrange for a straw buyer to get the 95% loan and default than it is to market the home if the market is sluggish.)
25. Applications received through the same broker have numerous similarities.
26. Sales contracts have numerous crossed out and changed figures for sales price and downpayment.
27. Appraiser for the project owns property in the project.
28. Lending officer buys a home in a project financed by the institution.
29. Assessed value for tax purposes is not in line with appraised value.
30. The project is reportedly fully occupied, but the parking lot always appears to be nearly empty.
31. The parking lot is full, but the project appears empty. Nobody is around in the parking lot, pool, etc.
32. After a long period of inactivity, sales suddenly become brisk.
33. Sales contract is drawn up to fit the lender's LTV requirements. For example, the buyer wants an \$80,000 home but has no down payment. The lender only lends 80% of appraised value or selling price. Contract is drawn up to show a selling price of \$100,000 instead of the actual selling price of \$80,000.
34. Builder claims a large number of presold units not yet under construction while many finished units remain unsold.
35. The borrower's interest in the property is not logical given the distance between the property and his/her place of employment and the supply of comparable housing near his/her employer. For example, employment of the prospective borrower/purchaser is 100 miles from the location of the property, while comparable housing is readily available within 10 miles of employment.
36. Applicant's stated income is not commensurate with his/her stated employment and/or years of experience.
37. Applicant's financial statement shows numerous assets that are self evaluated and cannot be readily verified through independent sources.

38. Applicant claims to own partial interests in many assets but not 100% of any asset, making verification difficult.
39. Appraised value of property is contingent upon the curing of some property defect such as drainage problems.
40. The applicant's financial statement reflects ownership of valuable items, such as jewelry and art work, but no insurance is carried on these items.
41. Applicant's tax return shows substantial interest deductions, but the financial statement shows little debt. For example, the borrower's tax return shows substantial mortgage interest deductions, but the self-prepared financial statement shows no mortgage or a very small mortgage.
42. Appraised value of a condominium complex is arrived at by using the asking price for one of the more desirable units and multiplying that by the total number of units.
43. Loans are unusual considering the size of the institution and the level of expertise of its lending officers.
44. There is a heavy concentration of loans to a single project or to individuals related to the project.
45. There is a heavy concentration of loans to local borrowers with the same or similar real estate collateral which is located outside the institution's trade area.
46. There are many loans in the names of trustees, holding companies, and/or offshore companies but the names of the individuals involved are not disclosed in the institution's files.
47. A loan is approved contingent upon an appraised value of at least a certain amount and the appraised value is exactly that amount.
48. Independent reviews of outside appraisals are never conducted.
49. The institution routinely accepts mortgages or other loans through brokers but makes no attempt to determine the financial condition of the broker or to obtain any references or other background information.
50. Borrower claims substantial income but his/her only credit experience has been with finance companies.
51. Borrower claims to own substantial assets, reportedly has an excellent credit history and above average income, but is being charged many points and a higher than average interest rate which is indicative of high risk loans.
52. The institution allows borrowers to assign mortgages as collateral without routinely performing the same analysis of the mortgage and mortgagor as they would perform if the institution were mortgagee.
53. Asset Swaps - Sale of other real estate or other distressed assets to a broker at an inflated price in return for favorable terms and conditions on a new loan to a borrower introduced to the institution by the broker. The new loan is usually secured by property of questionable value and the borrower is in weak financial condition. Borrower and collateral are often outside the institution's trade area.

#### **Suggested Action**

Review all real estate files and request any missing documents. Review appraisals to attempt to determine whether any land flips have been involved. Compare appraised value to other stated values such as assessed value or insured value. Attempt to identify any pattern or practice which appears to be suspicious such as a large number of borrowers having the same employer, a large number of properties appraised by the same appraiser, a large number of loans presented by the same broker, a large number of out-of-territory borrowers, etc. If possible, visit construction sites to see if activity is as represented.

### **SECURED LENDING**

#### **Potential Problems**

Financial institutions are often lulled into a false sense of security when they believe that they have adequate collateral for their loans; however, many institutions fail to properly record their liens and/or fail to physically verify the existence of their collateral. In many cases, there are no independent appraisals to support collateral value. Out-of-territory collateral may be difficult to verify and monitor. Where fraud is suspected, it is often difficult to prove in cases where institutions have failed to follow generally accepted procedures for documenting collateral.

#### **Warning Signs**

1. Lack of independent appraisals of collateral.

2. Significant out-of-territory lending.
3. Loans with unusual terms or conditions.
4. Poor or incomplete documentation used to intentionally conceal material facts.
5. Loans that are unusual considering the size of the institution and the level of expertise of its lending officers.
6. Heavy concentration of loans secured by the same or similar types of collateral.
7. Financing of 100% of the value of any collateral that is subject to rapid depreciation or wide fluctuation in market value.
8. Appraisals which appear to be made to cover the borrower's loan request rather than to reflect the true value of the collateral.
9. Appraisal fee based on amount of loan or on appraised value of collateral may encourage inflated appraisals.
10. Review of records indicates numerous related party purchases and sales of the collateral which could be used to inflate the collateral price far beyond actual market value.
11. Loans in the names of trustees, holding companies, and offshore companies may disguise the identity of actual borrowers.
12. Assigned notes and mortgages are accepted as collateral without verifying all underlying documentation and conducting normal credit analysis on the obligor.

**Suggested Action**

Review collateral inspection records to determine if there are any exceptions. Review appraisals for similar types of collateral and reconcile any differences. Determine whether in-house appraisals are based on physical inspection of the collateral. If not, why not? Be sure that adequate collateral margins are required at the inception of loans and monitored throughout the term of the loans.

**THIRD PARTY OBLIGATIONS****Potential Problems**

A guaranty is only as good as the guarantor and a guaranty without adequate documentation to support its value to the institution may be worthless. A guaranty that is separate from the note may contain restrictions that could render it worthless unless the restrictions are closely followed and a guaranty signed in blank may be legally unenforceable if contested. A false third party obligation may be created for the sole purpose of obtaining a loan from the institution. It may have no actual value. This is particularly true where offshore "shell" institutions are involved.

**Warning Signs**

1. Documentation on guaranties is incomplete.
2. Loans are secured by obligations of offshore institutions.
3. Lack of credit information on third party guarantor.
4. Financial statements reflect concentrations of closely held companies or businesses that lack audited financial statements to support their value.
5. A guaranty signed in blank may be used indiscriminately by some dishonest individuals to cover weak loans. Guaranties signed in blank may also be legally unenforceable if contested.
6. Guaranties that are separate from the notes may contain restrictions that could render them worthless unless the restrictions are closely followed.
7. Third party obligor is not informed of the assignment of the obligation to an institution; this may allow payments to be diverted to some use other than payment of the loan.
8. Guaranties from insurance companies or letters of credit from insurance companies to guaranty payment are accepted without an evaluation of the financial soundness of the guarantors and their ability to honor the guaranties or letters of credit if necessary.
9. Guaranties or letters of credit from insurance companies are not directly verified with the issuer.
10. The institution's audit procedures do not include a request for acknowledgement of guaranties by guarantors.
11. Corporate guaranties are used, but there is no information in the institution's files to support the authority of the corporations to make the guaranties or to indicate that they are still in force.



12. The institution purchases substandard consumer contracts from a third party relying on recourse to the seller without performing proper analysis of seller's financial condition.
13. The institution purchases substandard consumer contracts for automobiles, home improvements, etc., while relying on some type of insurance to cover delinquencies, skips, etc., without verifying the financial condition of the insurer.

**Suggested Action**

All guaranties should be reviewed to determine that all documentation is complete and that each guarantor is financially sound and reputable. Corporate guaranties and letters of credit from insurance companies and financial institutions should be verified directly with the issuer. If a loan is collateralized by an obligation of an offshore bank, determine if the lender has attempted to verify the existence, performance history, and financial stability of the offshore bank. Guaranties signed in blank should be reviewed to determine their validity.

**LENDING TO BUY TAX SHELTER INVESTMENTS****Potential Problems**

Be wary of deals where there is no economic purpose except to generate tax write-offs. If the Internal Revenue Service (IRS) successfully challenges the tax benefits claimed from the tax shelter, the investor would have to pay not only additional income tax on the amounts disallowed but also interest and possible penalties. Should this occur, investors might walk away from their loans, and institutions holding the loans would suffer losses.

**Warning Signs**

1. Block loans to individuals to buy tax shelters arranged by a tax shelter promoter.
2. Shelters which promise tax deductions that would not appear to withstand the scrutiny of the IRS.
3. Specific use of the invested funds cannot be ascertained.
4. Loan payments are to be made by a servicing company.
5. Investments reflect no economic purpose except to generate tax write-offs.
6. Financial "no cash" deals where transactions are structured to avoid any actual cash flow. For example, a long-term CD is matched against a loan payable from the proceeds of the CD at its maturity. Interest accumulates on the CD in an amount equal to or greater than the compounded interest owed on the corresponding loan. The depositor/borrower never provides or receives any cash but still gets the tax write-off.

**Suggested Action**

Try to determine if the tax shelter is legitimate. Section 465 of the Internal Revenue Code states that an investor can only use losses available from such at risk activity to the extent that the taxpayer is actually economically at risk in connection with the activity.

**LINKED FINANCING  
/BROKERED DEPOSITS****Potential Problems**

Linked financing and brokered deposit transactions have contributed to the failure of several banks and savings associations. Offers of large deposits in return for favorable treatment on loans to out-of-area borrowers or to other borrowers previously unknown to the institution should be handled with caution. Where the brokered deposits are not pledged to secure the associated loans, the institution is exposed to substantial risk since it must refund the deposits regardless of the collectability of the loans.

**Warning Signs**

1. Short-term volatile deposits are used to fund long-term loans of questionable credit quality.
2. A generous point spread exists between the loan interest rate and the interest rate on deposits, which are usually below prevailing market rates.
3. Out-of-territory lending to previously unknown borrowers.
4. Large dollar deposits are offered in consideration for favorable treatment on loan requests, but deposits are not pledged as collateral for the loans.
5. Brokered deposit transactions where the broker's fees are paid from the proceeds of related loans.

6. Institution is presented with a large loan request that cannot be funded without the use of brokered deposits.
7. An unsolicited offer to purchase the institution comes at about the same time as brokered deposits and related loans are processed.
8. Long term discounted certificates of deposit pledged or matched at face value and not actual book value and structured to repay the loan automatically.

**Suggested Action**

Loans and other transactions associated or connected with brokered deposits should be carefully reviewed. Special attention should be given to transactions where the broker's fee is paid out of loan proceeds or fees for other related transactions instead of being paid directly by the institution as a cost of obtaining the funds.

**CREDIT CARDS AND ATM TRANSACTIONS****Potential Problems**

Poor control by the issuing institution over unissued cards, PINs, returned mail, credit limit increases and name and address changes can contribute to credit card and ATM card fraud. Credit card merchant accounts can be used to defraud the institution, particularly where the institution does not exercise care in screening prospective accounts. If not handled properly, credit card programs secured by deposit accounts can create substantial liability to the institution for inadequate or improper disclosures of fees and interest charges to customers and can create losses where credit limits are not adequately monitored and/or controlled. Delay in payments to merchants and payments from cardholders could signal the beginning of problems with a third party servicer (generally an outside marketing firm).

**Warning Signs**

1. Lack of separation of duties between the card issuing function and issuance of personal identification number ("PIN").
2. Poor control of unissued cards and PINs.
3. Poor control of returned mail.
4. Customer complaints.
5. Poor control of credit limit increases.
6. Poor control of name and address changes.
7. Frequent malfunction of payment authorization system.
8. Unusual delays in receipt of cards and PINs by the customers.
9. The institution does not limit amount of cash that a customer can extract from an ATM in a given day.
10. Evidence that customer credit card purchases have been intentionally structured by a merchant to keep individual amounts below the "floor limit" to avoid the need for transaction approval.
11. Credit card merchant accounts are opened without obtaining any background information on the merchant.
12. Credit card merchant account activity reflects an increase in the number and size of chargebacks.
13. The institution's credit card merchant is depositing sales drafts made payable to a business or businesses other than the business named on the account.
14. Credit card merchant frequently requests the wire transfer of funds from the merchant account to other institutions in other parts of the country or to offshore institutions almost immediately after deposits are made.
15. Merchant is engaged in telemarketing activities and is the subject of frequent customer complaints.
16. The institution contracts with third party servicer to process credit card customer and merchant transactions without verifying the financial stability and performance history of the servicer.
17. The institution contracts with a third party to establish and market a secured credit card program without verifying the financial stability and performance history of the third party and without determining the institution's potential liability for participation in the program.
18. Credit card merchant account deposits appear to exceed the level of customer activity observed at the merchant's place of business.
19. Merchant has access to EDC (electronic data capture) equipment but frequently inputs credit card

account numbers manually. Be especially alert if manually keyed transactions exceed 10% of total transactions.

20. Merchant has a sudden or unexplained increase in the level of authorization requests from a particular merchant location.

### **Suggested Action**

Review customer complaints, no matter how insignificant they may appear to be, and review the institution's follow-up procedures. Be sure proper controls are in place at all points throughout the card issuing and transaction processing functions. Review possible causes of frequent malfunctions of the payment authorization system and follow-up on remedial actions taken by the institution. Monitor the level of authorization requests to spot potential problems before sales drafts are deposited. Conduct on-site inspections of merchant's operations. Review contracts and correspondence between the institution and Visa, MasterCard, etc. Review contracts with third party servicers, secured credit card programs and marketing agencies to determine possible exposure to liability.

## **ADVANCE FEE SCHEMES**

### **Potential Problems**

Advance fee schemes have been around for many years. They usually involve offers of sizable funds available for loans at below market rates, with the funds supposedly coming from some foreign interests who are seeking a safe haven in the United States. The targets are usually individuals or businesses experiencing financial difficulties. The goal of the perpetrator is to collect a fee in advance since the rest of the transaction is a sham and will never be consummated.

Although Institutions have been victimized by advance fee schemes, they are seldom the primary targets. However, institutions may be unwittingly used to lend false credibility to an advance fee scheme. Evidence of association with a reputable United States financial institution is critical to the success of the scheme. Institutions that act as agent, custodian, or in some other legal capacity face potential liability: (1) They have been sued by the perpetrators of the scheme for nonperformance under agency or escrow agreements, (2) They could be charged criminally for aiding and abetting a fraud, or (3) They may be civilly liable to the victims of the fraud.

### **Warning Signs**

1. A person having no previous relationship with the institution suddenly appears and offers fantastic opportunities for the institution and/or its customers.
2. Broker claims to be part of a major financial organization, but this claim cannot be verified.
3. Broker claims to have access to huge sums of money from a secret, undisclosed or unverifiable source.
4. Broker becomes irritated if the institution suggests that references be checked.
5. Broker makes frequent references to such terms as "ICC Form 254, 290 or 322" and frequently uses the terms "emission rate", "prime bank notes", "tranches", "letters of commitment", "bank acceptances", "arbitrage", "hedge contracts" or "escrow agreements".
6. Broker initially requests an advance fee for his services but often "reluctantly" agrees to defer the fee until settlement of the transaction.
7. As the deadline for settlement nears, the broker urgently requests an advance on his fee to cover expenses such as travel, documentation, communication costs, etc.
8. Broker states that funds will be forthcoming from some offshore bank in the Caribbean or South Pacific.
9. Attempts to verify the broker's references are unsuccessful.
10. Broker's references include telephone numbers which are answered by machines and addresses which are mail drops, hotel rooms, etc.
11. Broker proposes a self-liquidating loan where earnings from a deposit or other investment will be such that they will pay the principal and interest of the loan with no additional funds needed from the borrower.
12. Broker conducts most of the negotiations by telephone or telex and appears to resist any meeting with the institution's counsel.
13. Broker repeatedly delays the settlement of the deal citing numerous "technical" problems.
14. The deal frequently falls through at the last minute while the broker searches for another source of funds.

15. Broker asks institution to serve as a transfer bank, middleman or agent in the transfer of funds between a sending institution and a receiving institution.
16. Broker who originally presents the deal may be known to the institution but other persons involved may be unknown to the institution and may have questionable backgrounds.
17. Broker asks for the institution's telex numbers and frequently, a long, instructional telex from the lender's agent is received by the institution.
18. The receiving institution may be asked to send a number of letters, contracts, or telex messages to the lender's agent or the lender's institution.
19. Broker expresses a great deal of urgency in completing the transaction so that the loan will not be lost.
20. Broker offers funds that the borrower can invest in U. S. Treasury Notes or similar instruments at a 4 or 5 point spread which will help the borrower to cover part of the fees, but offers only flimsy excuses as to why the lender does not directly invest in these instruments.
21. Broker does not allow borrower or institution any direct contact with the proposed lender, often citing confidentiality requirements by the lender or some sensitive political situation in the lender's home country.
22. Broker often requests that the borrower's institution issue a standby letter of credit to the foreign lender to guarantee payment.
23. Broker is often a name dropper, but the people named are either deceased or impossible to contact for reference because of political reasons.

### **Suggested Actions**

The key to avoiding direct losses and/or potential legal liability in an advance fee scheme is to "know the customer" and carry out an extensive due diligence review. Each proposal involving any offer of large sums of money from previously unknown sources should be thoroughly investigated. No commitments should be made until all references are directly verified through some reputable and reliable source. Until references are verified, telex and written communications concerning the transactions should be avoided. Fees should not be paid until funds are verified and physically transferred. Suspicious transactions should

be immediately reported to the FDIC and to the FBI. Remember, if the deal sounds too good to be true, it probably is.

## **OFFSHORE TRANSACTIONS**

### **Potential Problems**

Although there are legitimate and reputable institutions operating offshore offices, many are only "shell" institutions with little or no capitalization, no actual main office, no fixed asset investment, no actual staff and few other characteristics of a legitimate institution. Licenses for many offshore financial institutions are issued upon receipt of relatively nominal fees and minimal background verifications. The names of these offshore "shell" institutions are often similar to those of major legitimate financial institutions which are listed in international banking directories. There have been many instances of fraud involving obligations of offshore institutions, including certificates of deposit, letters of credit, drafts, commitments, etc. In some cases, these obligations have been purchased for a fraction of their face value for the sole purpose of defrauding legitimate institutions and other businesses.

Offshore companies, including financial institutions, are frequently established for the purpose of hiding the true identity of the principals, laundering money, inflating financial statements and issuing false documents to secure loans. Loans to offshore companies and loans secured by obligations of offshore institutions must be viewed with extreme caution.

### **Warning Signs**

1. Loans made on the strength of a borrower's financial statement when the statement reflects major investments in and income from businesses incorporated in bank secrecy haven countries such as Panama, Cayman Islands, Netherlands Antilles, Montserrat and others.
2. Loans to companies domiciled in bank secrecy haven countries.
3. Loans secured by obligations of offshore institutions.
4. Transactions involving an offshore "shell" institution whose name may be very similar to the name of a major legitimate institution.
5. Frequent wire transfers of funds to and from bank secrecy haven countries such as Panama, Cayman Islands, Netherlands Antilles, Montserrat and others.

6. Offers of multi-million dollar deposits at below market rates from a confidential source to be sent from an offshore institution or somehow guaranteed by an offshore institution through a letter, telex, or other "official" communication.
7. Offshore companies are used to disguise the true identity of borrowers or guarantors.
8. No independent verification of the financial strength of the offshore institution is available from any source.
9. In order to make an offshore bank transaction appear legitimate, innocent third parties are brought into the scheme, unaware of its fraudulent nature.

**Suggested Action**

Offshore transactions should be closely examined to determine the legitimacy of the entities involved. Suspicious wire transfers to and from offshore institutions should be reviewed to determine the source and disposition of the funds. Obligations issued by questionable offshore institutions should not be accepted at face value unless the value can be substantiated through independent sources.

**WIRE TRANSFERS****Potential Problems**

Wire transfer fraud is often possible because of a breakdown in internal controls and/or system security measures at the financial institution. Transactions may be introduced by unauthorized persons who have obtained the proper procedures from an unsuspecting employee. Transactions may be altered in processing and posted to the wrong account, posted in the wrong amount or posted to the correct beneficiary but wrong account. Wire transfers are a popular form of laundering money, providing an easy way of sending funds to and from bank secrecy haven countries.

**Warning Signs**

1. Lack of separation between authority to initiate a wire transfer and authority to approve a wire transfer.
2. Indications of frequent overrides of established approval authority and other internal controls.
3. Intentional circumvention of approval authority by splitting transactions.
4. Wire transfers to and from bank secrecy haven countries.
5. Frequent or large wire transfers for persons who have no account relationship with the institution.
6. Large or frequent wire transfers against uncollected funds.
7. Frequent requests for immediate wire transfer of funds from a credit card merchant account to institutions in other parts of the U. S., offshore institutions or foreign institutions.
8. Frequent wire transfers from accounts with numerous cash deposits of just under \$10,000 each.
9. Frequent errors in payment by authorized system officials.
10. Lack of security of the wire transfer system safeguards such as the password and other details of wire transfer transactions.
11. Unconfirmed wire transfer requests initiated by telephone.
12. Incoming wire transfers in which the account name and account number do not match.
13. Wire transfer or payment request that does not conform to established procedures.
14. Absence of written funds transfer agreements between the institution and its customers.
15. Large international funds transfer to or from the accounts of domestic customers in amounts and of a frequency that are not consistent with the nature of the customer's known business activities.
16. Receipt of funds in the form of multiple cashier's checks, money orders, traveler's checks, bank checks or personal checks that are drawn on or issued by U. S. financial institutions and made payable to the same individual or business, in U. S. dollar amounts that are below the \$10,000 Bank Secrecy Act reporting threshold and which are then wire transferred to a financial institution outside the U. S.
17. The deposit of funds into several accounts and then aggregated into one account followed by the wire transfer of those funds from that account outside of the U. S. when such action is not consistent with the known business of the customer.

18. Any other unusual international funds transfer requests wherein the arrangements requested appear to be inconsistent with normal funds transfer practices, e.g., where the customer directs the institution to wire transfer funds to a foreign country and advises the institution to expect same day return of funds from sources different from the beneficiaries initially named, thereby changing the source of the funds.
19. A pattern of wire transfers of similar amounts both in and out of the customer's account on the same day or next day.
20. Wire transfers by customers operating a cash business, i.e., customers depositing large amounts of currency.
21. Wire transfer volume is extremely large in proportion to the asset size of the institution.
22. The institution's business strategy and financial statements are inconsistent with large volumes of wire transfers, particularly outside the United States.
2. Cash on hand frequently exceeds limits established in security program and/or blanket bond coverage.
3. Large volume of cashier's checks, money orders, traveler's checks, etc., sold for cash to noncustomers in amounts ranging from several hundred to just under \$10,000 each.
4. Large volume of wire transfers to and from offshore institutions.
5. Large volume of wire transfers for noncustomers.
6. Accounts which have a large number of small deposits and a small number of large checks with the balances of the accounts remaining relatively low and constant. The accounts have many of the same characteristics as accounts used for check kiting.
7. A large volume of deposits to several different accounts with frequent transfer of major portions of the balances to a single account at the same institution or at another institution.
8. Loans to offshore companies and loans secured by obligations of offshore institutions.
9. Large volume of cashier's checks, money orders and/or wire transfers deposited to an account where the nature of the account holder's business would not appear to justify such activity.
10. Large volume of cash deposits from a business that is not normally cash intensive, such as a wholesaler.
11. Cash deposits to a correspondent account by any means other than through an armored carrier.
12. Large turnover in large bills that would appear uncharacteristic for the institution's location.
13. Cash shipments which appear large in comparison to the dollar volume of currency transaction reports filed.
14. Dollar limits on the list of customers exempt from currency transaction reporting requirements which appear unreasonably high considering the type and location of the businesses. No information is in the institution's files to support the limits.
15. Currency Transaction Reports, when filed, are often incorrect or lack important information.
16. List of exempted customers appears unusually long.

**Suggested Action**

Review wire transfer procedures for possible circumvention of internal controls and system security measures. Follow-up on any exceptions. Verify source and disposition of suspicious wire transfers. Review accounts with frequent wire transfers to determine if the activity appears legitimate.

**MONEY LAUNDERING****Potential Problems**

An institution may be liable for civil or criminal penalties for willful participation in a money laundering scheme. The length of time involved in a money laundering investigation and the surrounding publicity can be disrupting and costly to an institution even if no formal charges are filed and no fines are levied. A money launderer usually needs the assistance of someone within the institution to whom he is often willing to pay a substantial fee. With the employee's assistance, money launderers are often able to hide their activities for an extended period of time.

**Warning Signs**

1. Increase in cash shipments that is not accompanied by a corresponding increase in number of accounts.

17. Customer expresses some urgent need to be included on the institution's list of customers exempt from currency transaction reporting requirements.
18. Customer requests information on how to avoid the filing of currency transaction reports on cash transactions involving amounts over \$10,000.
19. Upon being informed of the currency transaction reporting requirements, customer withdraws all or part of the transaction to avoid the filing of the CTR.
20. Customer frequently conducts cash transactions in amounts just under \$10,000 each.
21. Customer refuses to provide information required to complete a CTR.
22. Corporate customer makes frequent large cash deposits and maintains high balances but does not avail itself of other services such as loans, letters of credit, payroll services, etc.
23. Customer almost never comes to the institution but has numerous couriers making deposits to the account.
24. A large increase in small denomination bills and a corresponding decrease in large denomination bills with no corresponding CTR filings.
25. Customers who open accounts providing minimal or fictitious information or information which is difficult or expensive for the institution to verify.
26. Customers who decline to provide information that normal customers would provide to make them eligible for credit or other banking services that normal customers would regard as valuable.
27. Customers who appear to have accounts with several institutions within the same locality, especially when there is a regular consolidation of balances in the accounts and transfer of funds out of the accounts by wire transfer, or other means, to offshore institutions or to large domestic institutions.
28. Customers whose deposits frequently contain counterfeit bills or bills which appear musty or extremely dirty.
29. Customers who have deposit accounts at the institution but frequently purchase cashier's checks, money orders, etc., with large amounts of cash.
30. Retail customer which deposits a large volume of checks but seldom, if ever, requests currency for its daily operations.
31. Retail business has dramatically different patterns of cash deposits than other similar businesses in the same general location.
32. Exempted customer frequently requests increases in exemption limits.
33. Substantial increase in cash deposits of any business without any apparent cause.
34. Substantial increase in cash deposits by professional customers using client accounts or in-house company accounts such as trust accounts, escrow accounts, etc.
35. Customers who make or receive large transfers of funds to or from countries associated with production, processing and marketing of narcotics.
36. Size and frequency of cash deposits increases rapidly without any corresponding increase in non-cash deposits.
37. Size and frequency of cash deposits is not consistent with observed activity at the customer's place of business.
38. Customer makes large and frequent cash deposits but checks or other debits against the account are not consistent with the customer's stated line of business. For example, customer claims to be in the retail jewelry business, but checks are mostly to individuals and/or firms not normally associated with the jewelry business.
39. Customer frequently deposits large amounts of currency that is wrapped in currency straps that have been stamped by other financial institutions.
40. Customer frequently deposits strapped currency or currency wrapped in rubber bands that is disorganized and does not balance when counted.
41. Customer is often observed entering the safety deposit box area just prior to making cash deposits just under \$10,000.

**Suggested Action**

Review results of the institution's independent testing for compliance with the Bank Secrecy Act. Perform Bank Secrecy Act examination procedures. Request verification of Currency Transaction Reports filed by the institution. Review all transactions involving offshore institutions to see if they appear to represent legitimate business activities.

## **SECURITIES TRADING ACTIVITIES**

### **Potential Problems**

Speculative securities trading activities may result in unsafe and unsound banking practices. Some bond salesman have made extensive use of the telephone to employ high pressure sales techniques, sometimes accompanied by oral guarantees which purport to limit an institution's exposure. Situations have been reported where an institution's board of directors and/or senior management have not monitored or controlled these practices and, in effect, have relinquished the management of their institution's investment portfolio to a broker.

### **Warning Signs**

1. Management lacks the expertise needed to fully understand the ramifications of proposals made by brokers and/or they perceive an unrealistic opportunity to enhance income.
2. Investments bear no reasonable relationship to the institution's size or its capital accounts.
3. Overreliance is placed on the purported safety of the securities since they involve U. S. Government issues.
4. Little or no attention is given to "interest rate risk" prior to the transaction taking place.
5. Delayed settlements over unreasonable time periods sometimes allow management to make imprudent purchases and avoid booking the transaction on a timely basis.
6. The institution engages in reverse repurchase agreements with brokers which allows institutions to erroneously defer recognition of losses.
7. Securities held for short-term trading are not appropriately identified and segregated from those that are held primarily as a source of investment income.

8. Trading account securities are not revalued periodically and are not reported consistently at market value or the lower of cost or market value.

### **Suggested Action**

Review the institution's investment policy to see if the board of directors has implemented prudent limits and comprehensive controls to suit their particular circumstances. Review the institution's files to determine if the institution has satisfied itself that it is dealing with a reputable and financially stable dealer. Ensure that management has sufficient expertise to analyze each transaction independently of the broker's sales pitch and recommendations.

## **MISCELLANEOUS**

### **Potential Problems**

Lack of proper supervision and lack of effective internal controls makes an institution especially vulnerable to fraud and insider abuse. Customer complaints, even seemingly insignificant ones, may be an indication of much greater problems.

### **Warning Signs**

1. Lack of supervision of lending activities by officers of the institution.
2. Lack of lending policies or failure to enforce existing policies.
3. Lack of code of conduct or failure to enforce existing code.
4. Dominant figure allowed to exert influence without restraint.
5. Lack of separation of duties.
6. Lack of accountability.
7. Lack of written policies and/or internal controls.
8. Circumvention of established policies and/or controls.
9. Lack of independent members of management and/or Board.
10. Entering into transactions where the institution lacks expertise.



11. Excessive growth through low quality loans.
12. Unwarranted concentrations.
13. Volatile sources of funding such as short term deposits from out of area brokers.
14. Too much emphasis on earnings at the expense of safety and soundness.
15. Compromising credit policies.
16. High rate - high risk investments.
17. Underwriting criteria allows high risk loans.
18. Lack of documentation or poor documentation.
19. Lack of adequate credit analysis.
20. Failure to properly obtain and evaluate credit data, collateral, etc.
21. Failure to properly analyze and verify financial statement data.
22. Too much emphasis on character and collateral and not enough emphasis on credit.
23. Lack of balance in loan portfolio.
24. Poor loan administration after credit is granted.
25. Unresolved exceptions or frequently recurring exceptions on exception reports.
26. Out-of-balance conditions.
27. Purpose of loan is not recorded.
28. Proceeds of loan are used for a purpose other than the purpose recorded.
29. Lax policies on payment of checks against uncollected funds.
30. The institution is defendant in a number of lawsuits alleging improper handling of transactions.

written loan policy. Determine the circumstances under which they were approved and who approved them. Each attempt to circumvent existing policies, controls and/or regulations should be investigated. Be alert to any overrides or attempted overrides of internal controls and determine who is responsible and the reason.

**Suggested Action**

Out-of-balance conditions should be given proper attention and not merely charged off if their amount is small. Be alert to rumors and gossip inside and outside the institution because in many cases, embezzlers and perpetrators of other frauds are betrayed by jealous peers or subordinates. Review any loans that do not appear to conform to the