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## Fraud Schemes in the Banking Institutions: Prevention Measures to Avoid Severe Financial Loss

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### Abstract

The main incentive for fraudsters is in yielding the monetary gain – of which making banking institutions more fraud-fragile as these are where the bulk of the money are kept. Banking institutions are becoming more and more susceptible to fraud over the years, although various control measures have been put in place. Fraudsters are now more versatile in designing their modus operandi to circumvent the controls. The fraudsters could originate from both internal (employees) and external sources (customers, supplier, contractor, and lawyer). As banking institutions engage in a wide range of activities, fraud could potentially affect many parties, including the shareholders, the depositors, the borrowers, the staff as well as the banking institution itself. A study was conducted among management levels in banking institutions in Malaysia, with a focus on branch managers and assistant managers that handle the mortgage loan and hire purchase loan, to examine the types and extent of fraud occurrences in the portfolio of mortgage loans and hire purchase loans. Results show that in general, the most common fraud cases in branches that handled mortgage was money laundering, whereas for branches that handle hire purchase loan which were a common fraud occurrence in the banking sector of Malaysia. This paper will also showcase various attempted frauds and fraud cases for both internal and external fraud scheme in the banking institutions. This paper is geared towards providing valuable learning points for staff of banking institutions who handle daily banking operations in order to assist them in detecting and preventing similar occurrence of fraud cases.

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## 1. Introduction

Fraud is a threat to an organization's status and its interactions with outside stakeholders, such as customers, suppliers, financiers, and business partners. Likewise, fraud can result in huge financial damages. According to KMPG (2011), the U.S financial institution has discovered fraud case involving a complex loan application which was affected by the senior manager to manipulate non-performing loans into performing loans. This has resulted in the weakening value of the collateral and the related property in a corroding economy. Association of Certified Fraud Examiners (ACFE) (2014) reported fraud incidences of which 36.6% happens in the banking and financial services, government and public administration, and manufacturing. The highest number of fraud cases is in the banking and financial services (17.8%), with a median loss of \$200,000 (ACFE, 2014).

The main incentive for fraudsters is in yielding the monetary gain – of which making banking institutions more fraud-fragile as these are where bulk of the money are kept. The U.S Federal Bureau of Investigation (FBI) classified banking institution fraud as tier one strategic priority in its investigation planning (U.S. Department of Justice Report, 2001). Bank Negara Malaysia (BNM, 2012), the regulator for banking institutions in Malaysia, has recently launched a Financial Fraud Alert site on its website to provide the public with information on financial fraud including enforcement actions, relevant legislation, tips to avoid becoming a victim and contact points of the relevant regulators and enforcement agencies as part of their public awareness. This is part and parcel of their public outreach program to safeguard the public interest and furnish the latest information such as known offenders, enforcement actions even common tricks employ by fraudster on their typical get-rich-quick scheme as an example.

As reported in ACFE (2014), banking institutions are becoming more and more susceptible to fraud over the years although various control measures have been put in place. Fraudsters are now more versatile in designing their modus operandi to circumvent the controls. The key contributor to the fraud activity include poor internal control (KMPG 2009) and poor corporate governance practices (Beasley 1996; ACFE 2014). The fraudsters could originate from both internal (employees) and external sources (customers, third parties dealing with the banks such as property valuers, and lawyers). As banking institutions engage in wide range of activities, fraud could potentially affect many parties, including the shareholders, the depositors, the borrowers, the staff as well as the banking institution itself.

## 2. Critical Issues of Fraud in Banking Institutions

Fraud is a significant concern commendable of debate, particularly in current economy. Based on International Standard on Auditing 240 (2001), fraud involves the use of deception to obtain an illegal gain at the expense of unsuspecting victims. It is an intentionally act by an individual or a group of people among the management, staff or third parties. Academic research pertaining to fraud detection and prevention has emphasized in the audit procedures and addressing 'red flags'. As explained by Gullkvist & Jokipii (2013), red flags are warning sign or symptom which indicates the likelihood of fraud occurrences to experts in financial criminology.

It is perhaps interesting to understand why fraud is committed. Fraud is committed due to the following reasons: (i) perceived pressure, (ii) perceived opportunity and (iii) rationalization. These three elements or basic concepts were adopted from the "Fraud Triangle Theory" founded by a renowned criminologist, Donald R. Cressey (Omar et al., 2010). Fraud commonly happens due to financial stress and difficulty which give rise to pressure or motive for one to commit fraud regardless of risk involved. The second reason for one to commit fraud is the opportunity to do so. Opportunities will present itself as an employee climb the corporate hierarchy simultaneously being entrusted to wider responsibility while at the same time a weak internal control will provide opportunities for the perpetrators to defraud their respective organization. The third condition in fraud triangle is rationalization. Rationalization refers to rationalize this behavior by determining that committing fraud is acceptable for varieties of reasons.

KPMG (2013) also reports that 85% of the respondents opined that fraud is increasingly becoming industry aligned where some industries are more prone to fraud risk than the others. Banking industry, endorsed with the fact that this industry is a predominantly risk-taking industry in general, is one of the industries that is categorised as posing high fraud risk (Kingsley, 2012). Fraud universe in banking institutions are very expansive. It could cover from employee fraud to customer fraud; from institutional fraud to individual fraud; and from accounting fraud to transactional fraud. Two types exist for banking related fraud; namely External and Internal fraud. External fraud transpired when perpetrator using credit and debit cards to defraud the banking institution or outright theft in some cases the Automated Teller Machine (ATM) itself. Internal fraud takes place due to an inside job of an employee

stealing cash or cash equivalents. For example, Accounts fraud - Employee with specific position may have privileged access to suspense accounts or accounts payable, which is temporarily disguised or utilized as interdepartmental transfers, cash in transit or loans in process. Internal fraud is also known as occupational fraud and insider abuse. If the types of fraud are considered, it ranges from identity theft, cheque fraud, counterfeit negotiable instruments, mortgage fraud, loan fraud, asset misappropriation, corruption, money laundering, credit card fraud and the list continues.

### 3. Fraud Discovered in Banking Institutions

This section reports the findings of a questionnaire survey conducted to examine the types of fraud on mortgage and hire purchase loans among banking institutions in Malaysia. The amount of losses resulted from each type of fraud is also examined. The survey focused primarily on mortgage and hire purchase loans as they are the major business operating activities of banking institutions in Malaysia. A total of 110 branches of banking institutions responded to the survey.

Table 1. Summaries of Fraud Cases According to Loan Categories

Type of Fraud	Mortgage			Hire Purchase		
	No of Case	Amount (RM'000)	Percentage	No of Case	Amount (RM'000)	Percentage
Asset Misappropriation	14	7200	13%	37	2100	8%
Loan (credit) fraud	41	15700	29%	138	18065	69%
Credit card fraud	8	70	0%	21	1800	7%
Theft (cash)	4	465	1%	2	43	0%
Financial Statement Fraud	50	5000	9%	57	1080	4%
Money Laundering	13	25000	46%	25	1600	6%
Internet Fraud	34	1264	2%	20	1500	6%

The results of the survey on mortgage loans are provided in Table 1. The findings show that the major type of fraud on hire purchase loans on is loan (credit) fraud (69%), followed by asset misappropriation (8%), credit card fraud (7%), money laundering and internet fraud (6%), and banking statement fraud (4%).

Table 1 also highlights the types of fraud on hire purchase loans. The results show that money laundering activities (46%) is the most common type of fraud on mortgage loans among commercial banks in Malaysia. It is followed by loan (credit) fraud (29%), asset misappropriation (13%), banking statement fraud (9%), internet fraud (2%) and theft (cash) (1%).

Table 1 also presents the monetary losses on each type of fraud. Based on the survey, banking institutions in Malaysia have lost RM25 million as a result of money laundering activities on mortgage loans. It is followed by RM15.7 million on loan (credit) fraud and RM7.2 million on asset misappropriation. This indicates that lauders chose mortgage money laundering activities to clean up their money. Certain action may be needed to overcome this issue towards minimizing money laundering in the banking institutions.

In the case of hire purchase loans, banking institutions suffered a loss of RM18.1 million on loan (credit) fraud, RM2.1 million on asset misappropriation and RM1.8 million on credit card fraud. This suggests that loan credit fraud had causes a big loss to the banking industry.

This paper highlights the common fraud exposures in the banking institutions. Meanwhile, there are other types of fraud such as bribery, theft, misappropriation of assets, payroll fraud and so on. This paper demonstrates various types of fraud occurred in the banking institutions. Results of the survey found out that, money laundering, loan fraud and misappropriation of assets tops the list of the most common category of fraud.

## 4. Attempted Frauds and Fraud Cases

### 4.1 Fraud Involving Remittances

#### **Losses Incurred In Accepting / Collecting Of US Treasury Cheques**

##### **a) Background**

One of the branches had accepted two US Treasury Cheques and the proceeds were credited to two External Saving Accounts. Both the external account holders had withdrawn most of the proceeds via ATM (daily maximum withdrawal of RM2,000). The said US Treasury Cheques were confirmed to have been altered.

##### **b) Particulars Of The External Saving Account**

The particulars of the two External Saving Accounts were as follows:

Name	Jassie Y Gadong	James R Connie
Passport Number	GXXXX48 ( Philippine )	KXXXX29 ( Philippine )
US Treasury Cheque Collected	USD47,282.50	USD46,589.50
Original Cheque Amount	USD282.50	USD89.50

*Please take note that there was no confirmation whether the payees' names on the US Treasury cheques had been altered.*

#### **Preventive measures**

Branches are reminded to exercise caution and be vigilant when a check/ checks of the substantial amount (RM10, 000 and above) is :

- Deposited immediately / shortly after the account is opened;
- Deposited into a habitually small account;
- Deposited into an account where the relationship of the account holder and drawer appears abnormal.

### 4.2 Fraud Involving Exchange of Notes

We have been advised that Southern Lion Bank Bhd has informed that there was a fraud committed in their Bandar Putra branch involving exchange of notes.

#### **Modus Operandi**

A walk in Japanese man came to the bank's counter purportedly wanting to exchange cash of RM2,900 into denomination of RM50. After receiving the money, he tried to confuse the teller by insisting that he wanted USD50 denomination instead of RM50.

When the teller explained that the branch did not deal in US currency, the customer threw back the money (which was short) to the teller. The teller then returned him the original cash of RM2,900. The fraudster interrupted the teller when the teller was counting the returned cash by requesting to change RM100 into RM2 denomination and another RM100 into RM5 denomination.

Thereafter, he quickly left the bank. When the teller eventually counted the money, it was short of RM1,450.00

#### **Preventive measures**

Any cash received from customer(s) must be counted in the presence of the customer and not after the customer had left the bank.

### 4.3 Fraud Involving ATM

Bersatu Jaya Branch had reported a second incident of fraudulent withdrawal through the Automated Teller Machine with the same modus operandi.

Details of the incident as reported by Bersatu Jaya Branch :

Our customer has reported to branch that her ATM Card has been stuck in the ATM at Bersatu Jaya Branch and that a man claiming to be a bank staff has assisted her to cancel the card by calling the ATM centre via his hand phone.

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Sensing of the unusual practice we requested for her passbook to be updated just to discover RM4,000.00 has been withdrawn on 4 occasions through MEPS.

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### **Preventive measures**

Branches are to ensure that the notice to create awareness among the public on scams are prominently / strategically displayed for public viewing.

#### *4.4 Fraudulent Alterations of Cheques*

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##### **Modus Operandi of the Scam**

Cheques issued by our customers were either intercepted or stolen. The payee's name was then removed either by:

- i. Scrapping off the surface of the cheques, or
- ii. Soaking these cheques into a chemical solutions to dissolve the ink except the area which contain the signature of the drawer(s). New details were then written on the face of the cheques. The altered cheques were then deposited into the account of the fraudster for clearing via SPICK. In most cases, the fraudster will deposit the cheque via online branches or through CQM.

##### **Findings**

It is suspected that the perpetrators have insight knowledge of the SPICK clearing procedure and had taken advantage / capitalise on the process to penetrate the clearing system.

The perpetrators (intenal staff), knowing the process, will normally deposit these cheques via banker's clearing, i.e if the cheque was drawn on bank branches, they will deposit it through other banks or vice versa. They will not bank-in a house cheque to avoid instant detection by branch officer whilst verifying these cheques.

The bank will only be aware of such fraud when the drawer came to enquire why the payee has not received payment. By then, the fraudster had already withdrawn the funds and absconded.

##### **Salient Features of the Scam**

The face of the fraudulently altered cheques will normally have 2 features:

###### **i. Untampered portion**

The portion where the drawer signs on the cheque will look original / normal

###### **ii. Tampered portion**

Except on untampered portion as stated in item (i), the part where the payee's name was scrapped off and re-written appears to be a little bit bold with scrappy background next to it. As for cheques soaked into chemical solution, this whole portion is blurrish and looks a little decomposed.

The colouring of both portions of the cheque differs. This can only be noticeable with one's naked eyes. (That is the reason why most of this altered cheques passed through Cheque Processing Department undetected).

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### **Preventive measures**

Branches are thereby instructed to do the following:

- i) To brief your staff especially the frontliner, the clearing clerks and officers of these fraudulent incidents.
- ii) To take note of the salient features of the fraudulently altered cheques.
- iii) Be cautious and take extra precaution of banker's and branch's clearing deposits which is to go through BNM's SPICK especially via on-line. This also include cheques deposit through CQM.
- iv) To call the paying bank for confirmation upon detection and suspicion of such altered cheques. Alert them to take note of such cheques and put some form of marks in pencil for identification first before sending the cheques for clearing.
- v) To take other preventive measures once confirmed of fraudulent act by the "customer" such as tagging of the account or informing home branch to tag the account (in cases of on-line deposit) and make police report of the incident.
- vi) Report the incident to your respective management office.

#### 4.5 Fraud Involving Housing Loan

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##### **Background**

Reference is made to the memo to alert bank branches on the increasing housing loan fraud involving forged valuation reports. The seriousness of the matter was further emphasized by Bank Negara Malaysia advising all banking institutions to be extra vigilant against fraud perpetration.

##### **Highlights by Bank Negara Malaysia**

Bank Negara Malaysia's circular highlighted the following housing loan frauds:

- Borrowers giving false information and submitting forged documents e.g. salary slips and bank statements.
  - Borrowers overstating the prices of properties (usually condominiums and apartments located in another state).
  - The frauds were believed to be perpetrated with the assistance of employees of banking institutions who were recruited as direct sales agents.
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##### **Preventive measures**

Branches are reminded to minimize such frauds by adhering strictly to the Bank's housing loan processing guidelines and to adopt preventive measures. Among the measures that can be adopted are;

- i) Comprehensive verification of documents submitted
  - Example: cross-check information provided in salary slips against employee's fund contributions; verify with employer on status of employment, position; verification with other relevant authorities such as Inland Revenue Board on Income Tax file number or National Registration Department if suspicion is aroused.
- ii) Check credit-worthiness of the applicant
  - Bank officer should make full use of the CCRIS Report and other available reports / information to ascertain the character and capability of the applicant to repay the loan.
- iii) Professional valuers to be engaged by branch:-
  - Engage reliable valuers from the bank's panel of valuers to perform property valuation.
  - Branch managers and assistant branch managers may perform verbal checks with two or three other panel valuers and refer to the latest property market reports to ascertain the estimated value of the property to be financed or refinanced (sub-sale / secondary property market) pending receipt of the valuation report. Information from these valuers and the property market report can be used as a gauge when reading through the valuation report submitted by the appointed valuer.
  - Check basic details presented in the valuation report against documents received earlier e.g. location of property, type of property, details of the titles etc. Any variation found must be adequately addressed.
  - Go through the valuation report submitted by the appointed valuer for signs of irregularity or tampering.
  - Bank officers should call the appointed valuer to confirm the authenticity of the report and verify various pertinent details such as the amounts quoted. Such confirmation (name, date and time) should be noted on the valuation report for future reference.

#### **5. Outlook**

As the fraud universe in banking institutions is very susceptible and expansive, the banking activities require full compliance of the standards and best practices in risk management and internal controls. Full compliance to Bank Negara Malaysia's requirements in terms of fraud risk management is vital in ensuring fraud risk in the banking institutions is minimized. It calls for strategized efforts from all levels of staff, which include those of frontliners and senior management levels. Fraud occurs due to loopholes in the controls of banking activities, hence, concerted efforts to address the weaknesses in the internal control systems should be enhanced to include advancement of information technology applications, for instance by utilizing automated risk screening system. Fraudsters are becoming more and more sophisticated in their modus operandi and banking institutions need to be few steps ahead

of them in combating the fraud occurrences.

Due to the inherent nature of banking operations, it is impossible to achieve zero fraud risk in the banking institutions. Fraudsters will always find their ways and there is no guarantee that fraud can be eradicated even with the most advanced information technology applications. The fundamental functions of banking institutions staff should be better emphasized to make their roles more visible and indispensable in combating fraud. Banking institutions staff should take heed of the lessons learned from previous fraud occurrences and execute the preventive measures in their daily course of work. Senior management should be the advocators that push the importance of the staff to properly assess fraud risk before the risk is absorbed into the banking institutions. Every fraud is unique in itself, but the fraudsters can never be too smart to perpetually conduct the same *modus operandi* in committing their offences.

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