

Preventing Embezzlement Five Internal Controls Even the Smallest Bank Should Have

Over the past 18 years, employee dishonesty has represented more than half of the Financial Institution Bond claims paid by our program. Lending-related fraud accounted for the greatest source of loss, followed closely by embezzlement through account manipulation.

We often hear the following types of statements from our bankers:

“Our staff is too small to allow segregation of duties and dual controls throughout the institution.”

“Only the president has access to unilaterally complete a transaction.”

“The woman who controls that function has been with us for 35 years - she would never do anything wrong.”

In fact, our experience indicates that:

- › Severity of loss due to employee dishonesty is significantly higher in smaller institutions than in larger ones.
- › Almost half of lending-related losses arise from senior management. In most cases, the banks experiencing these losses are community banks with less than \$100MM in assets
- › Our customers are usually shocked to learn that the perpetrator is typically a long-term employee. Most of these individuals have experienced a personal crisis and intend to just “borrow” the funds until the crisis has passed.

To minimize your bank’s exposure to employee dishonesty, we suggest implementing the controls identified below. The most well-managed banks, whether they have \$10 million or \$10 billion in assets, maintain these controls to deter even well intentioned employees from “borrowing” funds. In each of the actual claims described, the loss could have been prevented had the bank instituted appropriate internal controls.

1 A formal program should exist requiring segregation of duties so that no single transaction can be fully controlled from origination to posting by one person

- » *An employee in a bank’s central services department was responsible for reconciling correspondent bank accounts. By debiting the bank’s Fed account and crediting an account established in her son’s name on which she was a signatory, the employee embezzled \$220,000 over an eighteen-month period.*
- » *The operations manager of a \$56 million bank, who had been with the bank for eighteen years, had complete control over the suspense accounts, including reviewing the unposted report daily and clearing out the items in the accounts. By preventing the posting of debits for checks drawn on her family members’ checking accounts, she manipulated entries through a series of suspense accounts, ultimately debiting correspondent bank accounts and embezzling over \$3,000,000.*
- » *A well-tenured administrative assistant of a bank loan officer embezzled bank funds by issuing bank checks made payable to various commercial customers with lines of credit. She endorsed the checks “For Deposit Only” and deposited them into her father’s business checking account through her own teller window. Then she transferred the funds into her own account. Over a three-year period, she embezzled over \$200,000.*
- » *A bookkeeper had the ability to work with numerous accounts and maintain complete control over one general ledger account. To embezzle funds, she would credit her account and place the offsetting debit in a customer account. She would later “reverse debit” the customer account, removing the debit and any evidence of the bogus transaction. With each transaction, the out-of-balance amount on her account accumulated accordingly. As no one checked or asked her about the growing carry-over amount, she was able to proceed undetected for a substantial length of time. She ultimately embezzled \$250,000.*

2 No employee should fund a loan they initiated and approved.

- » A \$28 million bank incurred a loss of over \$200,000 when a long-term and well-respected loan officer began generating fictitious loans on the accounts of real customers to pay for her medical expenses. In addition to the embezzled funds, the bank settled a lawsuit for \$290,000 stemming from customers whose credit ratings were impaired by the fraudulent dealings.
- » A loan officer in a \$22 million bank was responsible for collecting past due loans. To make himself look good to senior management, he initiated fictitious loans and applied the funds to the past due loans to make them appear current. He also misappropriated a portion of the funds for his own use. When the fraud was detected, the funds he stole—as well as legitimate payments subsequently received from customers on the past due loans—could not be traced and the bank incurred a loss of \$295,000.
- » An executive vice president of a \$52 million rural bank, who had complete funding authority, built a pyramid of unapproved and fraudulent auto dealership loans to uncreditworthy customers in return for kickbacks. He leveraged his scam further by misappropriating payments, causing a \$2,300,000 write-off to the bank for bad loans..

3 All currency shipments should be prepared, received, and counted under dual control.

- » A cash shipment was received by the head teller of a community bank. With no dual controls in place, the teller alone counted the funds and signed a form indicating receipt of three sealed bags of cash and that all the funds were present. At the end of the day, the teller drawer was \$50,000 short. The teller claimed that she must have miscounted. In contrast to the tight internal controls used by the courier, investigators quickly identified that without dual controls, the bank's internal controls were lacking, resulting in the bank being liable for the shortage.

4 The main and reserve cash vaults should be maintained under dual control, and the opening, closing and setting of the main and reserve cash vaults logged.

- » Due to what a branch manager at a \$50 million bank called "short staffing," she usually left the vault unlocked. When it was locked, the key was stored in an unlocked drawer. The head teller, who was responsible for auditing the vault cash each evening, also had complete access to the branch after hours and maintained control over two of the eight interior drawers of the vault. In a surprise audit, the vault cash was found to be \$152,000 short.

5 Signatures on all notes and documents should always be obtained in the presence of an officer.

- » The president of a small community bank denied a business loan to a customer due to insufficient collateral. The loan was later granted when the customer said that his brother had agreed to pledge his home as collateral. As the president knew both the customer and his family very well for many years, he allowed the customer to take the paperwork out of the bank to be signed by the family members. When the customer defaulted on the loan, it was found that his brother had never agreed to pledge collateral and that the signature on the loan documents was a forgery.
- » A community bank sustained a loss in the principal amount of \$165,000 in connection with a loan made to a couple who were long-term customers. The customers claimed that they never applied for the loan, and that their signatures on the loan documents were forgeries. The bank knew that the husband's forgery claim was not legitimate as they witnessed him sign the loan documents at issue; however, as he was permitted to take the loan documents home to obtain his wife's signature, they could not prove the validity of her signature.



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