CUNA MUTUAL GROUP

Managing Lending Risks

Through Internal Controls

Sound Controls Help Minimize Internal Loan Fraud

Internal controls are an integral part of all credit union operations – especially lending. And with loans, sound controls are critical in minimizing internal loan fraud.

Unfortunately, dishonest employees cost credit unions millions of dollars each year and consistently top the list of credit union bond losses. In fact, 47% of Bond Claim dollars over the last five years (source: 2015-2019 CUNA Mutual Group internal claims data) have been connected to Employee or Directory Dishonesty and Faithful Performance.

Employees who are part of the loan processing cycle—including those with access to loan approval, disbursement, file maintenance, or nonfinancial transaction authority—know the credit union's policies and procedures and their weak points.

The loan portfolio is one of the favorite hunting grounds for the credit union embezzler and these losses can go on for years before discovery – some losses easily reaching six figures.

Primary Weaknesses

35% lack of internal controls

19% lack of management review

14% override of existing controls

Source: 2020 Report to the Nation on Occupational Fraud and Abuse, Association of Certified Fraud Examiner, Inc.

Understanding the factors that can lead to fraud is the foundation of preventing future occurrences. According to the Association of Certified Fraud Examiners, in 35% of cases, a simple lack of controls was the main factor that enabled the fraud to occur, while another 19% of cases occurred because of the lack of management review.

Knowing what to look for in employees' behaviors and actions is a good proactive defense

Understanding and recognizing the behavioral red flags displayed by fraud perpetrators can help organizations detect fraud and mitigate losses. Generally, employees who have a need, an opportunity, and who can rationalize their actions are the ones who are most likely to commit internal fraud. Review Employee Red Flags Risk Overview for more detail and check points.

Managing Loan Fraud Through Internal Controls

A system of basic internal controls can help ensure compliance with policies and procedures. Internal controls will also help maintain the integrity of loan and collection policies and procedures, deter any employee considering noncompliance, and detect — at an early stage — when an employee is involved in a violation of policies or procedures.

Fictious Loans

In one embezzlement scheme, the VP of Lending created **three fictitious loans totaling $250,000**.

- Opened fraudulent accounts on the system
- Disbursed the loan proceeds
- Advanced the payment due dates to prevent the loans from appearing on the delinquency report

To help mitigate employee loan embezzlement, your credit union should randomly select a sample and review loans approved by each loan officer and credit committee. The selection process should include cash payment loans, not loans on payroll deduction. To do this, make sure all necessary documents are completed and contact the borrower by telephone to confirm he/she is a real person, and the loan proceeds were received.

Also, review the member account trial balance by checking loans indicators to determine their validity:

- Original loan amount and current loan amount are the same, but the loan is not listed on the delinquency report
- Paid ahead due date of more than three months
- High amount of interest due, but the loan is current

Employee and Family Member Loans

Employee and family member loans are an easy way for a dishonest employee to obtain funds by providing preferential treatment and/or circumventing loan policy. Analyze all employee and family member accounts through an account review confirming:

- Employees are not performing transactions on their own or family member accounts
- Interest rates are correct
- Loan payments are made in the proper amount and at the required frequency
- Collateral requirements are met, and the proper documentation is available
- Loan approval does not exceed loan policy

Delinquent / Charged off Loans

Delinquent / charged off loans should be verified to assure proper collection procedures are followed. Look at the loan files for indicators of fictious loans by asking these questions:

- Has existing collateral been repossessed and sold?
- If a co-maker is involved, has he/she been contacted to begin payments?
- Are delinquent / charged off loans reported to the board of directors and recorded in the board minutes?
- Is all collection activity documented?
- Are progressive collection efforts being followed?

Co-Maker Forgery

Co-maker forgery is another potential source of lending loss for credit unions. Authorized personnel should witness co-maker signatures, and if the co-maker is unable to come to the office to sign the loan documents then a notary public should witness the signature.

Loan Policy Violation

Another credit union scenario involved the Chief Lending Officer violating the loosely-enforced lending policy and procedures by opening new accounts and granting loans to non-members. No action was taken by Board of Directors / Supervisory Committee to ensure policies were followed. In this loan policy violation loss example, **50 loans totaling $750,000** were identified in losses.

File Maintenance Reports

Fictitious or unauthorized loans are often hidden through the use of file maintenance. The file maintenance report shows any data changes made in the computer system – which can be used to manipulate loan accounts.

Review File Maintenance Reports for these types of transactions:

- Advanced payment due dates
- Change in interest rates on any account
- Change in payment amount
- Multiple address changes to the same address
- Change in payment frequency
- Change in the collateral code

Indirect Lending Internal Fraud

Internal fraud can also occur with indirect lending programs – for example, if a loan officer approves an abnormal amount of loans from a dealer(s) in comparison to other loan officers. This often is the case if the approved loans are on lower class paper, as they have a greater chance of becoming delinquent. The loan officer could be receiving some type of benefit from these dealers. To help mitigate this risk, be sure to review the monthly reports indicating loans by dealer(s) and by paper to see if there are any discrepancies.

Tips for Thorough Loan Reviews

- Contact members to confirm loans
- Prohibit employees from performing transactions on their own or family member accounts or anyone with who they share an address
- No one should receive preferential treatment
- Verify delinquent/charged off loans for policy compliance
- Credit union personnel or a notary public should witness co-maker signatures
- Review file maintenance reports on a regular basis to ensure loan manipulation is not occurring

Separation of Duties

As with all areas of the credit union, there should be a segregation of duties with at least two employees in the lending process. An individual should not have the ability to receive a loan application, underwrite the loan, approve the loan, and disburse the funds. Also, collection personnel should not have the ability to post payments. If they receive a payment, they should have to bring it to a teller to have the transaction posted. By having a segregation of duties process in place, your credit union will minimize the potential for fictious or unauthorized loans.

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