

THE PROBLEMS OF FRAUD AND CORRUPTION IN FINANCIAL INSTITUTIONS

TEH YIK KOON
School of Social Development
Universiti Utara Malaysia

ABSTRACT

This paper is a product of case studies on fraud and corruption in financial institutions in Malaysia. It involves piecing together the complicated cases in order to show how fraud can be committed in financial institutions. The examples of fraud that will be given illustrate the different ways money can go missing. However, due to banking secrecy, no names of the financial institutions will be revealed. In the first section, this paper will give examples of fraud that have taken place in order to illustrate the different ways it can be perpetrated and how the money can go missing. From the examples given, the structure of the organisation that is problematic and conducive to fraud and corruption will be discussed, and this will be the focus of the second section. This will shed some light on the possible preventive methods that can be adopted by the organisation. Lastly, some suggestions will be given on what can be done to help lessen fraud and corruption in financial institutions.

ABSTRAK

Artikel ini membincangkan kes-kes penipuan dan korupsi dalam institusi kewangan di Malaysia. Contoh-contoh bagaimana penipuan boleh berlaku akan diberikan. Melalui kajian terhadap cara penipuan boleh berlaku, struktur organisasi yang bermasalah dan boleh mendorong penipuan dapat dikenal pasti. Artikel ini juga akan membincangkan cara-cara mencegah penipuan dan korupsi dalam institusi kewangan di Malaysia.

INTRODUCTION

Fraud and corruption in financial institutions fall under the purview of the Commercial Crime Division of the Criminal Investigation Department of the Police Force. Lay reporting contributes to a large extent the data concerning

fraud in financial institutions, while most financial institutions themselves would rather not report any fraud case. This is because they fear losing public trust in them, which would greatly affect their business. Thus Board members would rather settle the matter internally. This directly affects the annual data on fraud in financial institutions in Malaysia. Even though the data rely heavily on reporting and do not reflect the actual problem, they, however, give a glimpse of the trend of fraud in financial institutions for the relevant years.

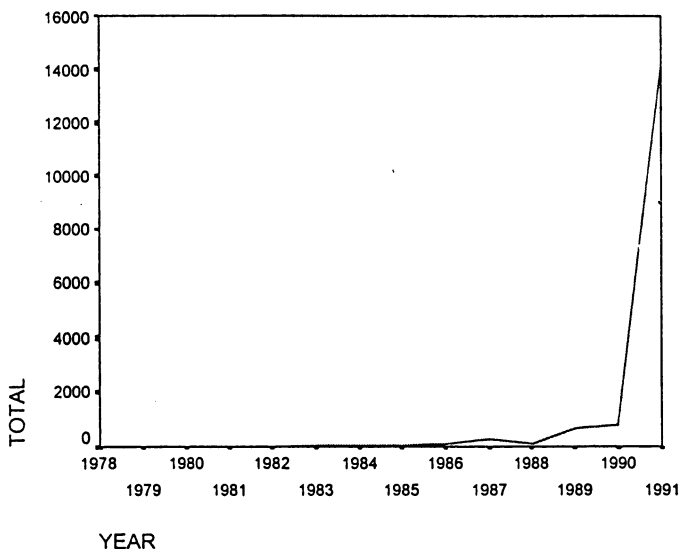
There was a steady increase in the number of reported fraud cases involving financial institutions from 1978 to 1991 (see Table 1 and Figure 1).

Table 1
 No. of reported fraud cases involving financial institutions,
 1978 – 1991.

No. of Case					Amount lost in millions(RM)			
Year	Commercial Bank	Finance Company	Merchant Bank	Total	Commercial Bank	Finance Company	Merchant Bank	Total
1978	1	0	0	1	0.96	0.00	0.00	0.95
1979	0	0	0	0	0.00	0.00	0.00	0.00
1980	4	0	0	4	0.20	0.00	0.00	0.20
1981	19	0	0	19	2.50	0.00	0.00	2.50
1982	27	0	0	27	2.80	0.00	0.00	2.80
1983	35	1	0	36	4.80	4.88	0.00	9.68
1984	36	11	1	48	1.70	0.99	2.30	4.99
1985	51	28	0	79	6.60	4.38	0.00	10.98
1986	87	4	1	92	6.60	1.80	3.30	11.70
1987	245	10	1	256	21.92	2.92	0.00	24.84
1988	120	17	1	138	23.67	0.50	0.13	24.30
1989	624	51	1	676	10.98	7.13	0.05	18.16
1990	769	9	0	778	22.42	0.14	0.00	22.56
1991	14,181	18	0	14,199	610.70	4.09	0.00	614.79
Total	16,199	149	5	16,353	715.85	26.83	5.78	748.46

Source: Bank Negara Malaysia (Central Bank of Malaysia)

Figure 1
Rise in reported fraud cases involving financial institutions,
1978 to 1991

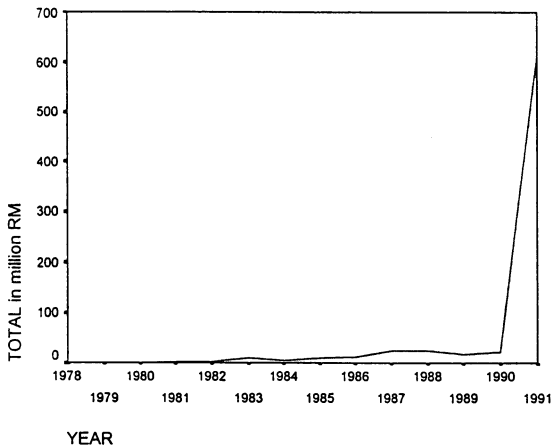


In 1978, there was only one reported case. However, by 1991, there were 14,199 reported cases. The increase between 1978 and 1986 had been rather steady, from 1 to 92 cases. In 1987, there was a sudden increase to 256 cases. The following year the number of cases dropped to 138. It increased drastically again in 1989 to 676 cases. There was also a drastic increase from 1990 to 1991, from 778 cases to 14,199 cases. Within a year the number of cases had increased by about eighteen times. This sudden increase by 1,825 percent made the validity of the data questionable. The drastic increase was also followed by a drastic increase in the amount lost through fraud cases as shown in Figure 2. Although the amount had been increasing steadily throughout the years from 1978 to 1989, from RM0.96 million to RM18.16 million, there was a sudden increase from RM22.56 million to RM614.79 million between 1990 and 1991.

Of all the fraud cases involving financial institutions, commercial banks made up the largest group of victims. Out of a total of 16,353 cases reported between 1978 to 1991, 16,199 cases involved commercial banks which made up about 99.06 percent of the total number of reported cases (see Table 1). The next largest group of victims was the finance company which made up only 0.91 percent of the total reported cases while the merchant banks comprised only 0.03 percent of the total reported fraud cases. It is not surprising that the commercial banks lost the most money through fraud cases, as shown in Table 1. However, in 1983, the amount lost by 35 commercial banks was equivalent to the loss by one finance company. The amounts were RM4.8 million and RM4.88 million respectively. In 1984 and 1986, the loss incurred by two merchant banks was

greater than the loss by 15 finance companies; RM5.6 million and RM2.79 million respectively. The total amount lost by all financial institutions from 1978 to 1991 was RM748.46 million. It could be seen that fraud cases in financial institutions were increasing rapidly even though Bank Negara, the central bank of Malaysia, had issued a formal code of ethics in October 1988.

Figure 2
Amount lost by financial institutions in reported fraud cases from 1978 to 1991



FRAUD IN FINANCIAL INSTITUTIONS

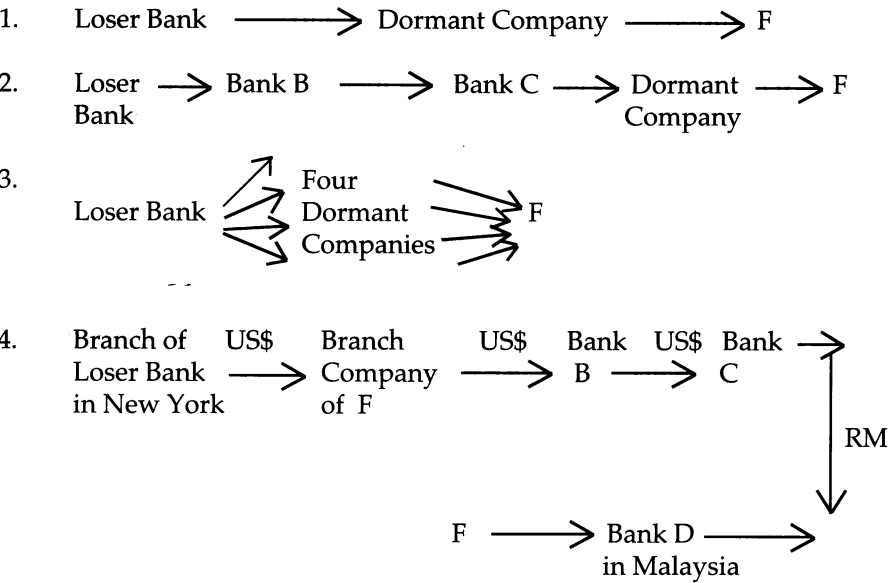
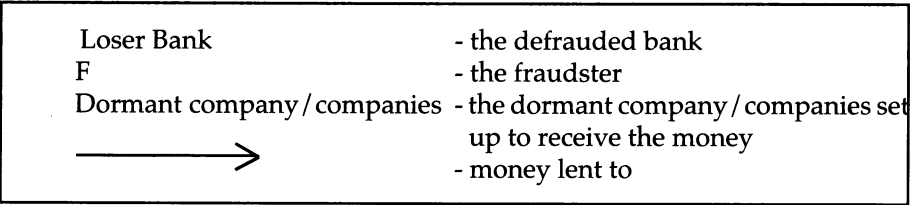
There are two types of fraud in financial institutions, internal fraud or internal ‘stealing’, and external fraud where outsiders are involved with or without the collaboration of members of staff of the financial institutions.

Financial fraud will occur as long as there is the opportunity to commit them. Opportunities present themselves when the chances of detection are remote, the control or supervision system is inadequate and where moral stigma is absent. The opportunities are also greater higher up the social and economic order where the chances of detection are less. There is thus, a need to identify the weaknesses in the structure of the institutions and society which create the opportunities and temptations for fraud to occur. As Goldstock (1989:71) reported :

"Corruption, like disease, is not monolithic. There is no one cure. We need to look at individual maladies, or individual types of corruption. Indeed, in each case, there should be a three part process in searching for means of control. First, the identification and description of symptoms. Second, the analysis of the mechanisms through which the integrity of the system is compromised. Finally, based upon that analysis, the development and implementation of a program of treatment using appropriate remedies. Ultimately, the treatment program may require a combination of preventive, structural and/or institutional measures."

Financial institutions seem particularly prone to fraud. The obvious reason is that the institutions deal directly with a highly irresistible and liquid commodity, i.e. money. Moreover, their transactions involving financial assets and liabilities are just a matter of book entries or storing information in a computer, rather than involving the exchange of physical assets. It is not difficult to put in a wrong entry with the stroke of a pen or a touch of a computer key. Transactions become complicated when they are of an international nature involving foreign currencies. In these international transactions, there are again no actual physical movements of funds as they are recorded like the local transactions. International transactions can take place 24 hours a day and seven days a week. These factors make things more complicated and thus increase the difficulty of controlling fraud.

In major fraud cases, the fraudsters would usually set up dormant companies to receive loans from a bank. The loans may also be transferred from one bank to another bank or company to hide the identity of the borrower. The diagrams below are examples of some of the major fraud cases that have taken place.



One of the major problems that allowed external fraud to take place was the way the loans were given out by the management. It was found that the loans were given out not in accordance with existing prudent practices. The manner in which they were released broke the rules set out in the financial institution's manual. For example, the identity and creditworthiness of the clients were not investigated thoroughly before the loans were approved by the Board of Directors, especially when the loans were unusually large. There were also instances where the loans were approved before the applications were received from the clients or were given out before approval. At times, loans were given out when interest payments on existing loans were not repaid at the deadline. These weaknesses were exploited by other employees. Sometimes approval was given to loans which were beyond the level of the officers' authorities. It could be seen from these problems that most major external fraud took place due to: a) carelessness and inefficiency of staff members; or b) staff members themselves, especially those in the management group, were involved in the fraud. Besides these problems, there was also inadequate evaluation of the feasibility of the projects proposed by the clients. The collateral negotiated for the loans was also not assessed and secured properly. In some loans, the collateral was just a guarantee from the clients instead of from a third party, post-dated cheques which were given by the clients which could be reissued when expired, or quoted and unquoted shares which would be valueless if the company went into liquidation. When the loans were released, they were not properly recorded or documented, for example, the identity of the borrower, the purpose of the loans and the type of loans approved. The records of the clients and those of the bank could also differ with regards to the loans.

There were cases where the dealings or investments done on behalf of the financial institution by the management, such as buying land at inflated prices, were for the benefit of the institution's customers (who was usually somebody they knew) or themselves and their family members, and a loss to the institution. In these cases, rules and guidelines seemed to be dispensed with. When the case was found out, there was confusion as to who was to be blamed as the records of the loans were not done properly.

These problems faced by financial institutions were summed up clearly by Ishak Tadin, and Lee Kong Lam.

Tadin (1990 : 1-2) reported that the failures of some of the Malaysian public companies and agencies had been due to:

1. Lapses in their management;
2. Lapses in their systems of control in general;
3. Blatant disregard of moral and corporate ethics.

Tadin defined corporate ethics as the professional standards of conduct of the people in an organisation, which ranged from personal behaviour and morality to managerial accountability in the stewardship of funds entrusted to an authorised person.

Lee (1992 : 7) reported that fraud was mainly caused by the following:

- a. Non-compliance of internal procedures by officers and staff;
- b. Negligence of officers authorising transactions;
- c. Lack of dual control or non-segregation of duties;
- d. Lack of supervision by supervisory staff;
- e. Staff and officers were not subjected to job rotation or required to take leave;
- f. Laxity of control over security documents and important records;
- g. Laxity of control over dormant accounts;
- h. Inadequate audit coverage or absence of internal audit functions on sensitive areas of operations;
- i. Registers were not kept or poorly maintained;
- j. Infrequent reconciliation or non-reconciliation of bank accounts;
- k. Surprise checks were not conducted on cash holdings and other valuables.

Huntington (1992) observed that the branches and subsidiaries of major organisations which had a strong central control had a low risk of fraud while autonomous operations remote from a weak central authority had a high risk. The risk increased with the complexity of an organisation and with the geographical spread of its subsidiaries and branches, and their physical and cultural distance from the head office. Huntington also suggested that the opportunities for concealment of fraud engineered from the centre were increased if a network of branches, subsidiaries and related entities existed. These autonomous branches or subsidiaries could, for example, be used by directors or top management to circumvent management control at operating level (Huntington, 1992:6). For opportunities to be minimised, the following must be present:

- a. an effective internal control system;
- b. an efficient and honest management group which would ensure that this internal control system is enforced properly.

The two factors are equally important for the prevention of fraud cases to be effective.

The conditions conducive for fraud to take place can be divided into two groups, the internal or individual factors and the external or social factors. Internal factors' refer to the personality of the individual or personal reasons,

for example, financial problems and family commitments. 'External factors' refer to factors which are outside the individual personality and which make it possible and conducive for fraud and corruption to take place. These factors have also been referred to as 'environmental factors'. Examples of environmental factors are the structure of the organisation or society, the cultural institution, the political system and the legal system.

In any organisation, an efficient internal control system seems to be the most important safeguard against fraud. As such any system of internal control should consider the following:

1. *Efficient, accurate and accountable reporting system*

A proper accounting system can exist only when the records of transactions are properly kept. Tadin (1990) reported that those which were prone to malpractice had the problems of inadequate disclosure of correct and factual information and an inadequate internal control system. Transactions should be made and recorded in accordance with specified procedures. There should be no allowance for any discretionary transaction to be made outside these procedures unless it has been brought to the attention of the relevant decision-making committee. This is particularly important where the dispensing of loans in financial institutions is concerned. The members in this decision-making committee must be independent members who are not members of the Executive Board to whom the loan application is given or any member whose opinion may interfere with the exercise of independent judgement, such as a family member. The financial background of the applicants, especially where large sums of money are involved, should be checked thoroughly. It should be a policy of the organisation not to conduct business with customers who fail to provide evidence of their identity. There should be proper lending guidelines to ensure that loans are not concentrated on one person or organisation. Collateral involved in the transactions should also be properly secured before dispensing these loans. The records should be maintained in sufficient detail in order to reflect the nature of the transactions. How the transaction decision was made and who was in charge should also be recorded for the purpose of accountability. These measures are meant to safeguard the true financial position of the financial institutions as well as to expose any irregularities.

2. *Segregation of duties*

Key functions like the authorising, recording, accounting and custody of assets should be segregated. This is to prevent one person dominating a transaction from the beginning to the end. If this is allowed, there will be ample opportunities for committing and concealing a fraud. The segregation of duties will

provide checks and balances whereby the work of one person can be verified by a second person. Moreover, this will also ensure accountability by all sections and levels of the organisation as there is no diffusion of responsibilities. This prevents the passing on of responsibilities and 'scapegoating' when things go wrong. As Croall (1992: 63) pointed out, there were classic instances of serious corporate offending which revealed a complex web of interlocking responsibilities and cover-ups at all levels which combined to conceal where responsibility ultimately lay. Clinard (1983: 17) argued that the immensity, the diffusion of responsibility and the hierarchical structure of large corporations fostered conditions conducive to organisational deviance.

3. *Effective, sensible and regular supervision*

In financial fraud, the money acquired from loans usually passes from one destination to another before returning to where it started. By checking and double checking, and making sure that all sections of the organisation are accountable for their actions, the problem can be traced at the early stages. Prevention is better than cure. As such, the management should keep reasonably close, regular and effective checks and supervision on the overall operations of the institution. This is to ensure that the proper procedures have been carried out throughout the firm and also to detect problems and irregularities arising. If the organisation has branches and subsidiaries in other parts of the country or in other parts of the world, the management at the head office should ensure that they know all the operations that are taking place at the other end. They should also make sure that the management at the branches or subsidiaries are following the procedures set out and that everything is in order. However, these checks and supervision should be carried out in a manner which is not antagonistic to the employees.

Besides making independent checks and supervision over the performance of employees, management should also:

- i. monitor, sometimes on a month-to-month basis and in certain operations, on a daily basis, the profit and loss account of the financial institution in order to pin-point financial problems and risks faced by the institution;
- ii. conduct regular management review on the effectiveness of its policies and procedures;
- iii. set up an independent audit and examination committee consisting of non-executive directors;
- iv. ensure that the internal auditors have access to the audit committee and to top management so that they could report any problem that is found.

4. *Sound personnel policies*

Although amendments were made, especially to the Banking Act 1973 and the Companies Act 1965, to prevent fraud, these amendments did not prevent abuse and mismanagement from taking place.

A good internal control system will work better if the employees are competent and honest. Although there are no hard and fast rules to determine which applicant for a particular position is honest and efficient, certain measures could be taken at the recruitment stage to weed out potentially unsuitable applicants. For example, due attention should be given to character references and past employment records. Lee (1992:42) suggested that the management should also keep a vigilant watch on their employees for vices, such as drug addiction, gambling or a penchant for luxuries beyond a person's means, as failure to observe these was as good as leaving the door open to theft. Levi (1988) suggested that fraud prevention measures might involve educating colleagues and internal security to watch out for and enquire into the circumstances of employees who were living in a style far in excess of their salaries. He said that several defrauded firms had allowed employees on modest salaries to go on driving new Porsche cars and taking expensive holidays without conducting any enquiry or more than superficial one into how they could afford this (Levi, 1988:13).

In order to encourage employees to report on their colleagues if they find any malpractice, the authority in the organisation must reassure them that their job will be secure. It will encourage them further if they are to be given an additional reward or promotion. Their evidence would be considered and an investigation would be carried out by the proper authority in the organisation. Great care should be taken not to reveal the identity of the employee in order to protect him or her. If the identity of the employee is revealed, the organisation must offer him or her whatever protection is possible against any threat to his or her life. If the organisation gives incentives to their employees to report malpractice, the organisation will ultimately benefit as a lot of money would be saved.

The social and cultural environment within which an organisation operates is also important. There should be a fixed and clear personnel policy covering the selection, training, promotion and remuneration of officers and employees. Tadin (1990) said that a competent group of employees was also the product of proper effective training, sensible evaluation and promotion practices, and a work environment which provided reasonable incentive for good performance. This is to prevent favouritism, nepotism and ill-feelings among the employees. Lee (1992) suggested that key or sensitive positions should be filled by personnel on a rotational basis. This is to prevent one person from getting too familiar with that particular position, especially if it is a high ranking one which is exposed to opportunities for fraud.

The key to healthy financial institutions depends fundamentally on good quality management. Improved internal controls and procedures, penalties against breaches of the law and code of ethics are insufficient to deter fraud and malpractice. Competent and trustworthy management members are the order of the day. Any management member who does not fit the bill has to be replaced as soon as possible.

5. *Technological improvement and retraining of management members*

The control system of the organisation has to evolve with the times. As technology improves at the operational level to compete with other organisations, the control system also has to keep pace and be familiar with this improvement in order to reduce the opportunities for fraud. This means regular retraining of management members. With the rapid advancement into international business dealings, there is a need to revise the internal control system to take into consideration overseas branches and subsidiaries.

6. *Declaration of businesses and assets*

Business activities of directors and management members, especially those in the public enterprises and financial institutions, must be declared to the relevant board. If other employees in these establishments intend to be involved in businesses, they should notify their department heads and obtain the necessary permission to do so. Their business ventures should then be recorded.

In addition to business ventures, the following assets should also be declared:

- i. Shares owned by employees and directors or heads of departments, especially in the financial institutions and public enterprises;
- ii. Assets like landed properties owned by them, both locally and abroad.

7. *Other considerations*

The control of fraud and corruption in any organisation will require ethical leaders as well as employees who are alert, confident and of high moral standards who would report and condemn malpractice. They would make sure that the system of internal control is enforced properly. Without them, financial institutions will always be at risk of fraud and corruption even if they have the best system of internal control and prevention technology. As Peter Drucker said, "Business ethics may be good politics or good electioneering. But, that is all. For ethics deals with the right action by individuals. And thus, it is society

that must stress the ethics of prudence and self-development. It must expect its managers, executives and professionals to demand of themselves that they shun behaviour they would not respect in others and act instead in ways appropriate to the sort of person they would want to see in the mirror in the morning" (Idid, 1990: 6). Moreover, the behaviour of the management members will raise the standard of the employees.

The employees should be encouraged to condemn fraud and corruption openly and to report to the relevant authorities if they suspect any illegal activity, especially involving the management. They should also be given the assurance that their reports are strictly confidential so that they will have the confidence to come forward. Likewise, the relevant management members must be sufficiently open to allow such protest.

In order to encourage the employees to condemn any fraudulent or corrupt act, they have to be made constantly aware by the management, politicians and the media of the ill effects of fraud and corruption and also the erosion of society's moral base, especially one which is materialistic.

CONCLUDING REMARKS

This paper looks at the problem of fraud from a sociological perspective. The internal factor of human beings such as the personality of the individual or personal reasons, has not been discussed. History has shown that corruption is basically caused by dishonest individuals who give in to temptations when provided with the opportunities to do so. There must be both the opportunity and the wish to commit the offence. There are people with opportunities open to them, but who do not wish to commit the crime. As Alatas (1990: 22) pointed out :

"The relation between man and his social structure is similar to the relation between a dwelling and its occupants. The structure of the dwelling conditions the life of the occupants, but the occupants can change the structure if they so wish. If the structure begins to leak and all the occupants resign themselves to it, blaming it on the structure, the structure will continue to leak. In this case, the explanation still lies with the occupants who do not wish to repair the structure. Something non-human cannot be held responsible for something human. The structuralist explanation of corruption shifts the locus of responsibility from the human actor to factors external to the actor. These external factors are significant in understanding the extent and manifestation of the phenomenon, but they are not the terminal point of explanation. They are the starting point. The terminal point is the nature of man."

The best and most sophisticated strategy designed to combat fraud will only provide a short term structural change. In the long run, it will still be defeated by some fraudsters. In order for these sophisticated strategies to succeed, it should be complemented with strategies that will produce changes in behaviour and internalized values. As McKinney (1986: 6) concluded, "Effective accountability can best be achieved when it is a learned pattern, a response to habit. This becomes particularly important when it is realized that unethical behaviour, inefficiency and inadequate initiative cannot be controlled simply by rules or other external means."

Omar (1990: 13) said that, "a reasonable presumption can be made that law and its enforcement alone are not a sufficient or complete answer to commercial crimes. Ethical values and virtues amongst persons in positions of trust in particular and amongst the populace in general must be nurtured and strengthened so that they become second nature for people, especially Malaysians". He added that "behaving strictly within the confines of the law is merely being prudent and law-abiding, but not necessarily ethical. Law imposes demands from outside, while ethics should come from inside. Besides, if law constitutes the only behaviour limits, Government and law enforcement agencies would swell to over-whelming proportions" (Omar, 1990: 20). Ethics is an internalised value from within the individuals themselves to guard against succumbing to base behaviour and temptations. The laws of Malaysia have made provision for more severe punishments to be meted out for crimes such as fraud, criminal breach of trust, cheating and forgeries, yet these severe penalties and sanctions will not deter everyone from perpetrating such crimes. Ethics will strengthen and enhance the effectiveness of these structural changes. The teaching of ethics alone does not prevent some people from committing crimes. There should be both structural changes and behavioural changes in order to reduce fraud.

It is also suggested that the inculcation of ethics must be rooted in the home and throughout the learning process (Omar, 1990). Outside of the home, the educational system can do its part by incorporating ethics into the system. Students from the primary level right up to the university and professional level should be inculcated with the appropriate universal ethical values and virtues like honesty, responsibility, accountability, kindness and justice. Ethical education should be planned and incorporated in the curriculum of education. In this aspect, organisations, too, can play their part by organising talks and seminars on ethics for their employees, or send their employees to such talks and seminars organised by other institutions. The purpose is to produce well balanced individuals for managing the organisation.

Universities in Malaysia are encouraged to incorporate the study of ethics in their curriculum. Even though the university is only one institution among many that will affect students' behaviour and lives, direct intervention by the university in instilling the right values and attitude is vital. The years the

students spend there represent an important stage in the development of most young people. It is there that students learn how to form critical ideas on moral and ethical dilemmas. An example of Malaysian universities which have ethics courses in their curriculum is Universiti Utara Malaysia. It has introduced a one-semester compulsory course on business ethics, combining general, philosophical and professional ethics. However, for any ethics education to make an impact on the students, the behaviour of the lecturers is important. In fact, the whole system and administration of the university must reflect and demonstrate the teachings of ethics. Otherwise, a "formal course on ethics would be a futile exercise and may only serve to produce cynics of ethics and morality" (Abdullah, 1990: 9). Similarly, the management of any organisation must reflect and demonstrate the teachings of ethics in order for its employees to be conscientious about their actions at all times.

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