

LOAN FRAUDS AND RED FLAGS: AN ANALYSIS

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Abstract

In this paper, the researcher explores the contours of loan frauds in the Banking sector. The paper commences with an illustration on loan frauds and the importance of red flags. This is followed by the different types of loan frauds. The next focus of the paper lies in identification of the various red flags in an account that might indicate a loan fraud. Further, the paper makes a case study which shows as to how the non-identification red flags and non-compliance extant guidelines made the Bank a prey to loan fraud. Finally, the conclusions and suggestions of the researcher winds up the paper.

Key Words: Banking frauds, loan frauds, red flag, sham loan, fake title deed, misrepresented financials statements, fraud prevention, fraud detection.

Introduction

ABC Bank allowed a Cash Credit Open Loan to XYZ, a sole proprietorship concern of Mr. X to meet their working capital requirements. The proprietor of the firm hypothecated movable properties of the firm as primary security. After availing the loan, the borrower failed to ensure the proper repayment in the which resulted in the account turning non performing asset. As a prelude to initiating recovery measures, Bank officials visited the mortgaged property and consequently it was revealed that the mortgaged property was already secured with DEF Bank. It was also understood that mortgaged property was sold by the said DEF bank as recovery measure.

The internal investigation revealed that the original of Primary Sale Deed and Certified copy of Prior Sale Deeds produced before the Bank were sham and fabricated documents respectively. The borrower with clear intention to cheat the bank, created a fake and fabricated title deeds.

It is at this juncture the importance of loan frauds and its red flags become pertinent. Loan fraud is a multifaceted activity that includes several types of criminal activities.¹ Loan fraud represents high risk areas for financial institutions. Let us commence with a bank loan fraud case.

Common Loan Fraud Schemes

The most common loan fraud schemes are elucidated as follows:

- Loan to nonexistent borrowers
- Sham Loans with Kickbacks and Diversion
- Double Pledging Collateral
- Reciprocal Loan Arrangements
- Swapping Bad Loans – Daisy Chains
- Linked Financing
- Loan Applications with False Credit Information
- Credit Data Blocking
- Single-Family Housing Loan Fraud
- Construction Loans
- Mortgage frauds

¹ Frauds Examiners Manual, published by Association of Certified Fraud Examiners (ACFE), USA.

Elaborating the Loan frauds

Let us now have a glimpse at the different types of loan frauds and understand the meaning of each of the above stated schemes.

- **Loan to nonexistent borrowers**

In this type of loan frauds, the fraudster uses false applications accompanied by inaccurate financial systems to deceive the Bank to avail loan. This can be knowingly or unknowingly accepted by loan officers. In simple words, loan to nonexistent borrowers, depending on its nature can be an external fraud or an internal fraud.

- **Sham Loans with Kickbacks and Diversion**

Loan officers will sometimes render loans to accomplices. These accomplices will then share all or part of loan proceeds with the loan officer. This is mostly an internal loan fraud. It is even seen that in some cases, the loans are charged off as bad debts whereas in some matters, the fake loans paid with proceeds of new fraudulent loans.

- **Double Pledging Collateral**

In this loan fraud, the same collateral security property is pledged before different Banks. The damages or the loss caused is very high and serious. In one of the analysed cases, the researcher noted that in a loan fraud involving double pledging of the collateral the fraudster registered charges for both the banks in two different villages. This helped the fraudster to escape detection of fraud while verifying the online or physical encumbrance certificates.

- **Reciprocal Loan Arrangements**

Insiders in different Banks cause their banks to lend funds or sell loans to other Banks with agreements to buy their loans. Such actions are all done solely for the purpose of concealing loans and sales. Such loan frauds are known as reciprocal loan arrangements.

- **Swapping Bad Loans – Daisy Chains**

In a daisy chain, a Bank buys, sells and swaps its bad loans for the bad loans of another Bank, creating new documentation in the process. The purpose of daisy chains are nothing but to mask or hide bad loans by making them look like good and recent.

- **Linked Financing**

Linked financing involves large deposits or brokered deposits offered. These are offered on the condition that loans are extended to people affiliated with deposit broker. Such brokers often make false promise on high returns but on the other hand, the loans will be of longer terms. In some instances, kickbacks paid to Banker or Broker

- **Loan Applications with False Credit Information**

Another common loan fraud is the scheme wherein the loan applicant who is the fraudster furnishes false information about credits to the banks. The fraudster shall also overstate assets. By furnishing false credit information and overstating assets, the fraudsters shall deceive the Bank to extend loan which it otherwise ought not to have extended.

- **Credit Data Blocking**

In some countries, the Banks largely rely on credit reports to decide if loan should be extended. Fraudsters manipulate credit reports to deceive Banks to extend loans. In a credit data blocking scheme, fraudster first applies for and obtains loans for property, vehicles, etc. and then intentionally defaults payment. In the next step, rather than allowing a negative report to sprout, the fraudster assert that the first loans were instances of identity theft. As a result, there will be a temporary suspension or removal of the fraudster's credit history while the veracity of their claim of identity theft is investigated. This facilitates the fraudster with more time to avail more loans which will also be defaulted.

- **Single-Family Housing Loan Fraud**

Characteristics of the housing unit is misrepresented in this type of loan frauds. The fraudster will be an unqualified borrower who will misrepresent his or her credit worthiness and will overstate the ability to repay. Further, the fraudster shall also resort to means such as reporting inflated income, transferring debts to a different family members name, inflating the square foot of the collateral, bribing the property valuer for valuing the collateral at a higher value than the market value.

- **Construction Loans**

When compared to already-built structures, constructions loans put the Banks at more vulnerability. Construction loans are more common and frequent. Some of the most frequently occurring construction loan frauds are draw requests, retainage/holdback schemes, developer overheads, etc.

- **Mortgage frauds**

Mortgage frauds within loan frauds are mainly air loans, fraudulent sale and fraudulent second lien. Air loans are loans given on a non-existent property. Fraudulent sale is a sale wherein the fraudster makes a fake and fabricated title deeds gives and impression that indicates his or her legitimate ownership of the property. The sale usually happens without the knowledge and consent of the actual property owner. A fraudulent second lien is a mortgage fraud wherein the fraudster, assuming the identity of the actual owner avails an additional loan or second mortgage on the latter's property.

Red Flags of Loan frauds

In simple words, Red flags are the indicators, a prudent bank should take as a tip indicating potential fraud:

- **Non-performing loans**

A non-performing loan or a non performing asset is a loan in default or close to default. Such accounts will be accounts wherein the principal amount and interests are overdue. The creditor will also have sufficient reasons to believe that the loan will not be repaid. This is a very common and frequent indicator of fraud.

The fraud schemes that finally cumulate in a non-perform loan mainly includes fraudulent appraisal, false statements, equity skimming, construction over-budget schemes, bribery, land flips and disguised transactions. These methods are adopted by the fraudsters when the cash flow cannot support an inflated loan and resulting debt amount and in order to conceal the deficit financial stability to be eligible for loans.

- **Unusual High Turnover**

High turnover in developer's personnel and high turnover in tenant matrix are also red flags of loan frauds. The red flag of high turnover in developer's can be usually seen in construction or real estate related loans. Generally, when there is a very high turnover is experienced by the developer, there is some error within the internal operation. This should be taken as the preface that paves way for more or larger frauds afoot.

A sudden major change of the tenant mix in a commercial or a decline in the tenant mix are indicators of errors in the operations of a management. In such situations, the same are to be taken as indicators of fraud.

- **Missing or incomplete documentation**

Missing documentation or incomplete documentation is not confined to loan frauds. This is a red flag for many other frauds as well. However, when it comes to Banking frauds, missing documentation is a very crucial red flag. This red flag is a definitive give away and also the key element is concealment of the documentation. In loan frauds, this red flag is particularly seen in construction field. Missing documents can also compliance the process of fraud detection.

When searching for a red flag of loan fraud, a prudent bank should analyze if the documents are missing or whether those documents were never received. Often, in some of the cases analysed by the researcher, it was noticed that, with an ulterior motive to conceal certain documents, the fraudster

often submits to the Bank that those documents are not available and obtains waiver citing reliable by artificially grafted reasons.

- **Replacement loan, Loan increases and loan extensions**

Constant and simultaneous loan extensions and increases can also be a red flag of loan frauds. Loan increases are typically for payment of interests. Numerous increases or extensions may also symbolize high appraisals which are untrue.²

- **Ownership Change**

In loan frauds, change in ownership makeups are often referred to as 'business divorce' which is an icon of fraudulent activity. It is neither rare nor an uncommon action to have a working partner and an equity partner. When the two partners are displeased with each other, they resort to separation which proves that things have gone sour among them.

- **Disguised transactions**

A disguised transaction is a transaction used to conceal the real nature of a transaction. Sometimes, as a result of target pressures, Banking personnel might engage in disguised transaction i.e. fraudulent loan scheme to forego the requirement to record additional loan reserves. One transaction tied to another transaction in this kind of loan fraud.

- **Cash Flow Deficiencies**

Cash flow deficiency is the best red flag that can unveil potential loan fraud. If there is an unjustified, unexplained and unexpected deficiency in cash flow, then, a prudent Banker should immediately take the same as a predication and analyze potential frauds.

- **Change Order Abuse**

Change order is the amendment of the contract terms by the parties to the contract in view of unanticipated changes in conditions. It is the abuse of this freedom and discretion that transforms itself as change order abuse, a red flag of loan fraud. The effect and impact of change orders is as severe as altering the original documents. If the changes are pertaining to a bid contract, the fraud can also indicate collusive bidding.

Case study

ABC Bank sanctioned housing loan of Rs.40 lakhs for the purchase of ready to occupy flat in the joint account of Mr.X. The property was to be from builders - DEF Associates, a partnership firm. One of the sanction stipulations was to register the sale deed in the name of Mr.X. Accordingly, loan documents were executed and equitable mortgage creation was completed by depositing the primary title deed. Subsequently, ABC Bank received Notice from XYZ Bank that the security property was already secured to the latter bank, housing loan was disbursed and Equitable Mortgage creation has also been done.

Thereafter, an internal investigation was conducted in the ABC Bank. It was then revealed that the primary deed was fake and fabricated title deed. Many internal and third party entity lapses were also unveiled in the investigation. More importantly, it was further identified that account to which the payment was made was also a fake account. As per the data of ABC Bank, the builder was a partnership firm whereas the Bank's account to which the payment was made had a different name and entity was shown as a proprietorship concern.

However, the above array of fraud is not the brilliance of the perpetrator. On one hand, the fraudster tactfully forged title deeds to deceive the Bank whereas on the other hand, the fraud was successfully perpetrated by the fraudster by exploiting the negligence of the ABC Bank staff. For example, the extant guidelines of ABC Bank stipulate that, before accepting a property as security, the concerned Branch shall obtain a certified copy of the primary title document. The extant guidelines also stipulates that a Title clearance report should be obtained from an external advocate verifying the primary deed, comparison with certified copy and to verify

² William T. Thornhill, *Forensic Accounting: How to investigate Financial Fraud* (Burr Ridge, IL: Irwin Professional Publishing, 1995).

the property for any encumbrance physically and online from the Government website. None of these guidelines were complied. Had any of those guidelines were followed, the fraud would not have occurred. For instance, if the encumbrance was verified the prior charge of XYZ Bank would have been detected. If the certified copy of the primary deed was obtained, verified and compared with the original, the document could have been detected as fake and fabricated.

Conclusion and Suggestions

In the Banking scenario, frauds are no novice. Of all Banking frauds, loan frauds are serious, can cause potential damage and reputational risk to Banks. There are different ways by which Bank can be defrauded under loan frauds. A loan fraud is not a single fraud. It often involves various dimensions. Most importantly, a loan fraud can be an internal fraud which involves collusion of insiders with outsiders or it can be a complete external fraud. In most of the loan frauds, it is seen that the negligence of the Bank staff has majorly contributed to the fraud which made the fraudsters successful in knitting their fraud web.

However, the researcher, in this paper has identified a set of red flags which can help a prudent Banker to identify any potential fraud. Due diligence and care on the part of the Banks accompanied by constant monitoring for the existence of any red flags can definitely bring down the number of loan frauds. Red flags may not always end in frauds. But red flags are indicators of an apprehended fraud. Even though the red flags cannot implement a blanket policy and completely eradicate frauds, it can definitely whittle down the number of Banks frauds and increase the efficiency of Banks.

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