Sources of Fraud and What to Watch,

plus Implications to Loan Underwriting

Moderator:

Elizabeth Williams
Managing Director
CEIS Review, Inc.

Panelists:

- Peter T. Blessing, Director, Forensic Services, KPMG LLP
- Joseph F. Finn, Jr., Managing Partner, Finn, Warnke & Gayton, CPA's
- Joseph D. Meddings, Principal, Hollis Meddings Group
- Zachary Swain, Vice President, Bank of Canton
- James M. Liston, Esq., Principal, Hackett Feinberg, PC
- Patrick Joyce, Executive Vice President and Head of Restructuring, Citizens Bank

Friday, March 18, 2016
The Conference Center at Bentley

Fraud in Commercial Lending:
Trends, Alerts, and Lessons

Peter T. Blessing, Director, Forensic Services, KPMG LLP

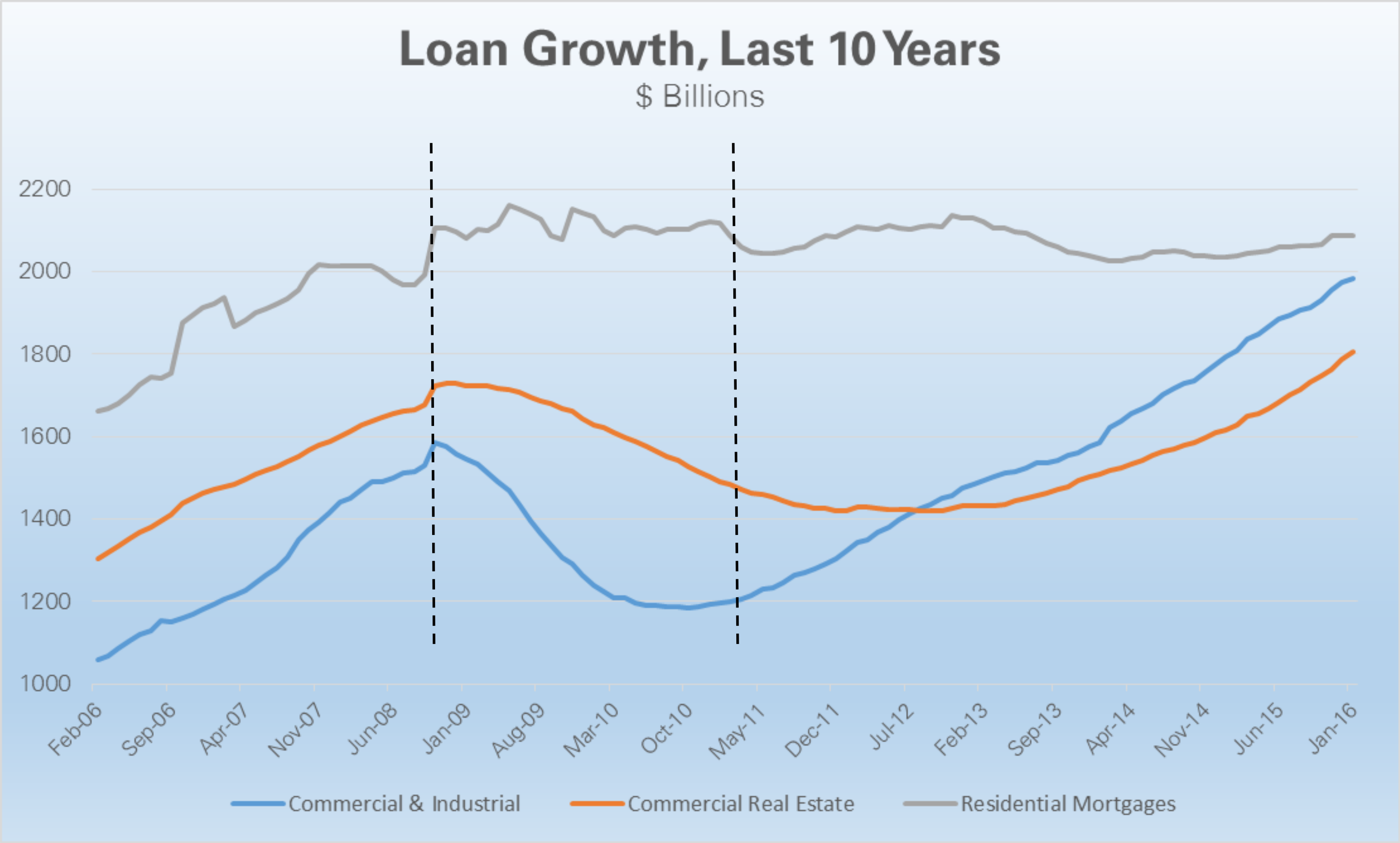
Commercial Loans, Last 10 Years

All Commercial Banks

($ Billions)	Oct 2008	Apr 2011	Jan 2016
Commercial & Industrial	1,587	1,215 (-23%)	**1,984 (62%)**
Commercial Real Estate	1,723	1,464 (-15%)	**1,808 (11%)**
Residential Mortgages	2,106	2,048 (-3%)	2,086 (-1%)

Source: Board of Governors of the Federal Reserve System (US)

Commercial Activity +41% since April 2011
+14% since October 2008



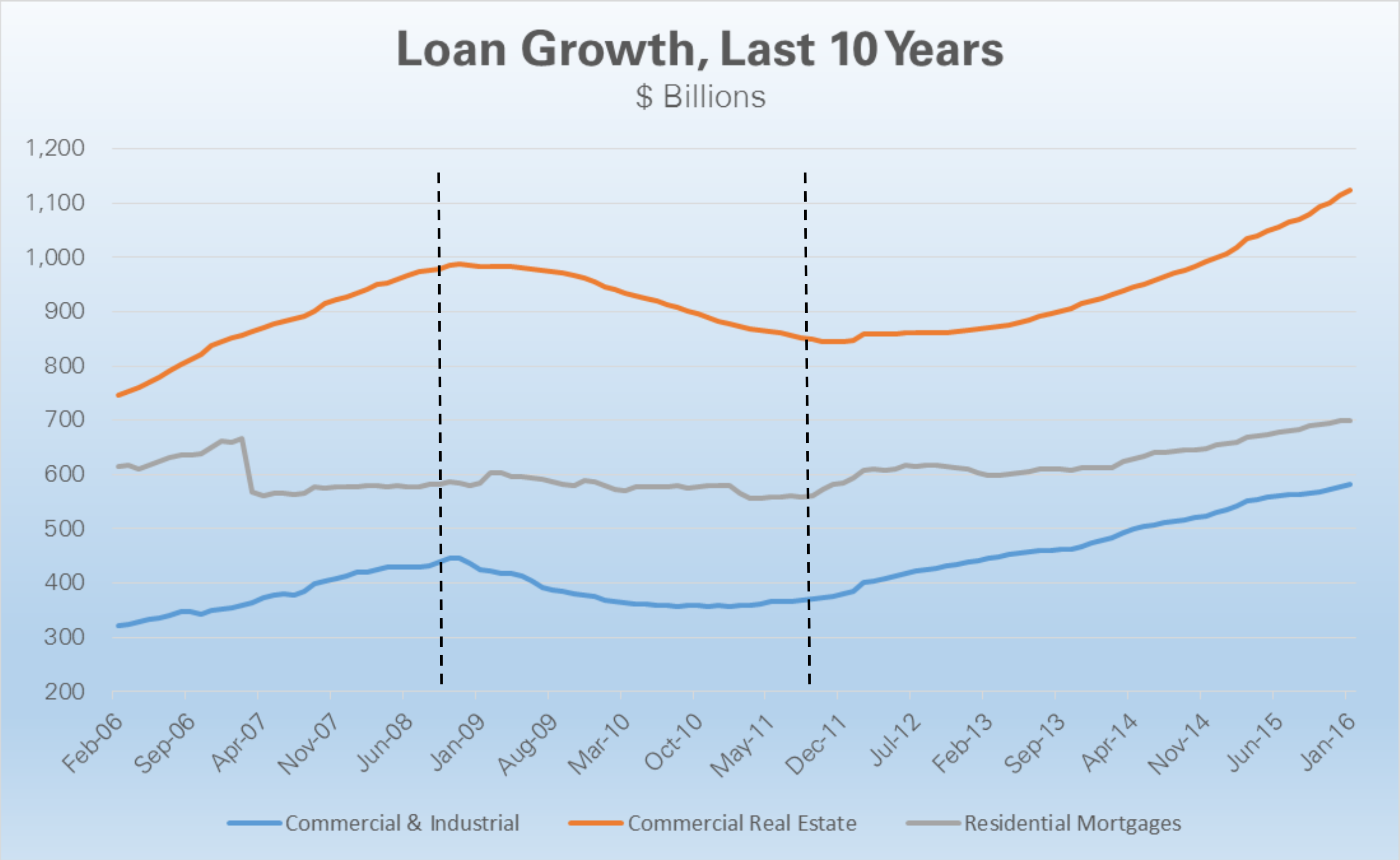
Commercial Loans, Last 10 Years

Small Domestically Chartered Banks

($ Billions)	Oct 2008	Sep 2011	Jan 2016
Commercial & Industrial	447	371 (-17%)	**581 (57%)**
Commercial Real Estate	986	849 (-14%)	**1,124 (32%)**
Residential Mortgages	586	561 (-4%)	699 (25%)

Source: Board of Governors of the Federal Reserve System (US)

Commercial Activity +40% since September 2011
+19% since October 2008



ACFE Report to the Nations 2014

Bi-Annual Survey Report on the occurrence and impact of Fraud

Typical organization **loses 5% of revenues** each year to fraud
Applied to 2013 Gross World Product - translates to **$3.7 Trillion**
Median loss $145,000; **22%** of cases involved losses > **$1 million**
Median duration (commencement to detection) – **18 months**
Banking and financial services – **greatest number of cases reported**
Smaller organizations suffer disproportionately large losses; notably under protected by anti-fraud controls
Collusion – helps to evade controls **leading to larger losses**

Commercial Lending Fraud

Recent Cases

Feb 11, 2016 - Pennsylvania Businessman Sentenced for Fraud Scheme
Previously convicted of bank fraud and filing a false tax return. Falsely represented purchase price. Portion of the mortgage loan was paid as kickbacks, also filed a false tax return.

Feb 2, 2016 - Pennsylvania Man Sentenced for Fraud and Tax Charges
Supplied fictitious earnings to banks to obtain numerous business lines of credit used for personal expenses. Provided false information to two banks. Filed false federal income tax returns.

Jan 22, 2016 - Missouri Business Owner, Son Sentenced for $5.5 Million Fraud Scheme
Submitted false financial documents to a bank to receive four commercial loans, totaling $5,592,583.

Jan 7, 2016 - Property Manager Sentenced for Role in Multimillion-Dollar Mortgage Fraud
Used phony documents and "straw buyers" to make illegal profits on over-developed condominiums. Created fraudulent loan applications and obtained false supporting documents for straw purchasers.

Dec 22, 2015 - New York Businessman Sentenced for Making False Statements and Filing False Tax Returns
Made false statements to a bank and filed materially false tax returns, to obtain $63.5 million in loans Lied on bank documents about purchase price and down payments being made.

Dec 22, 2015 - Ohio Man Sentenced for Credit Union Fraud
Fraudulently obtained more than $10.6 million in loan proceeds. Obtained the loans by providing more than $200,000 in bribes to the chief operating officer of the credit union. Largest credit union failure in American history.

Commercial Real Estate Fraud, SAR Filings

March 2011

March 2016

Source: US Department of Treasury, Financial Crimes Enforcement Network

Since 2013, SAR Filings increased on quarterly basis (on average) by nearly 140% over height of prior period

Commercial Loan Fraud Schemes

Misrepresentations
- False statements/documents (appraisals, financial statements, tax documents, rent rolls, draw requests, lien waivers, etc.)

Misappropriation of Funds
- Diversion or commingling of funds, used for other businesses/projects or for personal use

Bank Insider Collusion
- Collusion by bank insiders with borrowers, other insiders (i.e appraisers)

Flipping and Straw Buyer Schemes
- Schemes to generate equity for another purchase, for profit, to improve creditworthiness

Collateral Transfer
- Sold without disclosure, proceeds kept, hid/conveyed to associate or another entity

Advance Fee Schemes
- Fraudulent proposals, financial instruments targeting borrowers and lenders

Business Identity Theft
- Obtain loans using owner/officer as guarantor, open or access accounts/credit

FINN, WARNKE & GAYTON

Certified Public Accountants

Fraud in Commercial Lending

Trends, Alerts & Lessons

HOLLIS MEDDINGS GROUP

Hollis Meddings Group is a leading provider of collateral analysis, viability studies, turnaround consulting and strategic planning to the banking industry and their clients.

- ***Field Examinations***
- ***Business Risk Reviews***
- ***Turnaround Consulting / Strategic Planning***
- ***Portfolio Liquidations***

Background

HOLLIS MEDDINGS GROUP

- ***Validation of Quality of Accounting Systems and Personnel.***
  - *Systems/People to produce necessary reports.*
  - *Ability to protect the bank's collateral.*
- ***Examination of Assets being pledged to support loan.***
  - *Do the assets support the loan outstanding.*
- ***Review of Quality of Earnings and strength of Balance Sheet.***
  - *Statements fairly represent company strength*

Reasons

HOLLIS MEDDINGS GROUP

- ***Provide check on Borrower's Compliance***
  - *BBC reported according to credit approval*
  - *A way to test Management's Representations*
- ***Validate Reasonableness:***
  - *Collateral Values*
  - *Ineligibles*
  - *Advance Rate*
  - *Loan Balance*

Purpose

HOLLIS MEDDINGS GROUP

Purpose

- ***Determine additional collateral risk***
- ***Analyze Trends***
  - *Collateral Position*
  - *Availability*
  - *Overall financial health*
- ***Fulfill the Bank Credit Policy requirements***
- ***Meet Federal Regulators Standards***

HOLLIS MEDDINGS GROUP

- ***What a field exam in not***
  - *It is **<u>NOT</u>** designed to detect fraud*
  - *It is **<u>NOT</u>** a replacement for an audit*
    - *Does not certify any part of financials*
    - *Does not review all parts of financials*
    - *Does not look for GAAP compliance*
    - *Is not a validation of the operating statements*
    - *Is not a validation of the balance sheet*

Purpose

- ***A field exam is designed to:***
  - ***Keep "honest people honest"***
  - ***Catch dishonest people before a catastrophic loss***

Most people want to do a good, honest job – but some people are out to defraud you.

HOLLIS MEDDINGS GROUP

Purpose

Example #1 – Environmental Testing Company

HOLLIS MEDDINGS GROUP

- ***A little truth, a little (well, big) lie***
  - *Functioning underlying business that was losing money.*
  - *International business (same owner) that was remarkably profitable.*
  - *$30 million letter of credit from Saudi Arabian bank.*
  - *International invoices allowed in Borrowing Base since supported by letter of credit.*

Environmental Testing

HOLLIS MEDDINGS GROUP

- ***A little truth, a little (well, big) lie***
    - *Invoices to related business were being paid by owner distributions.*
    - *IRS Letter supporting payments from Saudi customer – also not real.*
    - *$30 million letter of credit – Saudi bank real, letter of credit not.*
    - *Term Sheet from competing bank – also not real.*
    - *Borrowing base report - $9K availability. Actual availability – ($3.6 million).*

Environmental Testing

HOLLIS MEDDINGS GROUP

Example #2 – Computer Consulting Company

HOLLIS MEDDINGS GROUP

- ***Almost no truth – A complete house of cards***

  Almost completely fabricated business:

  - *Invoices*
  - *Bills of Lading*
  - *Cash Receipts*
  - *Customer Checks*
  - *Deposit Slips*

- ***Almost no truth – A complete house of cards***

Almost completely fabricated business:

- *Accounts Receivable Aging*
    - *Adjust current column*
    - *Realign over 90 day column*
- *Inventory Counts and Valuation*

- ***Almost no truth – A complete house of cards***

Understanding of field examination process:

- *Manipulation of borrowing base*
- *Manipulation of accounting reports*
- *Manipulation of supporting documentation*
- *Manipulation of outside reporting*
  - *Bank Statements*
  - *Draft Audit Statements*

- ***Almost no truth – A complete house of cards***

  Reported A/R Balance - $7.3 million

  Actual A/R Balance - $381K

  Reporting Borrowing Base - $25K

  Actual Borrowing Base – ($7.8 million)

Thank you!

jmeddings@hollismeddings.com

HOLLIS MEDDINGS GROUP

A Presentation to

RMA New England

on

Construction Loan Fraud

March 18th, 2016

Zachary Swain, VP
Bank of Canton

Example I

84 Unit approved residential condominium project

Background/History

- Subject development was an approved 84 unit residential condominium project located on the South Shore in Massachusetts
- At the time of the Bank's involvement 12 units had been conveyed with an additional six units purported to be under agreement with all infrastructure with the exception of finish coat paving purported to have been in place and inspected The Bank was under the impression that we were financing pre-sold units in addition to the refinance of a private money mortgage
- At the time of closing the Bank refinanced a considerable portion of a private mortgage with the remaining private party balance fully subordinated. This was considered a possible fallback position as it was assumed that this individual would not walk away from the remaining debt he held in a liquidation scenario
- There was no verification/documentation that the funds advanced at closing for the refinance represented monies utilized to complete existing infrastructure work at the site

Actual Results

- Of the six P&S agreements, only one unit conveyed. Remaining buyers were non existent.
- Although approved for 84 units, borrower failed to reveal that the site could not physically support 84 units. Actual unit count ended up being 79 and involved considerable engineering/site costs. Collateral value ended up being $150,000 less at $30,000/unit.
- Underground work that was purported to be finished and inspected had not been. The waste water treatment plant alone cost $600,000 in parts and labor to complete. Remaining infrastructure including a clubhouse that had to be built exceeded $1.5MM
- The private mortgagee was a relative of the borrower who had no intentions of protecting his mortgage interest after he received proceeds from the Bank refinance.
- When inspections were completed for unit construction, the developer moved unit signs around so as to confuse the inspector. Several units became overfunded for work that had not been completed. Site plans/maps were also falsified to cause further deception.
- Developer did not disclose that he was involved in litigation with several abutters regarding storm water runoff and flooding issues which the Bank ultimately became responsible for
- Developer absconded with all condominium dues and reserves that had been set up

Lessons Learned:

- Had the loan officer completed the appropriate due diligence it would have became known that the sponsor had a checkered past and had defrauded banks previously
- Completing further investigation with town officials would have revealed that the borrower had ongoing litigation with several abutters due to water issues, infrastructure had not been fully completed and that additional units could not be added or sold until the wastewater treatment plant had been built.
- Contacting the buyers of the units that were purported to be under agreement and or asking for additional information in regards to confirmations of deposits and mortgage commitments would have revealed that the purchase and sale agreements were bogus

Example Two:

40,000 SF special purpose industrial building

Background/History

- New 40,000 SF industrial building located in an existing established park.
- Borrower acquired land initially and subsequently obtained approvals for the building
- Borrower was referred by his architect who would also act as the owner's representative on the project.

Actual Results

- Borrower's architect/owner's representative steered the project towards a contractor that had referred him work in the past.
- Despite budget constraints and a lack of capital, architect , borrower and contractor elected to construct a building and amenities that were substantially larger than what was originally contemplated and approved by the Bank
- Contractor/architect steered the borrower to an alternate funding source to finance the changes, however this did not transpire resulting in a partially completed building without sufficient resources to complete.
- Funds were diverted to pay for the larger building, and non payment of subcontractors eventually resulted in mechanics liens on the property
- Bank ended up having to finance considerably more than initially contemplated to finish construction. Borrower cash flow was unable to support this level of debt.

Lessons Learned

- Have the budget and plans thoroughly reviewed by a competent party well in advance of loan closing. Make sure that you hire a consultant whose experience is commensurate with the project. Do not have someone who inspects single family homes inspect and review budgets for large industrial and or residential projects
- Be leery of cozy relationships between the architect/owner's representative and contractor.
- Attend and or have your consultant attend monthly construction progress meetings to monitor ongoing activity, and budget.
- Require notarized lien waivers from all subcontractors prior to advancing funds

Protecting Against Fraud in Commercial Lending

Hackett Feinberg P.C.

155 Federal Street
Boston, MA 02110
www.bostonbusinesslaw.com

Common Categories of Fraud:

Asset Overstatement.

Liability Understatement.

Improper Revenue Recognition.

Fraudulent Financial Reporting Schemes.

Misappropriation of Assets.

Examples of Fraud: Fraudulent Appraisal and Tax Returns

Borrower obtained equipment appraisal from reputable appraiser but was unsatisfied with appraisal values.

Borrower altered values on equipment schedules to appraisal and increased total equipment value by $3 million.

Borrower found second appraiser who would support higher values on altered appraisal and substituted second appraiser's cover letter and conclusions.

Borrower then gave altered appraisal to prospective Lender who loaned based upon inflated values. Borrower filed bankruptcy two years later.

Fraud discovered when Lender's counsel, by coincidence, contacted first appraiser to obtain new appraisal for use in bankruptcy and sent him copy of his own altered appraisal with second appraiser's cover letter attached.

Borrower overstates rental income from apartment buildings on federal tax returns or schedules C or E from returns given to Lender.

Borrower email claims that loan made by Lender "defies gravity."

Examples of Fraud:
Management's Manipulation of Inventory and Accounts

Recorded fictitious inventory purchases in company's accounting system;
To satisfy auditors, produced checks payable to alleged suppliers which were actually companies controlled by management;
To satisfy auditors, altered inventory packaging and labels to show larger number of units than actually existed or inventory with higher than actual values;
Substituted in company's books higher values and quantities of inventory than actually existed and changed type of inventory purchased.

Entered false sales into company's books and created false shipping documents and false invoices to support false accounts;
Some sales to entities controlled by management which paid invoices and then the funds paid were returned to controlled entity;
Used scanning device to create fictitious checks to pay customer invoices;
Account verification letters sent to bona-fide customers by company auditor intercepted by management which coerced or forged signatures of customers.

Useful Terms in Loan Documents

Clearly identify guarantor assets in joint financial statements with non-guarantor spouse. Make sure financial statement is signed and complete.

Borrower covenants regarding accuracy of financial statements and other representations and affirming Lender's reliance thereon.

Events of default to include material misstatements of fact.
No grace periods prior to Lender action for such events of default.

Requirement that officers certify accuracy of financial reports, borrowing base certificates, etc. Confirmation of someone other than owner.

Requiring audited or review based financial statements and right to contact accountant directly.

Clause allowing Lender to seek appointment of a Receiver.

Liberal auditing and inspection rights in favor of Lender, with or without notice.

Steps to Help Mitigate Losses

Once fraud discovered, act immediately, without notice if possible.

Take management out of control of borrower. Seek injunctive relief, appointment of Receiver or, if in bankruptcy, appointment of trustee.

Secure computer hard drives in all business and personal computers including mobile devices.

Send "litigation hold letter" to borrower and its counsel to preserve electronically stored data.

Employ experts with fraud investigation experience to analyze extent of fraud, to whom assets transferred and develop plan for court action.

Commence law suits to avoid fraudulent transfers and enjoin further transfers of assets.

Mine the Computers.

Consider retaining a forensic computer specialist.

Review emails and expenditures. If assets misappropriated, look for emails with foreign banks or other entities, purchases of airline tickets, emails pertaining to travel abroad, communications with relatives, friends.

Check for deleted emails and other deleted electronic information.

Check for use of scrubbing or secure erasure software that permanently deletes electronic data, such as Active@Kill Disk, Data Shredder, Evidence Eliminator, Eraser or GhostSurf.

Although these devices may cover their tracks, their use can be detected by experts. Merely showing that one of these devices has been used will be immensely helpful for the Lender in court proceedings.

Recovery of Misappropriated Assets

If funds transferred overseas:

Consider immediately contacting overseas bank or entity. AT&T offers translation services. Let them know that funds were fraudulently transferred and request their help in stopping further transfers of funds.

Retain overseas counsel to seize or enjoin further transfers of funds.

Carefully consider where to sue first – U.S. or foreign country. Is there reciprocity between countries; consider statutes of limitation differences.

If suing in U.S., consider seeking court order compelling return of funds. Then seek incarceration of party refusing to return funds in response to court order under legal theory of civil contempt.

"Red Flags" of Possible Fraud

To numerous to describe but some common ones are described below:

Individuals who own multiple businesses in multiple jurisdictions and/or overly complex inter-company transactions for which there is no rational explanation.

Resignation of CFO, bookkeeper, auditors, attorneys or restructuring professionals.

Delay in delivery of required financial reports.

Borrower has no physical presence but is instead run by a Corporate Service Company.
Borrower's business does not look like others in its industry.

Significant sales increase at a time when such an increase is not expected.

"Unusual" sales and shipping documents for accounts, multiple invoices for exact same amount of product, invoices all to same customer, substantial invoices to a new customer.

Increased use of "credits" to clear accounts.

More "Red Flags"

Borrower frequently refinances.

Employees not allowed to talk to examiners or auditors.

Corporate Culture/Ethics – sense an absence of a code of ethics.

Substantial gifts and gratuities among insiders and payment of substantial personal expenses.

CEO controls internal and outside auditors.

Insider has substance abuse problems or is known to associate with people who have these problems.

Borrower constantly changes servicers or vendors but cannot explain why.

More "Red Flags" Refinancing Lenders

Unusual terms in payoff letter from previous lender.

"GBCC makes no representations, warranties, agreements and statements concerning Borrower, its business, financial condition, creditworthiness, prospects, the nature of the relationship between Borrower and its customers, the accuracy, genuineness or quality of Borrower's accounts receivable or inventory or the financial condition of Borrower's customers"

Does Lender have a duty to disclose borrower's fraud to new lender looking to refinance Lender's loan ? No, but also cannot mislead new lender or misstate facts.

Route all communications through single person to insure a consistent response.

Type of fraudster – Outlaw vs. Robinhood - may affect recovery.

Lessons Learned

Patrick C. Joyce
March 18, 2016

If it sounds too good to be true…….

- Count Victor Lustig and the Eiffel Tower – The Count discovered that the famous landmark was in need of repairs. He fabricated government papers showing that he was authorized to sell the tower for scrap metal. He managed to get two scrap metal dealers to come up with a total of over $200,000 in bribes to throw the multi-million dollar contract their way. Needless to say he departed town before he was discovered.
- Ken Lay & Enron employed approximately 22,000 people, claimed revenues of nearly $101 billion in 2000 and were often referred to as "the smartest guys in the room". In 2001 we learned that Enron's finances were a fiction, involving "creative" accounting. The scandal brought down Enron and its auditors, Arthur Andersen. It also resulted in the Sarbanes-Oxley act.
- Thomas Petter - $3.65 billion Ponzi scheme wherein he convinced investors that he had superior sources to obtain electronics and other hard goods at prices lower than any competitors. He completed the con by fabricating invoices to big box retailers and showing superior returns. It all came crashing down when one of his staff turned informant.
- Bernie Madoff - $65 billion Ponzi scheme wherein he convinced people that he could beat the market consistently and provide a regular rate of return even in years when others couldn't.

It probably is!

Trust but verify

- Pre-loan due diligence, controls and reporting are keys to minimizing the impacts of commercial loan fraud.
  - Borrowing Bases, Field Exams, Site Visits (including unannounced), Verifications, Clear Financial Reporting (complex intercompany relationships), Inventory Appraisals/Reporting, Good Common Sense.

Example: Customer's BBC represented that they had 114,560 troy ounces of silver. Does anyone know what that equates to in pounds?

Answer – 7,855 lbs – the average midsize car weights 3,497 lbs. Don't you think it would be hard to miss that much silver?

How Does This Happen ?

- There are typically two types of fraudsters – the professional thief/con artist and the business person who does something desperate.
- The latter usually starts as a result of working capital problems and liquidity -
  - Cost overruns on a major project
  - Rejection of a project after you have invested heavily into a new manufacturing line
  - Insufficient bidding discipline
  - Unwillingness to cut expenses in a timely fashion
  - Industry dislocation
  - Commodity swings

The first time the business person makes an adjustment on the BBC or in their financial reporting they do so out of desperation and more often than not in the belief that they'll be able to fix it before anyone finds out.

"It's a little white lie. What harm can it do as long as I fix it before they figure it out?"

From here things usually escalate as the lies become more complex and harder to unwind. The amount you stand to lose in either scenario will depend on the strength of your credit stewardship practices and how rigorously you actually apply them.

Impacts to Banks

- Obviously you lose principal and income. In addition you will add legal and collection costs to the mix as you try to unwind the web and this amplifies your ultimate loss.
- Loss of jobs – this impacts the honest workers who had no idea what their boss may have been up to. This could mean added losses if your bank has cross sold services to the employees who now have no income.
- You can expect added scrutiny to your business practices by your Second & Third line partners. Your regulators will also want to understand the breakdown and question the soundness of your end to end processes.
- In many cases banks have found themselves the subject of fines and lawsuits by aggrieved investors, creditors and regulatory agencies.
- Last but certainly not least, you must consider the potential reputational risk.