



## Truth or Deception

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Where does the truth end and deception begin? At what point does deception become fraud? These are important questions for bank fraud investigators and anti-money laundering (AML) compliance professionals. They go to the heart of knowing who you are dealing with (knowing your customer) and understanding what constitutes fraud (knowing the crime problem). Truth becomes deception when it is combined with one or more misrepresentations intended to put the individual in a more favorable position that provides benefits to that individual, which might not have been derived without the deception. Although being deceptive and making misrepresentations, the intent is not to nefariously make financial or personal gains. On the other hand, deception becomes fraud when the intent is to wrongfully or criminally make financial or personal gains at the expense of others.

The key to determining when deception becomes fraud is to understand intent. For example, what is the difference between an illusionist and a fraudster? The difference is intent. The illusionist is an entertainer who relies on trickery or sleight of hand as a form of deception. The fraudster relies on spin or misrepresentations as a form of deception. The difference between the deception employed by the illusionist and the deception used by the fraudster is intent. The intent of the illusionist is to entertain his audience. The illusionist makes money by charging his audience a fee to attend his show and watch him perform his acts of deception. The intent of the fraudster is to victimize his audience by stealing their money or other items of value through a series of misrepresentations.

By nature, people are honest, truthful and trusting individuals. However, there are varying levels of truthfulness that influence honesty and trust. Assessing truthfulness is the real challenge for bank fraud investigators and AML compliance professionals. When people are totally truthful, their candor is much easier to validate. When people are generally truthful, and make one or more misrepresentations or omissions to protect and/or promote their self-interests, truthfulness mixes with a certain level of deception. The less the deception, the more limited the impact on honesty and trust, and the more difficult to identify. The greater the level of deception, the more adverse the impact on honesty and trust. This leads to the risk that deception deteriorates to fraud and will be identified as such. Unfortunately, there are elements of unscrupulous individuals who prey on honesty and trust for illicit purposes. Their intent is to commit fraud. They achieve this through deception and a lack of truthfulness.

In the example of the illusionist, although he is deceptive through trickery, he is an honest businessman. He makes an honest living as an entertainer and is deserving of our trust. This type of individual causes

little trouble from an investigative or compliance perspective and is the kind of a person financial institutions want to do business with.

The fraudster, however, is a criminal who is neither honest nor deserving of trust. Ironically, fraudsters rely on the ill given trust of their victims to succeed. As with Ponzi schemes, fraudsters artfully create the illusion of legitimacy. They skillfully separate their victims from substantial amounts of money, often times, their life savings. Many of these schemes are seldom uncovered until the fraud scheme collapses due to the weight of the deception. In addition to individual victims, we often find that fraudsters fooled financial institutions into facilitating their criminal activity by presenting the appearance of honesty, truthfulness and trustworthiness. By accepting the fraudster as legitimate, and not detecting frauds until they collapse, financial institutions are confronted with greater potential financial losses, risk to their reputation and being subject to civil litigation for facilitating fraud schemes. It behooves investigators and compliance professionals to identify frauds more timely, before they collapse.

What about the situation where individuals start out honest, truthful and trustworthy, and find themselves being deceptive by making one or more misrepresentations? It could be in the form of applying for a mortgage or a business loan and falsifying income. It could be a business person falsifying monthly or quarterly financial statements, for what they thought would only be one time. It could be misappropriating funds to cover a debt on what started as a one off situation. It could be a myriad of circumstances that leads to deception. The problem is that once these types of deceptive activities occur, the pattern is that they continue. Individuals will find themselves in too deep and in a position where they must perpetuate the deception. This is the point where the intent to make payments or to pay back a misappropriation is blurred and the intent becomes more sinister.

Let's consider the situation our friend John finds himself confronting. John and his wife Mia are honest, truthful and trustworthy. They are a hardworking and aspiring couple. John is the Manager of Accounts Receivable and Accounts Payable at a small, but growing, business. He is also responsible for managing petty cash. The company maintains \$10,000 in cash that employees could draw from to cover out of pocket expenses. The company Mia works for abruptly goes out of business. It is unable to pay salaries or provide severance. John and Mia quickly find themselves in serious financial distress. A few weeks pass and they find themselves \$5,000 behind in their bills, including their mortgage. The couple begins receiving nonstop calls from creditors. John rationalizes that he can borrow money from his company's petty cash fund. The petty cash fund has become antiquated because all employees were issued company credit cards. The fund is dormant and the Internal Auditor checks it on a quarterly basis. John theorizes he has a month to pay back the cash. By then, Mia should be working again or he can get a loan or find some other way to make restitution. John takes \$7,500 in cash. Unfortunately, Mia does not find a job, and their financial situation further deteriorates. The Internal Auditor schedules a review of the petty cash. At this point, would you consider John to be a fraudster? After all, his intent has been to pay back the \$7,500. Some people would contend this was a fraud. Many would also contend it wasn't because John's intent was to pay back the \$7,500, as a form of a loan. At this point, John rationalizes that if he set up a shell company, he could submit invoices to his company and pay the invoices with no one knowing since he controls receivables and payables. John quickly sets up a shell company, creates invoices and opens a bank account for the shell. Initially, John reasons that this is only



a short term fix and he intends to make restitution. As we can see, John's deception is growing, and the line between deception and fraud has blurred. John submits an invoice from the shell company, in the amount of \$7,500, for consulting services. A month passes. No one has questioned the invoice. John rationalizes that he can submit monthly invoices until his financial problems are straightened out. What actually happens is John establishes three more shell companies and continues to submit invoices for services not rendered. After embezzling over \$1,000,000, John gets caught.

This scenario depicts real life. Many individuals have done what John did in this case. There are all too many actual schemes where otherwise honest, truthful and trustworthy people have taken advantage of control weaknesses, and because of a combination of opportunity, pressure, and rationalization (the fraud triangle), they compromised their integrity and betrayed their sense of honesty, truthfulness and trustworthiness. What you find in all of these cases is that, just like John, the person involved had the capacity to follow through with serious acts of deception that became fraud. (Capacity, combined with opportunity, pressure and rationalization, represents the fraud diamond).

At what point should bank fraud investigators and AML compliance professionals have discovered John's scheme? Red flags were not discussed in the case study. In actuality, numerous red flags should have been evident. How can investigators and compliance officers distinguish truth from deception, and then deception from fraud? There are at least eight internal steps that can be taken to distinguish truth from deception and deception from fraud.

1. Know your customer

Knowing you customer, both from an individual and business perspective, is essential. Are representations made by customers reasonable and consistent with their employment or business activity? Reasonableness should factor into the level of due diligence performed. An important part of the "know your customer" process should be identifying changes in a customer's profile or activities.

2. Risk recognition

Understanding, recognizing and mitigating fraud and money laundering risks is one of the most important keys to preventing fraud and money laundering. When assessing risk, determine the reasonableness of the activities involved and the threat they pose. An important element of risk recognition is: understanding the crime problems that present the greatest risk. Understanding the crime problems will enable investigators and compliance professionals to better identify risk.

3. Determine intent

When making the distinction between truth and deception, and then deception and fraud, you must determine intent. When assessing the circumstances, you must be able to determine at what point truth gave way to deception and when deception became fraud. In analyzing the



chronology or flow of events, consider the reasonableness of the situation. In some cases intent will be clear cut. In others, intent will be difficult to establish. In those cases, more enhanced due diligence will be required.

#### 4. Transaction monitoring

An important component of an AML compliance program is transaction monitoring. A robust transaction monitoring system, one that contains both automated and manual processes, flags transactions that require additional scrutiny. In the process of analyzing those transactions, potential suspicious activity is identified. Such suspicious activity often points to fraud.

#### 5. Financial intelligence

Financial institutions serve as repositories for financial intelligence. The analysis of financial intelligence can serve as a meaningful tool in assessing suspicious activity and working through deceptive actions to identify fraud. Financial intelligence is also important for identifying current and emerging trends. Suspicious activity reports are a great source for financial intelligence.

#### 6. Review and assessment of actual case typologies

Reviewing and assessing case typologies, especially actual frauds perpetrated against your financial institution, is an invaluable exercise. This form of after action evaluation builds experience. It demonstrates how fraudsters exploited the financial institution to carry out their criminal activity and should result in identifying and diminishing systemic vulnerabilities to the institution.

#### 7. Targeted monitoring

One of the attractive features about fraud is that the fraudster is proactive. Fraud investigators and AML compliance professional are usually reactive. In adapting and using a targeted monitoring strategy, based on select typologies, you can implement proactive mechanisms to identify fraud. This technique has been used successfully by certain financial institutions, in partnership with law enforcement.

#### 8. Training

Training is a critically important element. By no means should it be considered a low priority. Awareness, understanding and recognition are gained through training and experience. All of the above steps can be greatly enhanced through sound and comprehensive training program.

