Managing Fraud Risk: First, Second or Third Line of Defence Responsibility?

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Board member ACFE Belgium
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- Any organisation of which the speaker is a member

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However, we invite you to participate in the discussion today and later on.

Patrick Risch
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Outline

Introduction

Fraud Risk Management
  • Prevention
  • Detection
  • Fraud Case Management
  • Repair and remediation

Ownership of fraud risk
  • When it comes to fraud, there are no winners
  • Three lines of defence

Conclusion
Outline

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Conclusion
BNP Paribas Fortis, a Belgian bank with international reach

October 2011
# BNP Paribas Fortis: A Belgian Bank with International Reach

## The No. 1 Bank in Belgium
- A comprehensive offer of financial services
- To private and professional clients, wealthy individuals, corporate clients, public entities and financial institutions
- Through a multi-channel network

## Clients
- 3.7 million retail customers in Belgium (1 Belgian out of 3)
- 1 million in Turkey
- Over 400,000 in Poland
- 300,000 in Luxembourg
- 35,000 corporate clients

## Staff*
- Total: 27,870 FTEs
- 16,940 in Belgium
- 4,570 in Turkey
- 2,600 in Poland
- 2,070 in Luxembourg
- Present in 15 other countries

## Strong Credit Ratings
- Standard & Poor's: AA
- Fitch Ratings: A+
- Moody's: A1

## Ownership
- BNP Paribas (74.93%)
- Belgian State (25%)
- Minorities (0.07%)

## Market Positions
- In Belgium: #1 in deposits, #2 in consumer lending
- Leader in Private Banking in Belgium, No.2 in Luxembourg
- Market leader in Commercial and Corporate Banking in Belgium
- European player in Corporate & Transaction Banking
- Strong positions in renewable energy, trade finance and cash management
- Challenger in Poland and Turkey

## Community Focus
- Sponsoring of sports (RSC Anderlecht since 1981-82, tennis federations) and culture & film (Queen Elisabeth International Music Competition, Film Days, et al)
- Corporate philanthropy via BNP Paribas Fortis Foundation, to combat poverty and social exclusion
- Doing business in a sustainable way and reducing our environmental footprint

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*31 Dec. 2010*
BNP Paribas Fortis: part of BNP Paribas, a world player with extensive geographical reach

- More than 200,000 employees in 83 countries - 68% working outside France
  - Sizeable operations in North America (also in retail banking), Asia, the Mediterranean and in Central Europe
  - 18th place (and number 3 bank) in the Fortune Global 500 company rankings

* Of which BNP Paribas Fortis: 17,150
BNP Paribas: An integrated business model

Individual customers
Finance and development
Group Tax Department
Group Legal Department
Group Compliance
Group Risk Management

Corporate customers

Financial Institutions

Retail Banking
BDDF, BNL, BNPPF, ME, BW, PF, ES

Investment Solutions

Corporate & Investment Banking

Human Resources
Brand Comm. & Quality
Information Technology & Processes
Inspection Générale
Key financial figures of the Group in 2010 (in EUR billion)

<table>
<thead>
<tr>
<th>BNP Paribas Group: Sustained business growth across all the operating divisions</th>
<th>BNP Paribas Fortis: pursuing sales and marketing drive; reaping benefits of restored franchise</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2010</strong></td>
<td><strong>2009</strong></td>
</tr>
<tr>
<td>Revenues</td>
<td>43.9 (+9.2%)*</td>
</tr>
<tr>
<td>Operating income</td>
<td>12.6 (+48.1%)*</td>
</tr>
<tr>
<td>Net profit</td>
<td>7.8 (+34.5%)*</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,998</td>
</tr>
<tr>
<td>Employees (‘000 FTE)</td>
<td>205.3</td>
</tr>
<tr>
<td>Cost/income ratio</td>
<td>60.4%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>12.3%</td>
</tr>
<tr>
<td>Tier 1 ratio</td>
<td>11.4%</td>
</tr>
</tbody>
</table>

Sustained business activity thanks to the Group’s active role in financing the economy:

- Successful integration of Fortis taking the Group to a new dimension: synergies reevaluated at EUR 1.2 billion (+33%)
- Decline in cost of risk (-42.6% vs. 2009) in an improved economic environment
- Profit-generation capacity reinforcing solvency organically: 2/3 of net income reinvested

- Fast-paced growth in mortgages and upswing in demand from small businesses
- Good asset inflows into sight deposits and savings accounts; decrease in term deposits
- Successful cross-selling with CIB for midcaps (syndicated loans, acquisition finance, bond issues)
- Limited rise in operating expenses (continued business development plan and IT investments)
- BeLux Retail Banking’s pre-tax income of EUR 688 million (double the 2009 level)
- Assets under Management of Private Banking Belgium rose 13.2% compared to 2009

* Change from 2009
2010 Net Income fifth highest in the world

Net income attributable to equity holders*

<table>
<thead>
<tr>
<th>Bank</th>
<th>Net Income (EUR m)**</th>
</tr>
</thead>
<tbody>
<tr>
<td>JP Morgan</td>
<td>13,144</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>8,791</td>
</tr>
<tr>
<td>Santander</td>
<td>8,181</td>
</tr>
<tr>
<td>Citi</td>
<td>7,959</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>7,843</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>5,721</td>
</tr>
<tr>
<td>UBS</td>
<td>5,152</td>
</tr>
<tr>
<td>BBVA</td>
<td>4,606</td>
</tr>
<tr>
<td>Barclays</td>
<td>4,151</td>
</tr>
<tr>
<td>Société Générale</td>
<td>3,917</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>3,628</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>2,683</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>2,310</td>
</tr>
</tbody>
</table>

*Source: banks; **Average exchange rate for 2010

Net income that reflects BNP Paribas’ position in the banking industry
Market capitalisation BNP Paribas

Market capitalisation on 5 September 2010

BNP Paribas = 64 billion euros

Ranking

World # 12
Europe # 3
Eurozone # 2
France # 1

ICBC 165
CCB 150
HSBC 138
JP Morgan 121
Wells Fargo 105
Bank of America 105
Agr. Bank of China 101
Bank of China 98
Citigroup 88
Santander 81
ITAU Unibanco 78
BNP Paribas 64
Goldman Sachs 62
Lloyds Tsb 59
UBS 53
Barclays 47
Credit Suisse 43
Unicredit 38
BBVA 37
Société Générale 33
RBoS 32
Deutsche Bank 31
Intesa SPI 30
Nordea 29
Morgan Stanley 29
Crédit Agricole 26

Source: Bloomberg
In summary BNP Paribas + BNP Paribas Fortis: a strong and reliable bank

- A leading Eurozone bank of international standing
- A diversified and integrated business model
- Solid ratings
- A healthy solvency and liquidity position
- Centering on local relationship and presence for the customer
- Very broad offering of skills and expertise
- Integration gives customers better access to financial services on European and world scale
- BNP Paribas Fortis remains a Belgian bank, with a strong investment of BNP Paribas Group to foster development in Belgium
### BNP Paribas: A model based on hybrid brands

<table>
<thead>
<tr>
<th>BNP PARIBAS PERSONAL FINANCE</th>
<th>BANCWEST BNP PARIBAS GROUP</th>
<th>BGL BNP PARIBAS</th>
<th>BICIG GROUPE BNP PARIBAS</th>
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<tr>
<td>BICIS GROUPE BNP PARIBAS</td>
<td>BMCI GROUPE BNP PARIBAS</td>
<td>BICIGUI GROUPE BNP PARIBAS</td>
<td>BICICI GROUPE BNP PARIBAS</td>
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<td>BICIM GROUPE BNP PARIBAS</td>
<td>BNL GRUPPO BNP PARIBAS</td>
<td>UBCI GROUPE BNP PARIBAS</td>
<td>مصرف راه امامی BNP PARIBAS GROUP</td>
</tr>
<tr>
<td>BMOI GROUPE BNP PARIBAS</td>
<td>UKRSIBBANK BNP PARIBAS GROUP</td>
<td>УКРСИББАНК BNP PARIBAS GROUP</td>
<td>BNP PARIBAS NAJMAH</td>
</tr>
<tr>
<td>TEB BNP PARIBAS JOINT VENTURE</td>
<td>BNP PARIBAS EQUIPMENT SOLUTIONS</td>
<td>First Hawaiian Bank</td>
<td></td>
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</table>

**BNP PARIBAS FORTIS**

The bank for a changing world
Outline

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- Prevention
- Detection
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- Repair and remediation

Ownership of fraud risk
- When it comes to fraud, there are no winners …
- Three lines of defence

Conclusion
Definition of Fraud

Every book, every magazine, every jurisdiction appears to have its own definition of *fraud*.

Most definitions encompass the following three key elements:

• Misconduct or abuse
• Deception
• Enrichment/benefit
Cost of fraud

Financial impact
- Direct losses
- Indirect losses
- Increased credit risk
- Cost of Fraud Management and recovery

Reputational impact
- Reliability
- Ethics

Psychological impact
Why do people commit fraud?

Some people are honest all of the time.
Some people are dishonest all of the time.
Most people are honest some of the time.
Some people are honest most of the time.

-Tommie Singleton, PhD, University of Alabama
Fraud Risk Management

Prevention and Early Detection → Fraud Case Management → Repair and Remediation
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Policy setting

Yet another policy?

ZERO TOLERANCE

Some important messages:
- What do we consider as fraud
- How do we expect management and staff to deal with fraud risk
- Who is responsible for managing fraud risk
- What to do in case of a fraud suspicion
- What the consequences are of fraudulent behaviour
Talking about fraud

Issues

• No one likes to talk about fraud.

• They don’t know how to talk about fraud.

• There are business targets to be reached.
Learning to talk about fraud

- The real and possible impact
- Words to talk about fraud
- An appropriate framework to cover the entire range of fraud possibilities

Fraud Risk Categories

Internal Fraud
- Occupational fraud

External Fraud
- Abuse of Powers and Authority (Corruption)
- Conflict of Interest
- Misuse of company assets
- Fraudulent Disbursements
- Fraudulent Financial Statements

Non Financial Assets
- Fraudulent Disbursements

Financial Assets
- Asset Misappropriation

Non Financial Assets
- Fraudulent Disbursements

Financial Assets
- Asset Misappropriation

Fraudulent documents
Learning to talk about Fraud

If you don’t know fraud, you won’t be able to:

• Recognise it in your daily operations
• Prevent it when designing processes
• Detect it when performing control tasks

Learning to know fraud

• Part of a training path for newcomers and for new managers
  – Integrated in product training
  – Cross-product
• Other trainings and road shows
• E-learning
Assessing fraud risk

Why?

• Focusing limited resources on most risky areas
  – Frequency/impact
• Creating awareness
• Thinking out of the box

Nice side effect

• Putting fraud on the agenda
Fraud Risk Assessment

Preliminary

- Get an overall starting point
- Objective Yes/No questions
- Covers the entire fraud universe

Assessment

- Discussion with Line Management, based on preliminary questionnaire
- Inherent and controlled risk
- Fraud Awareness Maturity

Wrap Up

- Compare the outcome of the different assessments
- Action plan
Preliminary questionnaire

- 40 Questions on 8 topics
  - Financial statements
  - Access to assets
  - Access to information
  - Transactions
  - Relationship with customers
  - Relationship with suppliers
  - Decision power
  - HR Policies

<table>
<thead>
<tr>
<th>Question</th>
<th>Y/N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is cash available?</td>
<td></td>
</tr>
<tr>
<td>Access to confidential information?</td>
<td></td>
</tr>
<tr>
<td>One-on-one relation with suppliers?</td>
<td></td>
</tr>
<tr>
<td>Decision power on customer acceptance?</td>
<td></td>
</tr>
<tr>
<td>…</td>
<td></td>
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</tbody>
</table>
## Assessment matrix

<table>
<thead>
<tr>
<th>Fraud risk category</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Internal Fraud</strong></td>
<td></td>
</tr>
<tr>
<td>Abuse of power</td>
<td>Illegal gratuities</td>
</tr>
<tr>
<td></td>
<td>Economic extortion</td>
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<tr>
<td></td>
<td>Bribery</td>
</tr>
<tr>
<td></td>
<td>Conflict of interest</td>
</tr>
<tr>
<td></td>
<td>Collusion</td>
</tr>
<tr>
<td></td>
<td>Misuse of assets</td>
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<tr>
<td>Asset misappropriation</td>
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<td><strong>External Fraud</strong></td>
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<tr>
<td>Fraudulent documents</td>
<td></td>
</tr>
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<td>Asset misappropriation</td>
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</table>
Fraud Awareness Maturity

- Based on objective criteria
  - Communication of policy
  - Training
  - Risk assessment
  - Quality of internal control

- Maturity levels
Fraud Detection

The haystack

- 70,000 new mortgage loans
- 450,000,000 transfers
- 3,800,000 cheques
- 600,000 physical coupon payments
- 17,000 staff members
- 1,300 branches
- …
Fraud Detection

• What are we looking for?
  – Kerviel, Madoff, Leeson?
  – The great train robbery?
  – The one big hit?

• Remember
  – Fraud can occur anywhere at any time.
  – Big fraud schemes usually start small.
  – Errors, anomalies … indicate weaknesses.
Fraud Detection

Risk-based approach

• How will a typical fraud scheme appear in your systems?
• Determine risk factors.
• Isolate high-risk transactions by means of data mining.
Managing fraud cases

Independent and objective inquiry

• To find out what actually happened
• To define clearly losses and responsibilities
• To maintain legal evidence
• To avoid cover-up
  – By the fraudster or an accomplice in an internal fraud case
  – By someone who made a mistake and thus facilitated an external fraud
Repair and remediation

Cleaning up the mess …

- Accounting
- Loss collection
- Reimbursing customers
- Recovery
- Legal action
- Disciplinary action

… and avoiding reoccurrence

- Lessons learned
- Revise and update controls in place
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Conclusion
When it comes to fraud ....

In practice: No one likes fraud
- A Fraud Examiner is always the bearer of bad news.
- Fraud detection routines only prove that everything is functioning as intended.

In theory: Two overall approaches
- Fraud control is just like any other internal control.
  - Management responsibility
- Fraud risk is too specific to leave it in the hands of a layman.
  - Responsibility of a dedicated department

... there are no winners
Three lines of defence .... in general

First line of defence — Operational management
  • Ownership, responsibility and accountability for assessing, controlling and mitigating risks
Second line of defence — Risk management/Compliance
  • Facilitates and monitors the implementation of the framework
  • Assist the risk owners in reporting
Third line of defence — Internal Audit
  • Provide assurance to the organisation’s board and senior management
Three lines of defence .... and fraud

First line of defence — Operational management
• Ownership, responsibility and accountability for assessing, controlling and mitigating risks

Training on how to recognise fraud

Tone at the top

Detective controls

Investigate incidents

Mr./Mrs. Anti-Fraud

Training on how to react when confronted with fraud

Preventive controls

Learning organisation
Second line of defence — Risk management/Compliance

- Facilitates and monitors the implementation of the framework
- Assist the risk owners in reporting
Three lines of defence .... and fraud

Third line of defence — Internal Audit

• Provide assurance to the organisation’s board and senior management
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# Conclusion

<table>
<thead>
<tr>
<th>Prevention and Early Detection</th>
<th>Investigation of Fraud Cases</th>
<th>Fraud Repair And Remediation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Culture of fraud risk awareness</td>
<td>Fraud Alert Line</td>
<td>Accounting entries and register losses.</td>
</tr>
<tr>
<td>Fraud Awareness Training</td>
<td>Process for fraud case management</td>
<td>Reimburse customers</td>
</tr>
<tr>
<td>Fraud Risk in Risk Assessment process</td>
<td>Investigate fraud cases in a professional and objective way</td>
<td>Disciplinary action</td>
</tr>
<tr>
<td>Fraud preventive and detective controls</td>
<td></td>
<td>Improve internal control</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Oversight on Fraud Risk Management</th>
<th>Report on fraud risk exposure</th>
<th>Post Mortem analysis and recommendations to Line Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guidance, advice and recommendations Fraud Risk Assessment methodology</td>
<td></td>
<td>Monitoring Fraud Risk exposure</td>
</tr>
<tr>
<td>Knowledge Centre on Fraud Risk Develop Fraud Detection controls</td>
<td></td>
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</tr>
</tbody>
</table>

Provide assurance to the organisation’s board and senior management
Conclusion

• Managing fraud risk is more than managing fraud incidents
• A fraud risk management framework, adapted to the needs of your organisation
• Make sure that all aspects of fraud risk management are allocated somewhere
  • Role of management
  • Fraud detection
    – A statistical approach
    – Looking into your systems
  • Let audit play its role
• Ensure coherence with the overall roles of risk and control governance
  • Create a second line function to maintain oversight

Questions?
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