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ROLE OF THE CENTRAL BANKS IN PREVENTION AND MANAGEMENT OF BANK FRAUDS

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Abstract. The present paper has a significant contribution to the expansion of researches related to the prevention and anticipation of bank failures. The actuality of the investigated subject results primarily from the necessity and importance of maintaining a stable banking system able to withstand strong internal and external shocks, and also from the necessity of permanently completing the regulatory framework in order to prevent some probable crises and bankruptcies in the future, taking into account the continuous development and the emergence of new risks in the banking activity. The scope of the present paper is based on identification of the ways of anticipating bank failures in the domestic banking system as a result of theoretical researches and studies of international practice facilitate the elaboration of concrete proposals with applicability in the process of streamlining the banking supervision in order to ensure the financial stability of the banking system and the prevention of bank failures.

Keywords: *anti-fraud policy, banking system, banking activity, bank risks, code of ethics, financial services.*

Introduction

The banking sector is continuously developing and the frauds occurred are showing the banking regulators the necessity of developing also the regulations and the procedures used to manage and prevent the bank fraud. Recently, banking sector business has become more complex with the development in the field of information and communication technology, which has changed the nature of bank fraud and fraudulent practices. Banks have more technology and more incentive than ever to combat fraud in electronic banking services. However, whether they have enough technology and incentive to protect consumers from the headaches of a compromised account, payment card or doubtful identity.

Banks have a legal obligation to undertake the following actions for detection of money laundering: customer due diligence, to follow certain transactions or activities, to collect, store and provide data for suspicious transactions and customers. The control of entry of criminal money is strengthened through legal provisions, their implementation. Most important is to recognition and identification of criminal money, their sources and of course taking legislative measures and action for submission of data on suspicious transactions of individuals and legal entities on domestic and foreign countries. In that way, banks should take appropriate measures and activities aimed at applying the correct legal decisions, and activities of education staff in order to recognize, identification “suspicious” customers, suspicious transactions, and reporting to the competent state bodies and institutions for financial intelligence and prosecution of perpetrators of crimes for acts arising from crime and money laundering. In addition, fraud imposes numerous costs to organizations that experience fraud. The banks might suffer loss in term of monetary, reputation, human capital as well as the exposure to the risk of bankruptcy. Nevertheless, while banks are active in the quest to reduce costs of fraud, it is important to make sure that they do not immensely deteriorate the effectiveness of current functioning key fraud controls.

Regulations and laws governing the financial services sector in Republic of Moldova are continuously evolving. Republic of Moldova is getting technical assistance from European Union, US Treasury Fund and other international entities in order to implement and develop the existing regulation in order to achieve a more sustainable and safer banking system especially after the occurred banking failure, and the ongoing fight with the search of true beneficiaries of bank in RM.

The present paper has a significant contribution to the expansion of researches in the field, related to the prevention and anticipation of bank failures. The actuality of the investigated subject results primarily from the necessity and importance of maintaining a stable banking system able to withstand strong internal and external shocks, and also from the necessity of permanently completing the regulatory framework, in order to prevent some probable crises and bankruptcies in the future, taking into account the continuous development and the emergence of new risks in the banking activity.

The scope of the present paper is based on identification of the ways of anticipating bank failures in the domestic banking system as a result of theoretical researches and studies of international practice facilitate the elaboration of concrete proposals with applicability in the process of streamlining the banking supervision in order to ensure the financial stability of the banking system and the prevention of bank failures.

1. Overview of the NBM actions

After the bank frauds occurred, it is essential to know and to understand who is responsible for preventing the frauds in the banking sector and who is responsible for liquidation the frauds results. In order to answer this question it is important to know that National Bank of Moldova is supervising the banking sector and ensures a stable and “healthy” banking financial sector. In addition, NBM is responsible for the process of liquidation the banks, ensuring the legal and profitable sale of the assets after a bank is declared bankrupt.

After the collapse of 3 banks occurred, on 24 of November 2014, a roundtable on the "Internal control system - an essential element of fraud prevention" was held at the National Bank of Moldova. Representatives of 14 licensed banks and members of the Association of Moldovan Banks attended the event, which opened the Anti-Fraud Week within the NBM. The Forum has set out to address the importance of anti-fraud instruments in the country's financial and banking institutions, given the intensification of the fight against this phenomenon at international level. It was mentioned the importance of implementing a well-organized, structured and regulated internal control system for combating fraud, whose functionality is based on the responsibility of each employee.

In order to prevent the bank frauds on 19 of December 2013 there was approved by the National Bank of Moldova The methodological guide for the implementation of anti-fraud policy and programs in RM banks [10]. The primary purpose of implementing anti-fraud policies and programs is to develop corporate culture and create an environment that inhibits fraud. It is the responsibility of all staff within banking institutions to help create such an environment that will lead to increased awareness of the risks and consequences of fraud.

The overall objective of the methodological guide is to provide recommendations for action to be taken to prevent and detect fraud [10]. The implementation of the recommended procedures will enable the bank to properly assess the risks of fraud, implement anti-fraud policies and programs in a way that allows sufficient deterrence to be achieved by staff and third parties in committing fraud. The proposed objective is to be achieved through the adoption of a strategic approach to the development of anti-fraud procedures and mechanisms, correlated with the international standards and requirements of the Treadway Commission (COSO).

Banks also need to understand the effectiveness of implementing a fraud management program, especially due to the specific nature of their activity, where people's money must be strictly in line with the safeguards and security rules indicated by the regulator.

2. NBM Anti-Fraud Policies and Programs

Internal control is designed to provide reasonable assurance that the overall objectives of the institution are attained. That is why setting clear targets by the Bank Board is a prerequisite for effective internal control.

The Committee for the Sponsorship of the Treadway Commission Organizations - COSO, has developed an integrated model of internal control. The purpose of the model is to apply the basic concepts of establishing an internal control system and determining its effectiveness. This methodology is embedded in policies, rules, procedures and regulations and is used internationally by many institutions to control their activities in order to achieve their goals.

The four general objectives of internal control are: accountability (and reporting), compliance (with laws and regulations), operations (systematic, ethical, economic and effective) and resource protection. Achieving these goals directly involves exposure to a range of risks, including the risk of fraud - inevitably the same as other risks, but can be controlled by developing and implementing specific control programs and procedures to detect, prevent and discourage fraud [7].

There is interdependence between the general objectives (what a bank aims to achieve) and the components of internal control (what is needed to achieve them).

Below there are the components of the internal counter, in accordance with the COSO model, through which the Bank's Executive Management can fulfill its responsibilities with regard to the development of anti-fraud control programs and procedures [7]:

- creating a control environment;
- evaluating the risks of fraud;
- planning and implementation of anti-fraud control activities;
- information and communication;
- monitoring.

For a better understanding and application of the five components of the COSO model in anti-fraud, each component is described and addressed in the following aspects:

- purpose and objectives;
- participants and responsibilities;
- elements and planning;
- performance management performance assessment;
- internal control system documentation.

The analysis of weaknesses in anti-fraud programs and controls is part of the overall assessment of the bank's internal control system. The Bank Board must establish the effective organization and functioning of anti-fraud programs and controls ensure that its assessments are fully documented, including the identification of any shortcomings. Similarly, to other internal control deficiencies, the bank's board and internal audit should assess the significance of identified deficiencies [10].

3. Internal Control Environment

The control environment consists of general attitude, awareness and measures taken by the board of the bank on the internal control system and its importance within the institution. The control environment determines the "tone" of the organization, influencing the "consciousness" of control at the staff level [11]. It is the basis of all the other components of internal control, ensuring a discipline and structure that needs to be respected within the organization so that the internal control system can be effectively applied. In addition, the internal control environment is an effective tool in preventing corruption and fraud. The elements that define the control environment are [3]:

- personal and professional integrity, ethical values set by management for all staff, including an attitude of permanent support for internal control;
- the continued concern of the bank's board for the level of competence of all staff;
- "The top tone" (the bank's philosophy and style of activity);
- organizational structure of the entity;
- policy and practices on human resources.

The control environment is based on the organizational spirit and is asserted by a firm commitment to integrity and ethical values. The board of the bank is independent of the bank's executive management, exercising the supervisory role of the internal control system. In order to achieve the objectives, the Bank Board, together with the Executive Board, establishes the directions concerning the supervision, organization, reporting and exercise of the competences assigned to the structural units of the bank. The institution shall ensure recruitment, training and the maintenance of appropriate staff. Within the institution, there are functions in charge of internal control in order to achieve the objectives.

The control environment must be omnipresent in both actions and communication and extend to all hierarchical levels of the banking institution. The control environment must create and maintain a corporate culture based on honesty, professionalism, high ethical standards, promoting proper ethical behavior, and applying appropriate sanctions to breach the code of ethics / conduct; to advocate for a firm attitude towards fraud, and to implement effective controls to prevent, deter, and detect fraud [6].

The Board of the Bank and the Audit Committee have a decisive role in strengthening the internal environment and significantly influences its elements. Organizational culture can be established or may be fatally undermined by the "top tone", that is, the philosophy and leadership style of leadership. The bank's board's independence from executive management, the experience and capabilities of its members, personal and professional integrity, ethical values, involvement and research, and the timeliness of activities play a very important role. The executive management of the bank, along with those responsible for monitoring the financial reporting process, are the first to bear the responsibility for creating the control environment. The Internal Audit function, in its turn, has a determining role in the context of establishing the control environment and must have an independent reporting system directly to the Bank Board. Employees also directly participate in the development of the control environment, as they can contribute to integrating and supporting anti-fraud programs and controls, reporting suspicions of fraud and drawing new insights into organizational culture assessments.

The control environment must involve a support attitude of the bank's board towards the requirements of internal control, which implies encouraging an organizational environment and a working atmosphere based on open communication, consultation and ethical values. The board of the bank should take reasonable steps to evaluate the organizational culture and ensure that an appropriate attitude is promoted within the bank. Regular organizational climate assessments can consist of questionnaires and anonymous surveys from executive management or internal auditing [1].

Promoting an appropriate corporate culture by the bank's board encourages ethical behavior, such as the development and enforcement of anti-fraud measures.

The Internal Audit function is important in assisting in the design, implementation and maintenance of anti-fraud programs and controls. Internal audit is responsible for identifying and evaluating significant risk exposures, evaluating anti-fraud controls, recommending risk mitigation measures, and improving internal control. Internal auditing can serve both in identifying frauds and in deterring them by reviewing and assessing the adequacy and effectiveness of the internal control system. Internal auditors may carry out proactive audit missions to detect corruption, asset misappropriation, and misstatement of financial statements, reporting results to the senior organ of the institution.

4. Code of Ethics

The Code of Ethics should include provisions on conflict of interest, related party transactions, unlawful actions, and monitoring by the bank's management of compliance with the rules of conduct. The Code of Ethics is defined as a set of written standards / norms, reasonably developed to prevent the commission of offenses and violations, and to favor [4]:

- ethical and honest behavior, including settling the current or apparent conflict of interest in relations between bank employees or third parties;
- complete, accurate, correct and comprehensible disclosure of information in reporting and reporting documents;
- compliance with the laws, regulations and applicable regulations in force;
- to immediately inform the internal responsible person about breaches of the code of ethics / conduct committed;
- impartiality and uniformity in relation to strict compliance with the Code of Conduct.

The Code of Ethics must be applicable to all employees of the bank. The bank's management is responsible for monitoring compliance with the Code of Ethics, which is reviewed and approved at Bank Board meetings. Banks must decide to develop a code of ethics for all employees, ensuring that it is fully understood and accepted to be respected by employees. It is recommended to organize periodically training courses for the staff of the bank with regard to the code of ethics, in order to inform them about how to access the code of ethic and the indication of the persons to whom they can address in case questions and dissatisfactions arise over the policies adopted by the bank.

The Board of the Bank must respond objectively and in a timely manner to the occurrence of deficiencies in control procedures, significant statements or significant fraud, or non-compliance with the Code of Ethics.

The Bank Board is responsible for strengthening and enforcing the procedures necessary to deal with fraud complaints, and the initiation of investigations must be carried out in a timely manner. Fraudulent activities need to be taken promptly and appropriately, and any fraud committed involving executive management, whether material or not, should be reported directly to the Board of the Bank, the Audit Committee (if any) and external audit. Under certain circumstances, such as those involving executive management, it is recommended to launch detailed and independent investigations using external specialists. The board of the bank must ensure that major control deficiencies are removed within a reasonable time. Similarly, the board of the bank should ensure that appropriate and timely disciplinary action is taken on those who have violated the Code of Ethics, which would express the executive's commitment to the ethical values and strengthen the intolerance towards fraudulent or inappropriate behavior.

5. Evaluation of fraud risks

The purpose of entity risk management is to enable an entity's board to identify the element of uncertainty in achieving the objectives set and the associated risk (decisions on measures to mitigate or eliminate it), taking into account values such as equity and justice, the opportunity to add value, to provide more efficient and effective services. The risk management process involves:

- identifying risks in relation to the institution's objectives, including those caused by internal and external factors at institution and activity level;
- assessing the likelihood and impact of risk;
- consider the degree / level of acceptance of risks by the management of the institution;
- formulation of residual risk responses / determination of actions to be taken.

Principles underlying the risk assessment

- it sets its objectives with sufficient clarity to make it possible to identify and assess the risks involved in achieving the objectives;
- identifies and analyzes the risks in relation to the achievement of the established objectives;
- consider the possibility of fraud in the risk assessment;
- identifies and evaluates changes that may have a significant impact on the internal control system.

Purpose and objectives

Bank fraud risk assessments should be conducted at the level of the banking institution, taking into account the internal and external pressures and factors of the bank, at the activity level, considering the stages of decision, authorization, at the level of balances, focusing on accounts that could be significantly distorted, at the level of key subdivisions, as the risk of fraud occurs in different forms, depending on the type of activity line, organizational structure, corporate culture, etc.

Fraud risk assessment requires a focus on possible fraud involving collusion and the risk of driving controls being violated. Collusive fraud is explained by intentional and conspiratorial understanding among several people inside or outside the bank, which contravenes or implies violation of internal control activities. In most cases collusive fraud can not be identified by the usual testing techniques.

Participants and responsibilities

The Bank Board has the role of evaluating the executive management's performance in identifying the risks of fraud and must play an active role in overseeing the fraud risk assessment process. Executive board has the primary role of conducting fraud risk assessments.

Subjects seeking to obtain a material benefit are usually controlled by executive management and identified by employees and those responsible for corporate governance at other levels within the organization. Therefore, in evaluating the risk of fraud, it is essential that employees outside the executive management are also involved as process managers or those who demonstrate control skills, or have an influence on activities within critical business processes.

IT management must be one of the participants in identifying the risks of fraud, as some fraud schemes are favored by circumvention or deactivation of information technology controls.

In addition, the active involvement of internal audit in the conduct and ongoing monitoring of fraud risk assessments is very important.

Elements and planning

The fraud risk assessment needs to be carried out, documented and updated periodically. Updates should include changes in operations, adaptation of new IT systems, acquisitions, changes in the role and responsibilities of the position, organizational structure, self-assessment results of controls, activity monitoring, internal audit findings, new or successive trends in the field and review the identified fraud risks within the bank or the entire banking system.

Executive leadership should identify events or conditions that indicate incentives / pressures in perpetuating fraud, fraud opportunities or attitudes / rationalizations that justify fraudulent action –factors of fraud risks. Factors of fraud risk do not necessarily indicate the existence of de facto fraud, yet they are often present in circumstances where fraud persists and may serve to identify potential risk of fraud.

Investigating risk factors and evaluating fraud patterns and scenarios in order to identify those that may pose a risk of fraud is the responsibility of the executive management, which must provide for possible fraud schemes and scenarios. Identifying the risks that may lead to significant misstatements by committing fraud requires professional judgment and involves direct focus on risk characteristics: types; amplitude; probability; omnipresence.

Although the purpose of fraud risk assessment is not to identify insignificant risks (for example, avoiding non-essential office items), it is important to note that inappropriate behavior can signal and uncover the existence of major problems in the control environment. It is therefore advisable to report any fraudulent action, whether these are more or less significant, involving people in management structures or employees with / without an important role in developing internal control procedures.

Fraud risk assessment should be done without taking into account the effectiveness of internal controls. It is important that fraud risks are identified, documented and evaluated before the bank's board determines whether the existing control procedures sufficiently mitigate the identified fraud risk. Subsequently, during the development and implementation of anti-fraud procedures, identified fraud risks need to be addressed through anti-fraud control activities to ensure that all identified fraud risks are reduced and controlled to a sufficient level.

Management of Bank Board Performance

The bank's board needs to assess the effectiveness of the fraud risk assessment process and its functioning. Examples of situations or circumstances that may indicate that fraud risk assessments are not working effectively may be for example the involvement in the process of monitoring executive management and internal audit is insufficient, the frauds that have occurred indicate that the fraud risk assessment process is ineffective, external audit identifies fraud risks that were not originally identified by the bank, etc.

Documentation on internal control activities

The documentation must be complete and appropriate so that auditors know / understand how anti-fraud controls work.

Documentation on fraud risk assessment may include:

- periodic updates, including consideration of previous fraud, fraud risks and involvement of the targeted employees;
- monitoring and reviewing the process of fraud risk assessment by executive management;
- internal audit participation, including testing the effectiveness of the risk assessment process and internal control procedures;
- the assessment by the executive management of the fraud risk factors to determine;
- which of these are identified as fraud risks;
- the assessment and conclusions of the executive management on the effectiveness of the fraud risk assessment process.

Conclusions

- Economy of RM suffered essentially from the occurred frauds especially suffered the population by enduring the fast growing of the price of living. Because of ignoring by the board of three bank the risk reports of the responsible departments and approval of the loan contract, the three banks get bankrupt. In such a way we can surely note that the most important and decisive role in the fraud was the management of the banks. The involvement of the RM authorities into the money laundry, made the reputation of RM bank industry and country to low significantly and to lower the chances of RM into receiving forward technical assistance and international investment.
- The primary purpose of implementing anti-fraud policies and programs is to develop corporate culture and create an environment that inhibits fraud. It is the responsibility of all staff within banking institutions to help create such an environment that will lead to increased awareness of the risks and consequences of fraud.

➢ A low developed Core Banking systems is one the main reason a bank fraud occur, the cost of developing it is usually lower than the fraud losses (according to the Indian bank experience). There is no simple way to squash fraud, but by implementing the right mix of technologies and prevention techniques, treasury executives can greatly reduce the fraud risk. It is always important to know who is responsible for fraud detection and who is responsible for fraud prevention in order not to mix these duties with others and to leave them as a duty to do when you have time.

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