

BANK DEFALCATIONS

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When Mr. Meibuhr asked me to speak to you on the subject of bank defalcations, I was very happy to accept the invitation even though it is not a pleasant topic to discuss. It is my opinion that no other group of bankers is better qualified to do something about this deplorable situation than the National Association of Bank Auditors and Comptrollers. Your organization has already taken steps that will reduce the number of defalcations by developing and introducing internal controls and audit procedures.

As you well know, dishonesty on the part of bank employees is a very serious problem. However, human frailty is not a problem that is confined to banking alone. Unfortunately, it is found in every field of human endeavor--both public and private. Moreover, it is not a problem that is peculiar to this generation. Dishonesty, deception, and fraud have existed as long as there have been human beings. Two of the ten commandments, written thousands of years ago, are concerned with this aspect of human behavior. But because this problem is old and widespread and persistent is no reason for complacency. Bankers, especially, should make every effort to eradicate this evil from their profession. They are responsible for the funds of their depositors, and must have the respect and confidence of the public if they are to perform their proper function in our economy.

The Federal Deposit Insurance Corporation is acutely conscious of this problem, for since 1934 defalcations were the direct cause of the

financial difficulties in about 25 percent of the banks where it has been necessary for the Corporation to advance money to protect depositors. During the last six years, 19 banks have been merged with the financial aid of the Corporation. There were large defalcations in 16 of them. In one of the three other banks, the difficulties resulted from a kiting operation by a customer, but without the knowledge of the bank. In only two cases, then, were the financial difficulties caused by poor loans.

The Corporation has been concerned with this problem for many years, and our Division of Examination has studied it from many angles. Early in 1950, it was decided to bring together in one place all of the available information to provide a better guide for correction of this unwholesome condition. The first step was to get a measurement of the number of bank defalcations by years since the end of World War II. The ultimate purpose, of course, was to then make a study of recent cases to determine methods of prevention.

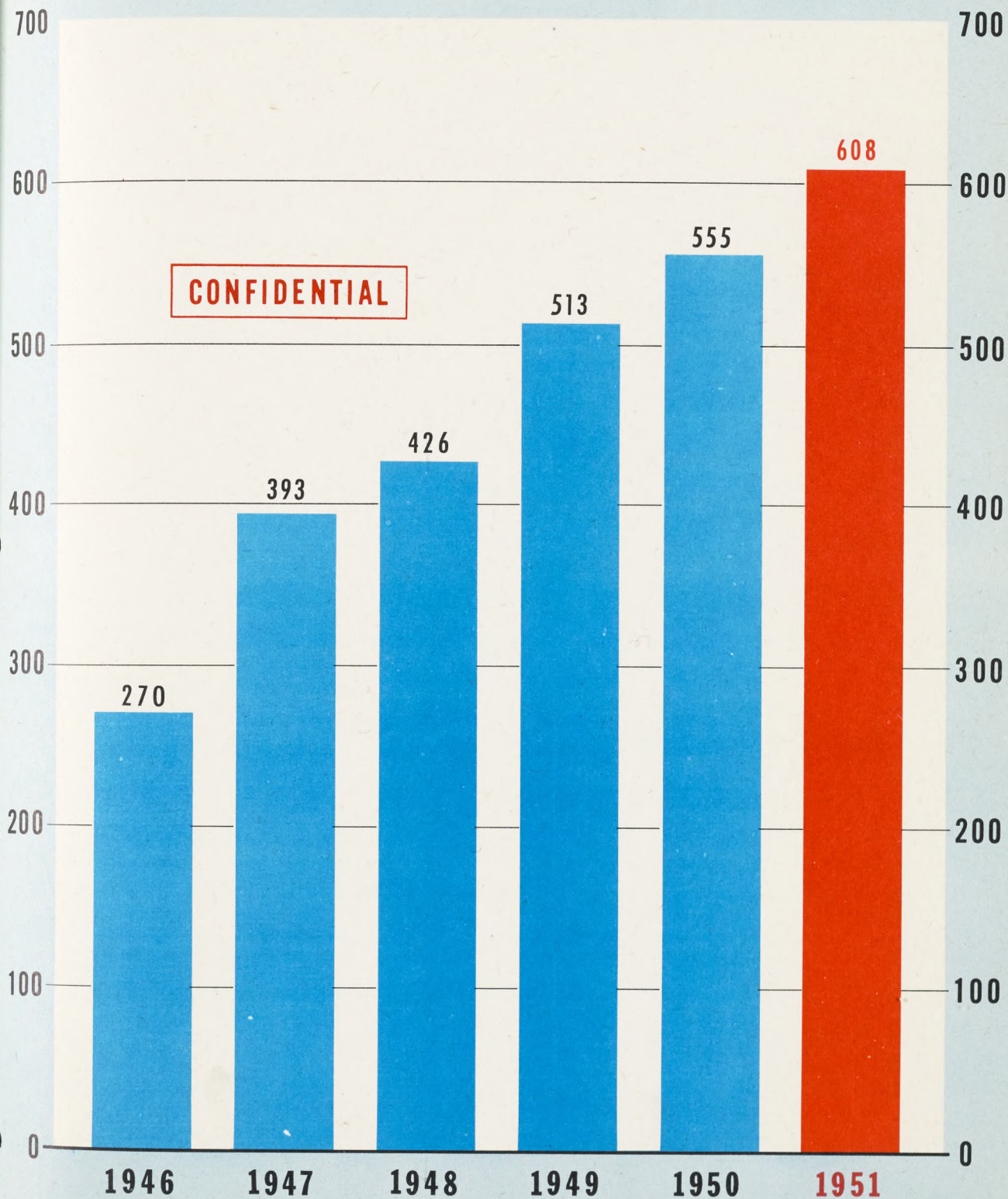
The three Federal agencies dealing directly with banks report to the Department of Justice all irregularities in insured banks that appear to be a violation of Federal law. Arrangements were made to have the Comptroller of the Currency and the Federal Reserve Board furnish us with the number of their reports by years beginning with 1946. After eliminating armed robberies and supplemental reports, we combined them with our own and used them as a basis for measuring the trend in the number of defalcations in insured banks. The results were startling.

Growth in defalcations. As you can see from the accompanying chart, the number of defalcations reported to the Department of Justice has shown a steady year-by-year increase, from 270 in 1946 to over 600

DEFALCATIONS

NUMBER REPORTED IN ALL INSURED BANKS

1946 - 1951



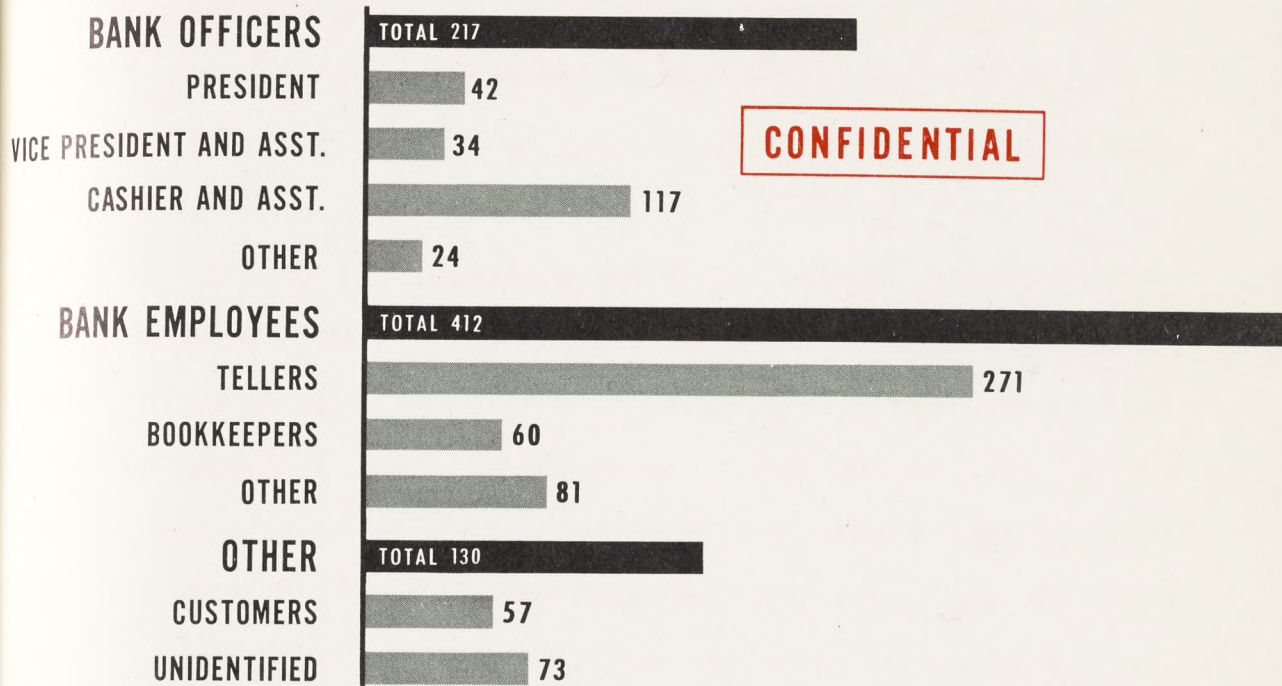
in 1951. This is an increase for the six years of approximately 125 percent. Percentagewise, the increase last year was less than average, but it was still ten percent. This steady growth is of grave concern to bankers, bank supervisory agencies, and all friends of our American system of free enterprise banking. Every effort must be made to reverse this trend.

The compilation and analysis of the relevant facts with regard to defalcations are the necessary basis for an effort to cope with this serious problem. Accordingly, the other two banking agencies were asked to furnish us with summaries of their current reports. This they did, and for 1951 we have data on all the cases of defalcations in insured banks reported to the Department of Justice. We have answers to such questions as: Who were the guilty employees? How did they attempt to conceal their irregularities? How much did they steal? How were their misdeeds discovered? Answers to these questions should suggest methods for detecting most irregularities. If disclosure is prompt and certain, and punishment severe, many of these crimes will never be committed.

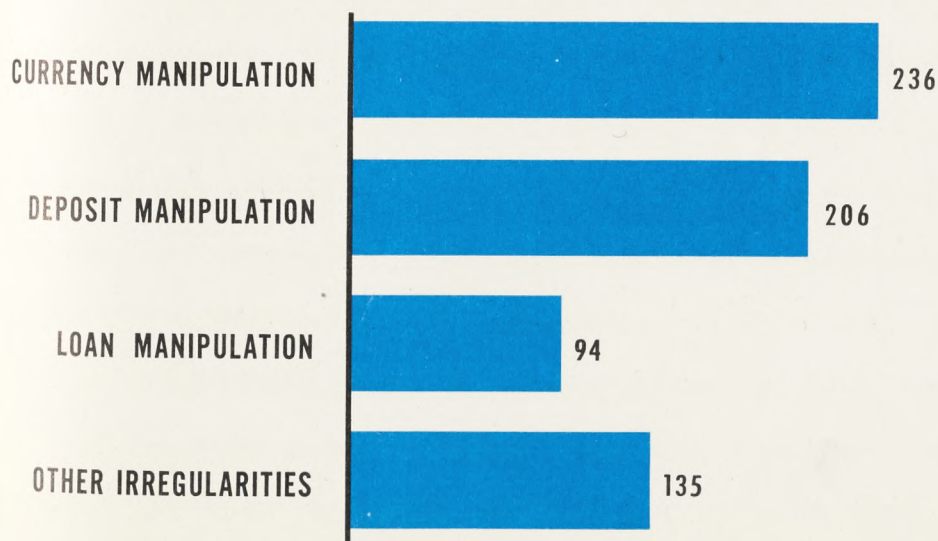
Status of persons involved. Our study shows that in the 608 criminal reports in 1951, there were 759 persons involved--217 bank officers, 412 bank employees not officers, 73 unidentified employees, and 57 customers. It is significant that defalcations by bank employees occurred only about twice as frequently as by bank officers, even though employees outnumber officers approximately four to one. In other words, on the basis of the number of persons working in banks, embezzlements on the part of bank officers occurred more than twice as frequently as on the part of other employees. To be more precise, there were 30 defalcations

DEFALCATIONS

STATUS OF 759 PERSONS INVOLVED IN 608 REPORTS COVERING ALL INSURED BANKS • 1951



ANALYSIS OF IRREGULARITIES INVOLVED IN 608 REPORTS COVERING ALL INSURED BANKS • 1951



for every 10,000 officers and only 13 for every 10,000 employees who were not officers. The reason for emphasizing this point is that in most of the banks which have failed because of shortages, the chief executive officer was the person responsible. These were "one man" banks where the president or cashier was in complete control and the few other employees were dependent on him for their job. This is the reason the shortages could grow to a size great enough to wreck the banks. No internal control or audit procedure can remedy this situation. Under these circumstances, bank directors and bank examiners are the only ones that can discover the irregularities.

Types of irregularity. Statements are sometimes made as to the exact number of ways an employee can embezzle a bank's funds. I certainly do not profess to know all of them nor would I venture to say how many there are. Your Manual states the only limitation is the "bounds of the defaulter's imagination." This study shows the number is great and the variations almost infinite. To classify the methods of concealment so that the categories will mean something to professional people like yourselves and others concerned with the problem, and yet to keep the classification concise and within reasonable limits is quite a problem. With this in mind, we classified the defalcations reported in 1951 into four main categories--cash manipulations, deposit manipulations, loan manipulations, and other irregularities. Each of these four main categories is divided into several sub-classifications.

Cash manipulations. For the purpose of this report, cash manipulations are defined as the abstraction of cash without a false entry on the books of the bank to conceal the irregularity. This type of embezzlement,

C O N F I D E N T I A L

DEFALCATIONS

ANALYSIS OF IRREGULARITIES INVOLVED IN 608 REPORTS
COVERING ALL INSURED BANKS, 1951

Type of irregularity	Frequency of irregularity
Total	<u>671</u>
Currency manipulation - total	<u>236</u>
Vault cash	26
Tellers' cash	175
Cash items	14
Miscellaneous	21
Deposit manipulation - total	<u>206</u>
Withheld deposits	58
Unauthorized debits	55
Dormant accounts	11
Pulled ledger sheets	7
Collusion in overdrafts	8
Collusion in kites	18
Kites - no collusion	17
Employees kiting or otherwise manipulating own accounts	17
Individual or Savings ledgers exceeded controls	7
Miscellaneous	8
Loan manipulation - total	<u>94</u>
Withholding payments	
Principal	28
Interest	14
Forged, fictitious or otherwise non bonafide notes	19
Irregularities in employees' personal obligations to bank	9
Loans and Discounts short of general ledger controls	8
Miscellaneous	16
Other irregularities - total	<u>135</u>
Misappropriation of bank income	16
Bank expense irregularities	12
Manipulation of correspondent bank accounts	10
Misappropriation from organi- zations and trusts	10

Type of irregularity	Frequency of irregularity
Manipulation of cashiers and treasurers checks, drafts, money orders, etc.	8
Misappropriation of proceeds of U. S. bonds, travelers checks, etc.	7
Withholding payments on collection items	3
Abstraction of checks before cancellation	5
Acceptance of gratuities, fees for loans, etc.	6
Unauthorized salary increases, advances, bonus	5
Misappropriation of customers' property	9
Miscellaneous	44

Federal Deposit Insurance Corporation
Division of Research and Statistics
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which includes mysterious disappearances, occurred 236 times, more frequently than any other. These manipulations occurred most frequently in tellers' cash, where 175 shortages were reported. Vault cash was involved in 26 reports.

A rather interesting case was a \$1,350 shortage in the vault cash in one of the large New York City banks. Bags containing \$50 in pennies were labelled with \$500 dime tags by someone unknown at the time the report was made.

An example of lack of control is revealed in a report of a teller's cash shortage of \$1,500. Before the bank opened one morning a teller reported his cash short \$1,500. He stated it had all been there the night before. Up to that time, it was the custom for each of eleven tellers to separate his cash by divider cards on which his cage number was marked and to place the bundles of cash on a shelf in the vault where it remained until time to close the vault door. Then the head teller would gather them up and place them in an inside safe. Any one of 34 officers and employees had access to the vault while the money was on the shelf, so it was impossible to place responsibility. The management states that this procedure has now been changed.

Cash manipulations also included 21 miscellaneous types such as theft of cash by mail clerks, secretaries and janitors, and shortages in armored car shipments.

Deposit manipulations. After cash manipulations, the next most frequent type of irregularity involved manipulations of deposit accounts totaling 206. Although the data are not yet completely available, the evidence seems to be that most of the large defalcations are in this category.

The well-known procedures of withholding deposits or making unauthorized charges to deposit accounts occurred in a total of 124 cases, of which 11 were in connection with dormant accounts.

A shortage of over \$360,000 was concealed by a teller by pulling savings ledger sheets during examinations in one of the Pittsburgh area banks, shortages of which have received considerable newspaper publicity. How could he manage this? It was quite simple. The commercial ledgers were kept on the second floor of the bank, but the four savings ledgers were posted and kept in the banking room immediately adjacent to the tellers' windows. This man made it a point invariably to come to the bank before anyone else. He used this as a pretext to assume the responsibility of taking the trial balances on the savings ledgers. He admitted that at the time of the last four examinations during which these defalcations were going on he succeeded in quickly removing ledger sheets when he saw the examiners coming in the front door. In the fifteen months preceding discovery, this man financed the drilling of fourteen oil and gas wells, became a substantial stockholder in several corporations, and maintained accounts with stockbrokers in his own city and in Canada--all on a teller's salary. Altogether there were seven cases of pulled ledger sheets.

The largest shortage reported during 1951, amounting to $2\frac{1}{2}$ million dollars, is classified as a deposit manipulation under the heading of "Collusion in Overdrafts." The case involved the withholding of checks of numerous customers, some of which created overdrafts in amounts ranging up to over \$1,500,000 when finally posted. It appears that for at least four years the assistant head bookkeeper had been withholding checks either permanently or until a later date. Another bookkeeper carried on the deception

for him whenever he was absent. One of the duties of the assistant head bookkeeper was to receive from the individual bookkeepers all of the checks which could not be posted on account of insufficient funds, supposedly to have such items designated for posting or for return by an officer. Whenever the checks of certain companies appeared on this list, the assistant head bookkeeper removed them and did not submit them to an officer for approval. Concealment was managed by adding to the debit total given to the culprit by the individual bookkeepers at the end of each day's business, the amount of the items withheld during the day and then giving this improper total to the general bookkeeper. Thus the books balanced, but the general ledger reflected an amount which eventually was less by over two million dollars than the balance reflected in the individual ledgers. This was possible because the individual ledgers had not been run simultaneously since early 1947. Upon discovery, nineteen persons were indicted, including the customers whose accounts were involved.

Collusion in overdrafts and collusion in kites accounted for 8 cases and 18 cases, respectively. The amounts involved in these cases are frequently large, as indicated above. The shortage of around \$900,000 in the one bank so far this year in which we advanced money to protect depositors consisted largely of an overdraft of one customer of the bank. This case is not included in the 1951 study. It appears that your Bank Fraud Prevention Committee is well supported in its statement made in Bulletin No. 8, December 1, 1951, "The most disturbing factor has been the increase in losses involving customer collusion."

In addition to the 18 cases of kiting operations with collusion, there were also 17 cases where apparently there was no collusion on the part

of anyone in the bank. Not all of these kiting operations resulted in loss. However, one case resulted in the bank having to be merged with another bank with the financial assistance of the Federal Deposit Insurance Corporation. This was a very small bank, run by an individual who insisted he did not understand what a kiting operation was--and presumably he was honest.

Loan manipulations. Just as the withholding of deposits was the most frequent type of deposit manipulation, so the withholding of principal or interest payments was the most frequent type of loan manipulation. There were 42 of these cases. An example of this is the case of a shortage of almost \$57,000 in a savings bank perpetrated by an assistant secretary. The manipulation which occurred over a 10-year period, represented the ledger balances of 39 mortgages which the borrowers had satisfied in full but which had never been shown on the books as paid. Another case is almost incredible. An officer withheld interest and principal payments on several notes. Since the notes appeared to be in default, the directors of the bank were advised to charge them off, which they did. The officer then recommended their sale for \$100, and purchased them himself. He thus removed from the records of the bank the notes that eventually implicated him.

Forged or fictitious notes are also used to conceal embezzlements. Our study revealed 19 such cases. In one, funds totaling \$47,000 were abstracted during the period 1939-51 through the medium of fictitious installment notes. The required payments of both interest and principal on the notes were made by the defaulter. The money to do this came from additional installment notes of the same type. I hesitate to mention to this group that the defaulter in this case--of all people--enjoyed the title of Auditor. Collusion appears in another case of this type. Conditional

sales contracts were purchased by a bank from an automobile dealer, who was permitted to make collections on the notes and remit to the bank. Soon forgeries and other irregularities developed in this paper, and shortly thereafter officers and employees of the bank were involved.

Other irregularities. A total of 135 violations are grouped under other irregularities, because they did not occur frequently enough to justify a separate classification. Misappropriation of bank income by withholding service charges, safety deposit rentals, exchange collections, insurance commissions, and the like accounted for 16 of these, more than any other type in this category.

Two of the large Pittsburgh area defalcations--one of \$600,000 and another of \$625,000--were perpetrated by manipulating the correspondent bank account. In one of these banks, the Federal Deposit Insurance Corporation found it necessary to protect depositors by financing its absorption by a sound insured bank. The other bank had a surety bond of \$350,000 against the \$625,000 shortage, but was in a position to take care of the capital impairment. We classified 10 irregularities as a manipulation of correspondent bank accounts.

As one might expect, there were cases of bank officers acting in a dual capacity and taking advantage of the situation. Among them were a village treasurer, a treasurer of the county cancer society, a treasurer of a church, and one who acted in a fiduciary capacity for an estate. One officer was treasurer of several organizations and had withdrawn \$48,500 from accounts under his control. Just the other day we received a report stating that the president of a bank who was also treasurer of a hospital had made unauthorized withdrawals from the hospital's checking

account and had sold \$25,000 worth of United States Government bonds belonging to the hospital. He used the funds chiefly to finance his son, who was an unsuccessful businessman. Our study shows 10 cases of misappropriations from organizations and trusts.

Amount involved. The figures on the amounts involved in the reported defalcation cases require a word of explanation. These figures derive from the amounts as shown by the reports, which are made as soon as defalcations are discovered and before a complete audit has been made. In some cases the final figure is larger than the amount available to us as we make the study. On the other hand, the figures do not represent the loss to the bank or to the bonding company. Restitution was made in some cases, recoveries were effected from customers involved in others, and some appear to be less than was first reported. For example, as stated above, the largest defalcation was $2\frac{1}{2}$ million dollars. This was first reported as $1\frac{1}{2}$ million dollars. In this case the surety bond was \$650,000 but as a result of large recoveries from some of the depositors whose overdrafts had been concealed, the net loss to the bank will not exceed \$50,000 according to our latest information. The total amount involved in all the cases in 1951 was over \$8,000,000.

For previous years, we have dollar amounts only for insured State banks not members of the Federal Reserve System. The number of reports and the amount involved in defalcation cases reported by the Corporation for the past six years are as follows:

<u>Year</u>	<u>Number of reports</u>	<u>Amount</u>
1951	246	\$1,826,000
1950	179	1,676,000
1949	156	1,387,000
1948	137	1,385,000
1947	116	1,848,000
1946	67	458,000

In 438 of the 608 cases reported in 1951 by all three agencies, the amount involved was less than \$5,000 and in 149 cases it was over \$5,000. Twenty-one reports did not specify the amount involved. I want to repeat that these figures on amounts are subject to a considerable margin of error. As a whole, they probably are understated rather than overstated.

How discovered. In his letter asking me to discuss bank defalcations, Mr. Meibuhr suggested that information as to how they are disclosed would be helpful. Our study includes a preliminary analysis of the methods of discovery. However, many of the reports do not give much detail on the method of discovery. All too many of them merely state the shortage was discovered by the bank or was discovered in the ordinary course of business. The tabulation we have made shows the following:

<u>Method of discovery</u>	<u>Total</u>
<u>Total</u>	<u>608</u>
By bank in ordinary course of business	266
Examination	169
Customers or other banks	54
Audits and verifications	21
Special checks by employees and officers	20
Vacations, illnesses, suicide, absences	19
Voluntary admission	10
Postal inspectors' investigations	3
Not reported	46

You may be interested in how some of the specific cases referred to were discovered. The big one, the $2\frac{1}{2}$ million dollar shortage, came to light as the result of an inquiry by a C. P. A. employed by a customer to audit the customer's books. He found discrepancies in dates on which certain checks were charged to the customer's account. An inquiry to the bank led to the assistant bookkeeper's confession.

The teller's shortage in the savings ledger was detected when the bank undertook an analysis of deposit accounts by size for the special call to all insured banks by the Federal Deposit Insurance Corporation in September.

A complaint from a customer whose account was charged for interest on a mortgage that she had paid in full was bad news for the assistant secretary who had carried the 39 paid-up mortgages in the bank's assets.

The \$600,000 shortages in the two banks in the same town near Pittsburgh, which were concealed in the correspondent bank accounts, were turned up by the examiners.

A shortage of over \$10,000 in one bank was disclosed when a depositor wrote in asking the transfer of her savings account to a checking account. The funds in the savings account had been withdrawn by a teller who happened to be on vacation when the request came in.

A shortage of \$10,000 in a Puerto Rico bank was discovered during the audit and transfer of reserve cash in connection with the regular rotation of officers and employees. The audit and transfer were set for June 30. On June 29 the defaulter died, and when the audit was made on July 2 cash was found to be \$10,000 short.

This seems unlikely, but discovery of the shortage involving the bags containing \$50 in pennies labelled with \$500 dime tags came about by a report from a customer.

A teller reported incorrect totals for his cash on hand, he was out sick later and a substitute teller found the cash \$10,000 short.

At 8:00 A. M. the examiners arrived at a bank in Kentucky. At 8:10 one of the tellers came to the door and the janitor told him the bank had "company" (meaning bank examiners). The teller turned around, walked away, and has not been seen since. His cash was approximately \$20,000 short.

A comptroller's check of delinquent safety deposit box rentals revealed a case of misappropriation of bank income.

An auditor's investigation of loan interest accruals disclosed withheld interest payments of about \$3,000.

A treasurer, becoming suspicious upon observing a decrease in the bank's income from service charges, made a check of one month's income from this source and found the head bookkeeper had been crediting a portion of the aggregate service charges to the bank income account and a portion to his own account, to the tune of a \$3,400 shortage.

A deacon became suspicious when the church collections began to fall off, and unbeknown to the banker-treasurer counted the cash in the collection plates one Sunday. He found the banker had abstracted a substantial amount.

Conclusion. In closing I want to urge NABAC to continue its fight against this plague that has afflicted so many banks. It is my hope that the information developed by our study will assist you in your campaign. I am not making any specific suggestions as to how you should procede, for

you are experts in the field of internal controls and audit procedures. However, I want to suggest that you have as your ultimate objective the eradication of this evil. If we can eliminate defalcations in our banks, we will increase the prestige of our profession, save money for our institutions, reduce the greatest single cause of bank failure, and save our fellow employees and their families from shame and disgrace.