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Financial Industry Security: A Qualitative Study for Reducing Internal Fraud in Banking Institutions

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〈Abstract〉

Because financial industry is closely related to the daily lives of people, internal fraud such as embezzlement by the employees can cause serious damage to the national economy, including credit crunch and contagious bankruptcy, as once demonstrated in the Savings Bank Scandal in 2011. Therefore, the importance of financial industry security is being emphasized and developed into converged security that combines physical, human and cyber security. In this study, to prevent fraud caused by internal employees in Korean financial sector, in-depth semi-structured interviews were conducted with a total of 16 participants including bankers, officials of financial regulators, and security experts, who were in charge of risk management in the industry. The collected data were analyzed at three stratification levels such as individual, organization, and socio-cultural factor. Based on this analysis, policy recommendations were suggested for the development of financial industry security and reducing internal fraud in banking institutions.

주제어 : Financial Industry Security, Internal Fraud, Bank Fraud, Qualitative Study, Financial Institutions

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목 차

Ⅰ. Introduction

Despite Sutherland's insight and ground breaking contribution to the neglected spectrum of crimes (Sutherland, 1961), 'white-collar crime' has been criticized by many scholars for the lack of clear definition (Coleman, 1987; Felson, 2002; Friedrichs, 2010; Haelterman, 2016). However, Marcus Felson, the Routine Activity Theorist defined white-collar crime in a novel way as 'crimes of specialized access' (Felson, 2002: 119). According to him, occupations, professions, and organization provide offenders with practical routes to their targets and legitimate features of the work-role offer a chance to do misdeeds. For instance, knowing passwords helps in breaking into accounts and the responsibility of control of organizational assets provides an opportunity to misuse them (Felson, 2002). To put differently, white-collar crimes are violations of the law committed in the course of a legitimate occupation and the goal of the vast majority of white-collar criminals is economic gain or occupational success that may lead to economic gain (Coleman, 1987: 407-408). In this regard, financial industry is one of the perfect arenas that may provide likely offenders with 'legitimate' and 'specialized' access to many opportunities, such as tremendous daily financial transactions at work (Hollow, 2014).

As a result, banking institutions are commonly a subject of study from the various academics ranging from security studies to criminal justice studies (Black, 2013; Ghosh, 2012; Mitchell et al., 1992; Saunders and Cornett, 2008). For example, a number of economists have proposed that financial crises, such as failures of banks, are not anomalies, but are inherent and cyclical features of advanced economies (Minsky, 2008; Roubini and Mimh, 2010). According to Minsky's financial instability theory, "success breeds excess, excess breeds failure." In time of economic prosperity, banks make more loans to finance speculative ventures, ignoring the lessons of previous financial crises (Minsky, 2008: 236-237). Because of these cross-disciplinary interests, various approaches have been adopted to prevent bank failures, such as the concept of risk management (Ghosh, 2012). However, empirical analyses have been surprisingly rare especially in this field, probably because of the difficulty of obtaining relevant data (Button, 2008). Fortunately, this study has successfully obtained data by conducting sixteen semi-structured interviews with bank managers and employees in Korean banking industry. Therefore, this study aimed to suggest more effective counter-fraud methods to reduce internal fraud in Korean banking institutions.

Ⅱ. The Failures of Banking Institutions and Financial Industry Security

1. Savings and Loan Crisis in the US and Savings Banks Scandal in Korea

The 1980s and early 1990s witnessed a severe crisis among US savings and lending institutions (commonly called the S&L Debacle). More than 2,100 savings institutions and commercial banks failed, the largest number since the Great Depression (Tillman, 2015). The savings and loan industry was rescued from total collapse with a $125 billion, taxpayer-funded bailout. It was estimated that it would cost $500 billion to bail out insolvent savings and loan institutions by the year 2021. While estimates varied on the exact proportion of this financial crisis that was attributable to fraud, there was widespread consensus that bank fraud enabled one of the costliest series of white-collar crimes in history (Calavita and Pontell, 1991). The US federal agency calculated that fraud was the cause of the insolvencies of 40 percent of the 450 savings and loan institutions. In 1987 and 1988, the federal thrift regulatory agency referred over 11,000 savings and loan cases to the Justice Department for possible criminal prosecution. The analyses of the crisis focused on the roles that deregulation, corruption, and criminogenic market structure played in creating incentives for insiders to loot their institutions, sometimes called 'collective embezzlement' (Calavita et al., 1997; Tillman, 2015).

For example, late twentieth-century capitalism in the US was decreasingly characterized by production and manufacturing activity and was increasingly centred on financial transactions. In this 'finance capitalism', profits were made by so-called 'fiddling with money'. The new means of production entailed corporate takeovers, land speculation, currency trading, real estate ventures, futures trading, and land swaps. Given the significance of the economic and organizational structure in the broader economy, the qualitatively different 'production' process in finance capitalism generated new forms of corporate crime in response to new sets of 'pressure' and 'opportunities.' The variety of criminal activity that was uncovered in thrift institutions was seemingly endless. However, the most blatant form was 'collective embezzlement', siphoning off of funds from an institution by that institution's top management (Calavita et al., 1997; Calavita and Pontell, 1991).

Different from the traditional embezzlers described by Cressey (1953), the offenders of 'collective embezzlement' were not lone lower-level employees but institutions' owners and operators, acting within networks of conspirators inside or outside the institution. Collective embezzlement ranged from an outright looting of an institution's cash or other resources, to business practices where the sole purpose was the generation of personal profits for management, despite their negative effect on the health of the bank. Throwing lavish parties, travelling around the world in private planes, and buying expensive antiques and yacht, thrift executives spent billions of dollars on personal luxuries. Plus, transactions were fabricated in order to receive fees and commissions, profits were inflated to extract additional dividends, and executive salaries were padded. The most widespread form of embezzlement used ‘land flips’, transfers of land between related parties to fraudulently inflate the value of land (Tillman and Indergaard, 2005). After analyzing the crisis, Calavita and Pontell (1991) suggested that these financial institutions had a number of fundamental characteristics in common, but the most obvious one was that they functioned as the organizations handling other people’s money; the opportunity structure and the composition of risk as defined by regulation and enforcement activity provided the causal context for the preparation of wide spread embezzlement and other financial crimes, creating criminogenic conditions in the US financial industry (Tillman, 2015).

Surprisingly, some banks in Korea were not different from those in the US. Although savings banks in Korea made up only 2 percent of the assets of the whole financial system, many families and pensioners have lost their life savings due to internal fraud and corruption in banking institutions. Furthermore, the elder brother of the then Korean President and a leading congressman, were arrested for receiving bribes from a director of a savings bank for loosening regulations in 2011 Savings Banks Scandal (KBS News, 2012). The incident led to questions about the policing of regulators. About 200 people, mostly the executives of savings banks across the nation, were indicted by the special investigations team at the Korean prosecutors' office and four savings bank executives committed suicide in the midst of investigations. The financial losses due to the Savings Banks Scandal were estimated to be around $26 billion and regarded as the Korean version of S&L Debacle in 1980s in the US (Oliver, 2011; The Kyunghyang Shinmun, 2012).

2. Financial Industry Security

Corporate security or industrial security helps a company mitigate or manage any developments that may threaten the resilience and continued survival of a corporation (Briggs and Edwards, 2006). The importance of more effective ‘financial industry security’ is being emphasized by the rise of high profile financial scandals such as the collapse of Lehman Brothers, the bail out of insurance company AIG, and the US government takeover of mortgage giants Freddie Mac and Fannie Mae in the wake of the Subprime mortgage crisis (Tillman, 2015). In Trusted Criminals: White-collar crime in Contemporary Society, Friedrichs defined 'finance crime' as 'large-scale illegality that occurs in the world of finance and financial institutions' and argued that various kinds of 'finance crime' played a significant role in all of these failures. (Friedrichs, 2010: 168-169). Many studies of banking crises also concluded that fraud and abuse were prominent causal factors (Black, 2005; Calavita et al., 1997; Tillman, 2015). Therefore, it is pivotal to secure 'security' from within the financial industry because tens of millions of investors, taxpayers, homeowners, and consumers are likely to suffer from the failures, as the victims of 'finance crime' as clearly demonstrated in the first decade of the 21st century (Friedrichs, 2010; Krugman and Wells, 2015).

Firstly, security can be defined as "the objective condition of being without threat: the hypothetical state of being absolute security." Secondly, it is defined by the neutralization of threats: the state of being protected from. Thirdly, it is a form of avoidance or non-exposure to danger (Zedner, 2003: 155)." George and Button (2000) maintained that security is used to protect four main areas: the protection of (1) people, (2) physical assets, (3) information and (4) reputation. With regard to protection of physical assets, people start to find a 'secure' place to keep them safely after 'surplus wealth' was produced in industrial capitalism. As a result, financial institutions, especially banking institutions were established for the protection of physical assets, such as cash and gold. Moreover, the use of money as a medium of market exchange established financial institutions as the trustees of other people's money and as the intermediary agents between the demanders and suppliers of fund (Coleman, 1987).

Following industrial capitalism, however, 'finance capitalism' has emerged producing 'vast wealth' and sometimes a criminogenic condition where profits are created from speculative investment, not production (Calavita and Pontell, 1991; Tillman, 2015). Some argue that unlike industrial capitalism where customers receive real goods for their money, in 'finance capitalism' clients receive a mere promise that their money will be protected and insured by deposit insurance. Ironically, deposit insurance itself is blamed for motivating 'moral hazard' of the financial sector, a situation where one party gets involved in a risky event knowing that it is protected against the risk and the other party will incur the cost (Krugman and Wells, 2015). Some even argue that a financial institution itself can become a 'weapon' or 'vehicle' to commit fraud when control over an organization is realized, which is referred to 'control fraud' (Black, 2005). As a result, analyses of fraud in financial institutions have focused on the roles of deregulation and corruption in producing systemic incentives for 'insiders' to loot their institutions (Calavita et al., 1997; Tillman and Indergaard, 2005).

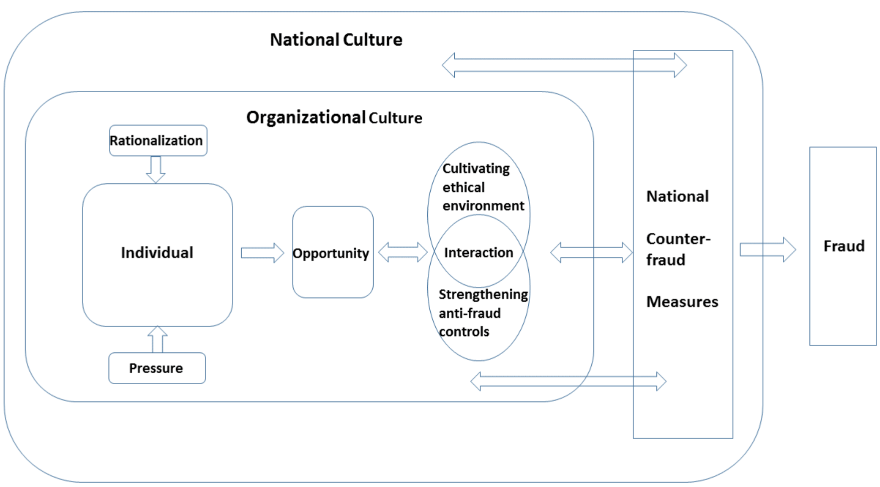
Ⅲ. Research Method

For the study, the researcher conducted a qualitative research method from December 2016 to April 2017. Qualitative research is an investigative process to make sense of a social phenomenon by contrasting, comparing, cataloguing and classifying the object of study (Miles and Huberman, 1984). Semi-structured interviews, which are open and allowing new ideas to be brought up during the interview, were scheduled with managers and employees of each type of bank, supervisory officials of the Financial Supervisory Services (FSS), a policy maker of the Bank of Korea, and a university professor, who all had a keen interest and experience in managing fraud risk.

〈Table 1〉 Interview list by sector and type of the institution

Financial sector	Type of financial institution	Number of Interviewees
The first sector	Nationwide banks	5
	Regional banks	1
	Specialized banks	1
The second sector	Local agricultural and fishery cooperatives	1
	Community credit cooperatives	1
	Credit unions	1
	Savings banks	2
Others (Specialists on fraud risk management)	Korean Financial Supervisory Services (FSS)	2
	The Bank of Korea	1
	Security expert	1
	Total	16

The interview data were transcribed and significant parts of texts and themes that relate to the conceptual framework were extracted from the transcribed texts. The findings of the qualitative study were aligned with the Fraud, Resilience and Cultural Model (Button and Gee, 2013) that posits a three-level analysis for a counter-fraud framework: The perpetrator (micro-), organizational (meso-) and societal and national (macro-) levels. The conceptual framework for qualitative findings is depicted in Figure 1.



〈Figure 1〉 The conceptual framework for data analysis

(Source: Button and Gee, 2013: 65)

The first level of analysis focuses on perpetrators, collusion and the Fraud Triangle components that are associated with individual factors; the second level of analysis is based on organizational aspects such as tone at the top, management override and some constraints on organizational capacities. In addition, whistle-blowing systems and corporate governance structures are included in the organizational-level analysis. Lastly, the study analyzes societal and national-level factors, such as the criminal justice system, national culture and counter-fraud legislation.

Ⅳ. Findings

At the micro level, firstly, the study revealed that the pressure or incentive of fraud stems mostly from financial motives, such as failures of investing in stock market or future trading, not by job-related pressures. Furthermore, a theme appeared that some female offenders committed internal fraud for the protection of her family or other close people rather than financial motives. Plus, more fraud is likely to be committed when employees feel unsecure about their job stability. However, the interviewees displayed skepticism on the usefulness of employee support program that was invented to lessen the pressure of employees, because many believed that the condition for successful implementation of the program was not ready yet in the banking industry. In order for the banks to prevent employees from investing excessively in highly volatile speculative markets, anti-fraud education should be administered to the bankers about the severe consequences of excessive investments in those markets. Furthermore, the red flags of fraud discovered by Albrecht et al., (1984) should be trained to the employees in the financial sector to find and support their co-workers with those red flags prior to fraud being committed.

Secondly, poor segregation of duties and infrequent job rotations were underscored as one of the main contributing factors of fraud opportunities. Plus, the small size and limited-staff issue in the second-sector banks were very frequently mentioned as a reason for those internal controls not being properly implemented in the sector. Although there were issues regarding the lack of staff and insufficient investment to prevent fraud in the small-sized banks, a valuable insight was suggested in the interview that segregation of duties and check and balance systems can be conducted by a creative method not necessarily by a large number of staff. In addition, a theme has emerged that although computerized fraud monitoring system (fraud pattern analysis system) can increase the employee's perception of detection, some employees can still bypass the system and commit fraud. Moreover, concentrated regulations and monitoring controls in the industry might cause inefficiency and fatigues to the bankers. Therefore, striking a right balance between monitoring and allowing leeway to employees is stressed as a very important condition for bank managers to have in order to successfully manage fraud risk in organizations.

Thirdly, many of the interviewees expressed that bankers' integrity is the most important factor that affects occurrence of fraud in organizations. However, despite this significance, there were mixed opinions found whether ethics training is effective in enhancing personal integrity of the employees. Some participants disclosed disbelief on the usefulness of ethics education, but others expressed the importance of ethics training to cultivate personal integrity. A recent study has found the evidence that comprehensive ethics training is positively related to ethical organizational culture, such as observed unethical behavior, intentions to behave ethically, and perceptions of organizational efficacy in managing ethics. Furthermore, the study found that many of these effects persist in the years after the introduction of the training program in the bank (Warren et al., 2014). Therefore, the banking industry should change their focus how to make ethics training more effective, not to an argument of whether the training really works or not.

Lastly, at the micro level, the study has detected an important theme that when collusion with outside parties was involved in occupational fraud, the banks had a tendency to disguise the nature of fraud by exposing only the external accomplices to the public, thus minimizing the adverse publicity and criticism from the mass media. A bank interviewee acknowledged that there was actually more fraud between insiders and outsiders and the interviewee also stated the difficulty in proving this kind of collusive fraud compared to single-offender fraud. Moreover, this study found a slippery slope passage to bank fraud, where a normally honest, but unlucky employees could be exploited by carelessly hanging out too closely with the customers, who actually planned to take advantage of the banker and extract more funds from the bank. To prevent this slippery slope for bank works, especially loan officers, the importance of anti-fraud education is again underlined.

At the organizational level, five subjects were discussed; (1) tone at the top, (2) management override, (3) whistle-blowing systems, (4) limited authority for fraud examination, (5) corporate policy for criminal prosecution. First of all, many interviewees underscored the importance of tone at the top and ethical leadership as a vital factor to combat internal fraud in the banking sectors. To improve CEO's ethical conduct in the banking industry, one interviewee suggested an ingenious way that the CEO's conduct should be evaluated regularly by an independent party or audit department, which is not currently being carried out by many banks in Korea. Simply put, the conduct score should comprise the CEO's overall performance score, which is, hence very important for every CEO to behave ethically and should put effort to set ethical tone at the top.

Secondly, many interviewees expressed the view that management override is a serious problem and effective check and balance systems against overrides are not working properly in the industry. An important system of preventing management override comes from the effective oversight from the board of directors, especially outside-directors (non-executive directors) to independently check the management of companies. One more important factor to prevent fraud is related to the quality of external audit. However, despite the crucial role of the board of directors and external auditors, many concerns and skepticism were found during the interviews regarding their proper roles for the check and balance system in corporate governance structure. This theme is also closely related to a national-level legislation (Act on Corporate Governance of Financial Companies) that is recently enacted by the Korean government in 2017 to lessen the concern about the independent check and balance system.

Thirdly, protection of whistle-blowers appeared as an important theme during the interviews. It was revealed that the current protection system for whistle-blowers is not working properly in the financial institutions. The nature of a small number of staff and close relationships among co-workers were attributed to the cause of not fully protecting the anonymity of whistle-blowers in the banking institutions. A fresh suggestion was made during the interview that the audit/compliance department in a bank should have the power to transfer a whistle-blower to another department or office to protect them; a synergy effect is expected when the HR department and audit/compliance department in a bank collaborate to promote the usage of fraud reporting hotline and to prevent retaliation against whistle-blowers.

Fourthly, the same theme about the limited resource in the small and medium sized banking institutions of the second sector appeared. However, another subject was mentioned that the lack of inter-organizational financial tracing system limits the effective organizational investigation of employee fraud. In other words, when the internal audit department in a bank starts to investigate a fraud case, auditors cannot look through the other banks' accounts, because they lacked the authority to do so. This is also related to strengthened personal data protection act recently enacted in Korea. Therefore, the inter-organizational collaboration on this issue is hard to be solved unless a proper legislation is made by the government. At the same time, the different relationship between individual credit unions and the central federation of the unions has been discovered during the interviews. In commercial banks, the branch-office and headquarters of the bank are something like a front-office and back-office relationship. However, the second sector's different relationship from that of the first sector has turned out to restrict the effective oversight in the community banking institutions in Korea.

In the sociocultural and national level, firstly, many of the interviewees raised concerns about the sociocultural factors that hinder the protection of whistle-blowers in the Korean society. However, it should be noted that this tendency to see whistle-blowers negatively is not confined to Korea. Trevino and Victor (1992) found that in the absence of social structures supporting whistle-blowing, co-workers operated under pressures that prohibit whistle-blowing behavior and they suggested that groups should share the cost of a violation or adopt code of conduct that mandates the reporting of violations to authorities to lessen the problem. In this respect, the Korean society should create a social structure that sees whistle-blowers positively and protect them. However, many interviewees opined that it will take a long time and will not be an easy task.

Secondly at the macro level, the role and performance of the Financial Supervisory Services (FSS) were evaluated generally positively by the interviewees. Furthermore, it was revealed that Korea has enacted the Act on Corporate Governance of Financial

Companies in 2017. The aim of the Act is to ensure the sound management of financial companies and to protect depositors, investors, and consumers by prescribing basic matters concerning the governance structures of financial companies. This newly enacted act includes requirements for qualification for executive officers of financial companies, the organization and management of the board of directors, and the internal control system. Yet, the Act is still regarded as imperfect because an Act on the Aggravated Punishment of Specific Economic Crimes (a legislations that deals with mass scale fraud and corruption) is not included to the Article that limits shareholder's qualification to become executive officers of financial companies. However, to accept this public criticism, an amendment bill has now proposed in the National Assembly of Korea (The Chosun Ilbo, 2018).

Finally, at the sociocultural and national level, a theme was found that the Korean criminal justice system should pose a harsher stance against white-collar criminals, especially the powerful corporate executives who committed mass-scale occupational fraud. It was found that Korean President overuses his Constitutional authority to pardon and reinstate CEOs of chaebols, which has a negative impact on Koreans, by producing unequal feelings towards the society.

Ⅴ. Recommendations and Conclusion

This study has discussed the issues that relate to the research question: "what and how can systems be improved to reduce internal fraud in Korean banking industry?" For that, qualitative in-depth interviews were analyzed based on three different hierarchical levels; the micro (perpetrator), meso (organizational) and macro (national) aspects of fraud prevention and detection. Based on the analysis of the interview transcripts, the recommendations are presented to reduce internal fraud and improve financial industry security.

Firstly, Korean banking institutions should establish a consolidated fraud data sharing system to boost collaboration for fraud prevention and detection between the different financial sectors and institutions. The qualitative study has detected serious concerns among the interviewees that pre-screening checks and staff vetting are not properly conducted due to the difficulties in gaining personal information such as certificate verification and criminal history. This situation has emerged recently due to the strengthened data protection act in Korea. However, the interviewees opined that the banking institutions are currently relying solely on the documents that are provided by the job applicants but have difficulty in verifying the authenticity of the information. Hiring the right kind of employees is one of the essential elements in creating a culture of honesty (Albrecht et al., 2015; Gill and Goldstraw-White, 2010). Therefore, the banking institutions should invest time and resources to set up a consolidated fraud data sharing system in the industry. If they can share the information regarding convicted fraudsters' data like the fraud intelligence systems in the UK (Cifas, 2018), the Korean banking industry can significantly benefit from this system to prevent internal fraud.

Secondly, the Korean Financial Supervisory Services (FSS) should increase the scope of its direct supervision to the second financial sector. The FSS is a quasi-governmental supervisory authority founded for integrated financial supervision. However, a serious weakness was revealed through the interviews that its effective oversight usually ends within the boundary of the first financial sector. In other words, the FSS tends to entrust its supervisory authority to the respective federations of cooperatives and it only intervenes ad-hoc basely once fraud occurs. For example, community credit cooperatives are not currently supervised by the FSS, but are overseen by the Ministry of the Interior and Safety, which is responsible for the local autonomy and decentralization issues in Korea (MOIS, 2018), thus lacks expertise in fraud risk management. Therefore, the FSS should engage more actively in supervising the second financial sector, which was exposed to more serious fraud risk.

Finally, the findings of this study should be embraced by Korean banking industry. For example, the respondents in the second sector had a significantly lower level of awareness about internal fraud. Furthermore, the importance of ethical corporate culture and personal integrity should be communicated to the financial employees. Unfortunately, some studies have discovered that the overall levels of honesty and integrity are decreasing in most of the advanced countries, which can make the fraud problems more serious (Albrecht et al., 2015: 35). This overall moral deterioration in societies and some criminogenic conditions of the financial industry can be a serious challenge for financial industry security (Calavita and Pontell, 1991; Tillman, 2015). As revealed by the semi-structured interviews of this study, personal integrity and ethical corporate culture are the most important foundation to prevent fraud although it sounds a little like an old-fashioned idea. Moreover, the slippery slope passage of bank employees leading to internal fraud should be trained to prevent inexperienced staff from becoming an accidental fraudster. Finally, the seriousness of investing in risky markets, such as stock or future trading, should be alerted to stop bank employees from having non-sharable financial problems (Cressey, 1953).

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【Abstract】

금융산업보안: 은행권 내부부정 방지를 위한 질적 연구

서 준 배

금융산업은 일상 국민 생활경제와 매우 밀접한 관련이 있다. 따라서 저축은행 사태와 같이 금융기관 임직원들에 의한 횡령, 배임 등 부정행위(fraud)가 발생할 경우, 신용경색과 연쇄파산 등 민생경제에 심대한 악영향을 끼칠 수 있다. 이에 외국에서는 금융산업 보안의 중요성이 특히 강조되고 있고, 물적, 인적, 사이버를 통합하는 융합보안(converged security)으로 발전하고 있다. 본 연구는 우리나라 은행권에서 내부 임직원들에 의해 발생하는 부정행위를 방지하는데 목적이 있다. 이를 위하여, 리스크 관리(risk management) 업무를 담당하고 있는 은행권 임직원, 금융 정책수립 및 규제기관 담당자, 보안전문가 등 총 16 명에 대하여 반구조화된 심층 인터뷰(in-depth semi-structured interview)를 실시하였다. 수집된 데이터를 개인, 조직, 사회·문화적 레벨 등, 세 가지 계층화 수준에서 분석하였고, 이를 바탕으로 금융산업보안(financial industry security)의 발전과 금융권 내부부정 행위 방지를 위한 정책적 권고사항들을 도출하였다.

Keywords: 금융산업보안, 내부 부정, 은행권 부정행위, 질적 연구, 금융기관