

# Managing fraud risk in a time of economic crisis

As often happens in times of economic distress, the risk of fraud—both internal and external is greater than it has been in a number of years. Many insurers already have controls and systems in place to identify, monitor, and manage fraud risk, and to protect themselves, their policyholders, and their shareholders from these risks. However, the current environment will put those measures to the test.

Economic downturns historically feature increased risk of fraud-related losses. Insurers need to focus on the leading sources of fraud, both internal and external, including policyholders, business partners, and employees.

Perhaps the most common fraud risk comes from false claims made by policyholders; for example, homeowners who have over-leveraged the equity in their houses. Falling housing values in Ontario, Alberta and British Columbia particularly at the higher-end of the price spectrum in more expensive city markets, mean that some homeowners currently

possess property that is worth less than what they owe on the mortgage. Unscrupulous owners may try to cover losses through insurance claims, and second homes and investment properties are especially at risk of arson or other criminal actions. The risk is not only from homeowners: small business owners, unable to obtain credit, may resort to arson or false claims to raise money.

## **Business partners provide another source of fraud risk**

In recent years insurers, like many other financial institutions, have outsourced some of their basic functions. They hire third-party administrators (TPAs) to process claims, rather than handle them in-house. Often they grant TPAs effective control over the company's cheque book as a means of expediting claims payment. In such circumstances, TPAs could use the insurer's funds to cover their own operating costs or debt payments.

Insurers also have retained managing general agents (MGAs), especially for specialized lines or 'program business' in which they lack in-house expertise. However, MGAs could apply underwriting guidelines more loosely to under-price new business in order to make sales. In two or three years' time (when claims begin to flow), the MGA and the company's commissions may be gone. There is also a risk that MGAs delay reporting claims and slow premium transfers to take advantage of the float.

Because retail agents operating on commission make most insurance sales, they face the temptation to skirt guidelines to increase sales. There have even been cases in which agents have created false statement balances for their customers, with the agent pocketing the money, or collude in false valuations. In the life insurance industry, with the huge drop in the equity markets, there will surely be policyholders claiming that they did not understand the risks in the variable policies they were sold.

Other business partners, such as investment managers, also could engage in fraud for their own ends. People whose incomes are tied to performance may not want to see their income drop too far.

### **An insurer's own employees present another source of fraud risk**

They may be in financial distress because of investment losses, excessive debt, or reduced income. Even senior executives may be at risk. Some executives may have lost a significant portion of their personal wealth or seen their life savings evaporate. In addition, some executives may have purchased second or third homes as investments, and over extended themselves. Their personal situation may lead them to fraudulent behavior, including the acceptance of bribes or embezzlement, 'borrowing' from the till, if only until their circumstances change. Directors should remember that, no matter how strong their company's controls are, many executives often have the ability to circumvent those controls.

A recent PricewaterhouseCoopers survey of insurance company directors and executives found that the boards of directors at 93% of the respondents have not determined whether any of the top five or ten executives in their company are currently in significant personal financial distress. In three years' time, will directors be accused of being aware of this risk but be unable to demonstrate that they responded to it?



**Insurers need to take proactive steps to identify, monitor, and mitigate fraud risk from all common sources.**

- In light of the high risk of policyholder fraud, insurers need to carefully monitor property claims for evidence of arson or other malfeasance. This is especially true for residences with overextended owners or businesses that are failing. Some of this is common sense: a fire at a failing business that has recently increased its coverage limits should automatically raise red flags and spur closer investigation;
- Insurers need to make certain that they have maintained rigor in executing sales compliance, and monitor sales efforts by agents and MGAs;
- Insurers need to prevent other business partner fraud by monitoring TPA claims processing and expenditures, and carefully examining MGA activities to make certain that guidelines are being followed. Insurers should not take it for granted that adequate controls are in place or that controls that worked historically will continue to operate effectively; and

- Employees, including senior executives, should not be exempt from scrutiny, both before and after hiring. Insurance company boards should make certain that their financial and operating controls are robust and cannot be circumvented by any one individual. Even in today's control-focused world, a single highly placed executive may be able to override systems or approve contracts or claims.

Since internal theft is usually covered by directors' and officers' insurance, the real loss in cases of employee fraud is in reputation and a loss of the company's credibility. That cannot be insured against, so strong steps are needed to preserve it.

Better screening during hiring, identification of at-risk employees through credit and background checks, and automated approval systems can help reduce the risk of internal fraud.

Strong conflict of interest policies can reduce the opportunity for fraud. In addition, employee assistance programs—including something as basic as a helpline for individuals who may be experiencing financial distress—can help provide overextended employees with the help they need to avoid the temptation to defraud the company.

**In many cases, the losses caused by fraud will come when they are least expected**

Since these threats are both internally and externally generated, the solutions must be directed at identifying and neutralizing potential threats from both sides of the fence—something that insurers, reluctant to alienate customers, employees, or business partners, have been historically reluctant to do. But the implications of the threat to reputation, credibility and profitability mean that insurers should take proactive steps to protect against fraud.

If you would like to discuss the issues raised, please speak to your PricewaterhouseCoopers representative or contact:

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