Investigation and Prosecution of Insider Misconduct in the Insurance Industry

A Guide for State Insurance Departments
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Investigation and Prosecution of Insider Misconduct In The Insurance Industry

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NAIC
National Association Of Insurance Commissioners
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INTRODUCTION

On June 12, 2000, upon recommendation of the NAIC Executive Committee, the NAIC Antifraud Task Force adopted a new charge to address insider fraud in the insurance industry as follows:

Establish guidelines on the investigative and prosecutorial resources necessary to investigate insider insurance industry fraud, based on such parameters as volume of insurance premiums written, the nature of the industry activity, population and other objective measures.

The Antifraud Task Force has examined the charge, and has had several public discussions on the subject, and has offered the opportunity for interested parties to comment on this paper. This paper seeks to define an antifraud strategy for state insurance departments to facilitate the investigation and prevention of insurance industry insider fraud.

DEFINITION & CHARACTERISTICS OF INSURANCE INDUSTRY INSIDER FRAUD

For the purposes of this paper, insurance industry insider fraud can be described as:

“At any fraudulent act committed against an insurer by an officer, director or a key employee using their position to further the fraud, conceal it or prevent its detection, if the fraudulent act has the potential to financially impair the insurer, or if the fraudulent act is part of any complex or sophisticated manipulation against the insurer, its employees or customers, or if any act committed in furtherance of the fraud demonstrates a person’s unfitness to hold a position of authority in an insurance company. Attempts are explicitly included in the definition of insider fraud.”

This definition does not intend to specifically include insurance producers that tend to conduct business off-site from the insurance company and that tend not to have managerial, decision-making, or fiduciary responsibilities within the insurance company.
It has been reported that, since 1969, there have been over forty insurance company insolvencies due to alleged fraud; and that the average cost of insurance insider fraud is $72,000 per incident.

Characteristics noted in past insider fraud and misconduct include the following:

- Forgyery
- Kickbacks
- Embezzlement
- Money Laundering
- Destruction of records
- Falsification of records
- Policy misrepresentation
- Manipulation of reserves
- Intentional financial failure
- False filings with regulators
- Marketing and pyramid schemes
- Bribery and improper influence
- Investment in over-inflated assets
- Operating without proper licensure
- False and misleading financial statements
- Sequestration, diversion, or rental of assets
- Manipulation of claims reserves and settlements
- Destruction or manipulation of computers or computerized data

Factors that can encourage insider fraud and misconduct:

- Motive and opportunity
- Attitude, ego and greed
- Ill-informed boards of directors
- Lax internal controls and oversight
- Vulnerable and uninformed consumers
- Pressure for quotas, commissions and profits
- Complex, lengthy and expensive investigations

OVERVIEW OF CURRENT INSURANCE DEPARTMENT ANTIFRAUD CAPABILITY

State insurance departments continue to increase their regulatory and oversight capabilities, including a commitment to address insurance industry insider fraud. As of this writing, a survey of state fraud statutes shows that 49 NAIC members have specific statutes criminalizing insurance fraud. While every state department of insurance (DOI) addresses insurance-related misconduct, 30 DOIs have dedicated insurance fraud units. Additionally, 13 DOIs address insurance fraud via other department divisions (i.e. Legal, Market Conduct, Consumer Protection) or in other state departments (State Police, Labor, Workers Compensation, Medicaid, etc.), and eleven states address insurance fraud in the state Attorney General’s office. Forty-two DOIs specifically investigate insider fraud, and twelve DOIs have dedicated or readily available prosecutors to handle insurance fraud matters. These numbers are dramatically higher than ten years ago and continue to rise. Nevertheless, every DOI may arrange to utilize other governmental investigative and prosecutorial agencies, and may prosecute under general and common law theft and fraud statutes, whether or not it has a direct statute criminalizing insurance fraud.


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The gains noted have come about in part as a result of a heightened awareness of, and an enhanced focus on, insurance fraud. As the fraud-fighting capabilities have developed within state insurance departments, it has become relatively easier to adjust and refocus on new or heightened fraud problems and fraud prevention needs as they arise. Other particularly useful fraud fighting enhancements available to many NAIC members also include dedicated fraud investigation units, law enforcement powers, funded prosecutors, dedicated training, and improved information technology, coordination, and communication.

There is a welcome increased federal presence in the community of agencies addressing insurance fraud. Several federal fraud statutes, including the Violent Crime Control and Law Enforcement Act of 1994, mail and wire fraud, money laundering and tax fraud are available and frequently used in fighting insurance fraud. While enhancing the efforts to fight insurance fraud, the presence of the federal investigative and prosecutorial agencies add, of course, another dimension to the complexities of coordination, information sharing and resource allocation. The NAIC Antifraud Task Force has developed strong working relationships with the U.S. Department of Justice and the other federal agencies concerned with fighting insurance fraud.

COMPONENTS OF AN EFFECTIVE ANTIFRAUD PROGRAM

From the foregoing section, it is clear that an appropriate statute is available in each NAIC member jurisdiction to address insurance fraud. This satisfies the first need for prosecution, that there be a statute that provides jurisdiction and prohibits the undesirable act. However, the best statutory scheme for insider fraud would include a specific statute in each state’s insurance code that specifically prohibits insurance industry insider fraud. The reasons for this are that: 1) insider fraud, by its nature, may occur in many jurisdictions simultaneously, 2) that the acts involved may be compartmentalized so that the whole scheme is not committed in any one jurisdiction, and 3) the victims and perpetrators may be remote from the location where the fraud occurs. These factors can impede successful prosecution of insider fraud using general or common law fraud or theft statutes. As such, sections 2 and 5 of the NAIC Insurance Fraud Prevention Model Act offer useful provisions to fully address insider fraud.

Given a statute, there are several other components necessary for an effective approach to investigation and prosecution of insurance industry insider fraud. Each component separately affects the ability of an insurance department to successfully bring a fraud case from the point of detection to the point of successful prosecution.

- Detection
- Training
- Investigation & Prosecution
- Coordination
DETECTION

The Association of Certified Fraud Examiners has reported that 56% of all insider fraud cases are initiated based on information provided by another company employee, and 23% of all insider fraud cases develop from information uncovered during an audit of the company. As such, every insurance department has methods for receiving complaints or other information from consumers or others. Additionally, twenty-nine departments have a fraud reporting telephone “hot-line,” and twenty-three departments allow individuals to report suspected fraud on-line.

A basic component of insurance regulation is the insurance examination – both financial and market conduct. Every insurance department has statutory authority to conduct examinations of insurance companies operating in their state. In 1999, state insurance departments conducted over 3100 examinations.

Financial Examinations

In brief, financial examinations monitor the solvency and regulatory compliance of companies, and can add a proactive component in the search for signs of insider fraud. Patterns that have been identified during the commission of insider frauds can be added to the examination review to increase the chances of early detection. As in a market conduct examination, some key data can be reviewed before an on-site examination formally begins. Examiners should receive preliminary fraud training to broaden their awareness of the problem and to become familiar with the fraud unit in their department.

Market Conduct Examinations

Market conduct examinations also serve a very important role in regulating insurance. A market conduct examination, which can often arise as a result of outside complaints, is usually a reactive process, and can be like closing the barn door after the horse gets out. However, it can provide insight into a company with problems – where there’s smoke there’s usually fire. However, like many professions, auditors and examiners are often focused on a singularly specific task – verifying information provided by the people or the company under examination, which, in and of itself, can be a self-defeating exercise. A focus on only traditional market items may obscure other, less obvious, fraud-related signals. Training examiners in the areas of fraud detection, warning flags, and when a fraud investigator should be contacted may better serve the public and the industry.
Internal Audits

Encouraging more frequent internal audits will also reduce the risk of insider fraud. Having stated this, we must consider that internal fraud at the highest levels may be more difficult to detect for two reasons: 1) an inaccessibility to necessary documentary evidence, and 2) a natural reluctance to confront a superior regarding bad news or perceived wrongdoing. Procedures should be established to allow appropriate accessibility to necessary accounts and other financial records. Accounts should be monitored regularly, looking for changes or irregularities. Electronic monitoring such areas as claim activity should be more efficient and should reveal patterns of potential wrongdoing more readily. Internal procedures and culture should allow and encourage auditors and other insiders to be able to comfortably report perceived wrongdoing, while, at the same time, remaining fair to all.

The detection and investigation of insider fraud must be a cooperative effort from the inception. Such activity cannot be investigated if it is not detected. And the best opportunity to be successful in detecting and protecting our citizens finds its strength and effectiveness in early detection before most of the damage has been inflicted.

TRAINING

The development of a formal cross-training program for insurance examiners and insurance fraud investigators is highly recommended.

Financial examiners have a background in accounting, including a working knowledge of the regulatory requirements of insurance entities. They are regularly assigned the responsibility for examining insurance entities for the purpose of determining their financial condition along with regulatory compliance matters. Market conduct examiners are knowledgeable about insurance products, marketing, sales, and customer service. In carrying out their duties, insurance examiners may occasionally uncover possible wrongdoing. However, examiners may have limited fraud detection skills, limited knowledge of insurance fraud laws and indicators, and limited contact with insurance fraud investigators.

Insurance fraud investigators, on the other hand, have in-depth experience in conducting white-collar crime investigations, but may lack sufficient financial examination and regulatory oversight experience. An insurance fraud investigator may be responsibility for investigating several types of insurance fraud schemes. In matters relating to insider fraud issues, investigators are responsible for acquiring numerous different types of financial records, including accounting, business, investment, banking and legal documents. It is essential that fraud investigators understand the concepts of financial examination and terminology.

Recently, there has been a concentrated effort on the part of several organizations to develop and provide antifraud training for insurance examiners, fraud investigators, and industry. The NAIC, the National White Collar Crime Center, the Association of Certified Fraud Examiners, and the Antifraud Task Force of the NAIC offer valuable state-of-the-art training.
INVESTIGATION & PROSECUTION

Investigations of insider fraud usually require more resources and are more labor intensive than other types of fraud investigations. This is because a great deal of the investigation centers on forensic accounting and interviewing skills and requires a multi-disciplinary approach. Interviewing and investigative skills are used to gather information and statements, and to support a prosecutor. Financial skills are used to gather documentary evidence in support of, or to refute, an investigation. In the reverse, detecting financial irregularities during the examination process can provide needed information and direction to the investigative effort.

An investigative team approach would seem to be the best solution. The team could ideally be comprised of fraud investigators and examiners. Cases involving multi-jurisdictions may warrant inclusion of state and federal agencies, primarily state securities regulators, the FBI, IRS, Postal Service and SEC. The use of a multitude of databases is also important in an effort to track, locate, and secure subjects and illicit funds and assets.

The NAIC Antifraud Task Force encourages state insurance departments to aggressively refer prosecutable cases involving insurance industry insider fraud and misconduct to an appropriate prosecutor. Given the potential financial impact on the company and the underlying fiduciary relationship owed to the company, a referral for prosecution is necessary to satisfy the principals of both punishment and deterrence. In addition to state resources, federal prosecutors from the United States Department of Justice actively participate in the NAIC Antifraud Task Force and have advised that they welcome case referrals from the state insurance departments.

Early consultation with a prosecutor is suggested in order to provide the prosecutor with an overview of the case, and to solicit timely input from the prosecutor on strategy, evidence collection, and legal analysis. This type of approach is designed to develop and maintain a high level of interest in the case from the prosecutor, to establish a rapport and working relationship with the prosecutor, and to develop a “team” approach in building the investigation and case. State prosecutors have an inherent interest in prosecuting insider fraud violations committed in their jurisdictions, and state insurance fraud directors are encouraged to build strong working relationships with both state and federal prosecutors in their states.

Additionally, after a documented case of insider fraud has been referred to a prosecutor, the investigating agency should maintain close communication with the prosecutor, perform any requisite follow-up investigation, monitor the case through the judicial system, and assist the prosecutor with trial preparation issues. In other words, make it easy for the prosecutor to prosecute the case or, said another way, hard for the prosecutor to decline prosecution.
It has been difficult to quantify the resources expended on past insurance industry insider fraud investigations, but state insurance fraud directors recognize and advise that:

- Insider fraud takes substantially longer to investigate than most insurance crimes.
- Insider fraud expends substantially more resources and requires more expertise to investigate than most insurance crimes.
- The apparent infrequency of high-level insider fraud cases does not readily justify the allocation of full-time dedicated resources.
- Insider fraud cases demand large prosecutorial resources, which can discourage an already overburdened prosecutor’s office from taking the case.
- Greater emphasis on early detection, ideally through proficient and timely internal audits and regulatory examinations, is a key to detecting, deterring, and investigating insurance industry insider fraud and misconduct.

COORDINATION

In order to prevent insider fraud, coordinated action is needed among the elements of the industry and regulatory community. Because the financial condition of insurance companies is strongly monitored both by the companies themselves and by the regulators, the framework for coordination is already in place for concerted action on this issue.

Today’s clear understanding is that insider fraud committed by a single individual can affect many diverse jurisdictions, and can simultaneously escape detection by federal and state regulators. We must establish a higher level of communication and coordinated investigations. In October 2001, the NAIC Antifraud Task Force established the “NAIC/NASAA Enforcement Coordination Subgroup” to enhance communication and investigative cooperation among and between the NAIC, the North American Securities Administrators Association, and state insurance and securities regulators. Existing state-level structures can further establish specific standards for systematic monitoring of insurer assets and liabilities, claims practices, pooling and reinsurance. Consistent and timely prosecution of insider fraud will also have a deterrent affect.

The roles of state insurance departments, insurance companies, and federal agencies can be further described as follows:

STATE INSURANCE DEPARTMENTS: State insurance examiners have the on-site presence at an insurer’s facility and the examination skills to potentially detect and deter insider fraud. Insider fraud training and a specific permanent focus on insider fraud at the highest levels in the Insurance Departments are necessary ingredients as well. Given those, insurance examinations can be expected to unearth insider fraud though careful review of financial statements, complaints, marketing, claims handling, and reinsurance transactions. There must be thorough and regular communication about suspected fraud among all states in which an insurer does business. States facing a multi-jurisdictional insider fraud problem must be fully supportive and cooperative with one another.
INSURERS: The very effective coordination now seen among insurers and insurance departments on external fraud detection and prosecution is encouraging. However, the detection and prosecution of insider fraud is very noticeably missing from the trade journals and the annual “top ten” fraud lists. Insider fraud is seldom presented as a substantive issue. Now, with a greater understanding and recognition of insider fraud, and with an effective internal/external audit routine, insider fraud should become an increased focus. Auditing, investigation and prosecution avenues exist already. With good coordination on this issue, effective action against insider fraud can be expected in all cases where an insurer or insurance examiner detects fraud early, and refers it to the state insurance department for investigation.

FEDERAL AGENCIES: Coordination and communication between the DOIs and the federal financial regulators and investigative agencies is needed to ensure proper marketplace conduct and effective investigations. It may be necessary to perform outreach and to propose regular meetings and discussions on this topic. The NAIC Antifraud Task Force has established strong working relationships with several federal agencies in an effort to facilitate communication and investigation of multi-jurisdictional insurance fraud matters.

RECOMMENDATIONS

To bring an effective level of investigative and prosecutorial resources to bear on insurance industry insider fraud, it is suggested that state insurance departments consider the following recommendations:

- Establish a commitment to detect, investigate, and prosecute insider fraud.
- Review existing state statutes and, if necessary, seek legislation to criminalize insurance industry insider fraud. The NAIC Insurance Fraud Prevention Model Act provides guidance.
- Establish effective ongoing antifraud training for examiners and investigators.
- Establish cooperative relationships with other insurance departments, state and federal prosecutors, law enforcement and financial regulators. Establish specific roles and procedures for coordinated action to detect, investigate and prosecute insider fraud.
- Investigate and prosecute whenever possible, not only out of duty, but also to deter other wrongdoers.
- Consider the employment of DOI prosecutors dedicated to insurance fraud prosecution.
- Strive for early detection of insider fraud. Early detection is the key to deterrence, protecting the public and companies, and the efficient use of resources.

The NAIC Antifraud Task Force developed this paper. Throughout, interested parties have been afforded numerous opportunities to provide input and comment. Public and industry input into the development of this paper have been worthwhile and extremely useful. Lastly, the NAIC Antifraud Task Force encourages and welcomes participation from all state insurance departments, as well as other state agencies, federal agencies, industry representatives and interested parties.