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RISK MANAGEMENT REVIEW



Soft Fraud and Possibilities for Prevention

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Soft fraud

Lying and cheating to secure an advantage for oneself is as much a human trait as its opposite – supporting and helping other people without any expectation of reward. We have the potential for both egotism and altruism.

Altruistic behaviour may not arise very often in the relationship between insurance companies and policyholders, but cheating and fraud are much more widespread.

If we were not already aware of the fact, the publication of Dan Ariely's book *The (Honest) Truth About Dishonesty* published in 2012 taught us that, in the vast majority of cases, lying and cheating do not arise from a particularly criminal disposition and do not follow the cost-benefit principle of the Simple Model of Rational Crime (SMORC).

Instead, according to Ariely, we cheat just a little when the opportunity arises, and gain only a slight advantage. So what stops us exploiting the bounds of possibility and, if we are going to cheat anyway, taking everything we can get away with?

From the experiments he conducted with over 30,000 people, Ariely concluded that

> *"... most people cheat up to the level that allows them to retain a self-image as reasonably honest individuals."*

He maintained further that this self-image must not suffer as a result of the fraud we commit.

Research findings in the areas of behavioural economics and neuroscience have clearly shown over recent years that people involved in economic activities often do not behave rationally in line with the cost-benefit principle when making decisions. Heuristics and cognitive bias make us unconsciously take decisions that contradict the behaviour of the ideal "homo economicus". For the interested reader, we can recommend the accessible books by Daniel Kahneman and Amos Tversky (or by Dan Ariely, who has already been cited here), who have used experiments to shed light on the irrational aspects of our actions.

The spectacular cases of insurance fraud – in which people have themselves declared dead so that their next of kin can receive life assurance pay-outs, or in which insurance customers have themselves run over by "friends" in order to

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receive payments from their accident insurance provider – are the exception in the overall scheme of claims. Faking damage that does not exist and deliberately causing damage are indicators of a greater criminal energy on the part of the policyholder. These are the cases on which insurance companies tend to concentrate in their fraud prevention strategies.

In this article, however, we intend to look at the vast swathe of small insurance claims in which damage has been caused by an accident. In these cases, the insurance sums rarely exceed EUR 1,000 and are usually between EUR 100 and EUR 500.

Issues needing answers in small-scale insurance fraud

The decision to cheat an insurance company in the event of a small uninsured loss or damage is one we have probably all come across. But this decision cannot be explained by the cost-benefit principle either – not if we look at the risk entailed, such as a penalty or social ostracism. The question is: What drives an honest insurance customer to commit insurance fraud? And what facilitates such an individual's immoral behaviour?

Small-scale insurance fraud that yields a little bit more than an individual lost, or reimburses the loss if the individual lies about the actual course of events, is easy for that person to justify to him/herself. One's self-image as an "honest person" is not really tarnished by it.

Which kinds of low-sum insurance frauds are the most common? How does the fraudster justify his/her actions? And, above all: What can the insurance industry do to counter these kinds of fraud attempts?

Redefining and exaggerating

In 2015 three german economic researchers, Vanessa Köneke, Horst Müller-Peters and Detlef Fetchenhauer, addressed the mass phenomenon of insurance fraud in a wide-ranging publication. For this they evaluated hundreds of studies and surveys and conducted research in large companies.

According to their findings, the most common form of fraud consists of "**redefining**". In this case, the policyholder has suffered loss or damage as a result of an unfortunate event, but the loss or damage is not covered by the insurance terms. In order to receive the insurance sum anyway, the course of events leading up to the loss or damage is altered to make it fit the terms of the insurance cover. A camera forgotten or left on a park bench is turned into theft; something at home breaks down and the customer claims on a friend's personal liability insurance. The purpose of redefining is therefore to replace a genuine, but uninsured, loss.

But why in such cases – annoying, but not drastic – do people willingly run the risk of being convicted of fraud and prosecuted? Kahneman and Tversky's "prospect theory" maintains such individuals have a sense of loss aversion, where people perceive losses as greater than gains of the same magnitude. This explains why people are prepared to take higher risks when faced with impending loss.

Someone committing this kind of fraud will use arguments to justify it to himself. We look at the typical justification strategies later.

The second most frequent form of fraud, according to the three German researchers, is "**exaggeration**", in which the material loss resulting from the unfortunate event is presented as being greater than it actually was. The main reason for this form of fraud appears to be that the policyholder is looking for reimbursement for "subjective additional costs". These include the time and money spent on the claim, immaterial losses like stress, or damage to objects with a high sentimental value. Policy excesses can also lead to "exaggeration", as policyholders add the excess amount to the actual damage value. But with "exaggeration" too, the insurance customer is not inventing additional loss or damage but attempting to obtain reimbursement for what he or she subjectively perceives as the actual loss or damage.

The "honest" fraudster

If we assume, as Ariely does, that we want to see ourselves as "honest individuals", won't we find it easier to look at ourselves in the mirror in the morning without too much of a bad conscience if we can somehow justify our cheating and wrongdoing?

Here again Köneke et al. proposed an explanation based on eight justification strategies that make it easier for the "honest individual" to commit fraud. Knowledge of these justification mechanisms can provide pointers for insurance companies wanting to develop new or improved fraud prevention strategies.

Justifications for immoral behaviour

Without wanting to present the statistical analysis in detail, we will give a brief overview here of the justifications that may make it easier for a policyholder to commit fraud through "redefinition" or "exaggeration".

Denying the damage

The damage to the insurance company caused by the fraud is not visible to the policyholder. The customer's perception is all that matters because, from his perspective, the small value of the fraud has no impact on him or on anyone else. The insurance company is seen more as a collector of insurance premiums than as a provider of benefits, so the fraud affects a company that appears to have plenty of money.

Denying the victim

If there is no damage, there cannot be a victim in the narrower sense. And even in cases in which the policyholder is aware of the damage caused, he or she justifies the actions with the argument that there is no victim. The anonymous, supposedly financially strong insurance company does not fit the role of victim.

Blaming the victim

Many insurance customers perceive the image of the insurance sector in general – and some insurance companies in particular – as bad. They therefore justify their actions using the psychological concept of "blaming the victim" and declare the company itself to be fraudulent. In the policyholder's view, the insurance company has brought the fraud on itself. Poor customer service or insufficiently clear exclusion clauses in policies are cited here as factors that make the fraud appear less severe.

Comparing with more serious offences

If the policyholder is aware that there has been damage and a victim, his or her justification may consist of referring to offences that cause greater damage and playing down the damage that he or she has caused so that, in comparison, those acts appear to have caused no real damage to anyone. In this case, the "honest fraudster" is helped in his or her attempt to justify the lesser damage caused by "redefinition" or "exaggeration" by references to the professional insurance fraudsters.

Referring to higher motives

This justification argument refers for example to the poverty of the policyholder, who intends to obtain money that he or she desperately needs by means of fraudulent behaviour. The policyholder knows that he or she is doing something wrong, but uses higher motives to justify the deed. As with Robin Hood, who takes from the rich and gives to the poor, justice is achieved in the eye of the fraudster.

The metaphor of the balance sheet

Opportunistic criminals, in particular, according to this theory, keep an internal "moral bank account" in which good and bad deeds are recorded. As long as the good deeds are in the majority, "bad deeds", like low-value insurance fraud, do not carry much weight. If there are plenty of entries on the good side of the balance sheet and if it meets the policyholder's idea of impeccable moral behaviour, fraud of this kind is excusable in terms of the fraudster's sense of self.

Referring to the norm

The final self-justification is based on the widespread opinion that insurance fraud is a trivial offence because "everyone does it" and "something that everyone does cannot be that bad". In this case, the individual's own wrongdoing is justified by the supposed – not proven – wrongdoing committed by other insurance customers.

Preventing fraud

For insurance companies, the benefit of the work by Könecke et al. is that they did more than categorise the justifications that make it easier for otherwise "honest" policyholders to commit fraud – they also suggested ways in which companies can fight it.

Denying the damage

Greater transparency when presenting income and expenditure could paint a more realistic picture of insurance companies in the minds of policyholders. If the customer is aware of cost pressures in insurance companies as well, and of the loss ratio of 90% or more in some sectors, it invalidates the argument that the fraud does not cause any damage.

Denying the victim

This justification of fraud can also be weakened by educating the customer. The policyholder needs to understand that even private insurance companies are mutually supportive organisations in which insurance fraud turns all the insurance company's customers and staff into victims because of the need to keep increasing premiums. The "denying the victim" justification can be refuted even more successfully if the victims are personalised, given a face and a traceable, individual story.

Blaming the victim

To refute this argument, the economic researchers recommend changing the image of the insurance industry as a whole. As long as the industry suffers from a generally negative reputation and people have preconceptions such as "insurance companies are fraudulent themselves", the fraudulent policyholder will not be putting too much of a strain on his or her moral balance sheet. The researchers suggest that insurance companies make clearer reference to exclusion clauses and ensure that customers understand the reasons for rejecting claims. There have been some initial studies that have shown that better education of policyholders can improve the sector's image.

Beyond providing a detailed, comprehensible justification of claim decisions, adding new services is another way in which an insurance company can improve its image. For many customers, good service is actually more important than price.

Comparing with more serious offences

Cheating, lying, redefining, exaggerating – even if these offences carry less of a penalty, they are still forms of fraud. The only way an insurance company can counter this justification is to highlight the damage it causes.

Referring to higher motives (justice)

If the insurance company decides not to pay for a claim, or to pay only part of a claim, and if this decision is perceived as unfair by the policyholder, a discrepancy arises between the customer's subjective sense of fairness and the objective fairness in terms of the policy terms. These two perceptions of fairness have to be harmonised to prevent insurance fraud being justified by the policyholder with the argument that he or she "just wanted to make things fair". This too can only be achieved by educating the customer and explaining matters, along with friendly customer communications that provide transparent information and take the customer seriously.

The metaphor of the balance sheet

Insurance companies have hardly any influence on the moral bank balance that a customer creates unconsciously. At this

level, the focus can only be on appealing to the customers' conscience and, as Ariely says, "appealing to their honour".

Referring to the norm

"If everyone does it, it can't be wrong" is an argument used in this justification strategy. Here, too, it is important to educate the customer because, in fact, cheating is not something everyone does. The majority of insurance customers do not cheat. That is the norm; the honest insurance customer is not the exception. Insurance companies should emphasize this fact more so that they give the policyholder the option of joining the honest majority.

Conclusion

Fraud prevention in the area of small-scale fraud can be achieved through more intensive customer support, through faster claims processing and more transparent policy wording, as well as by educating customers to invalidate the arguments used to justify fraud. If the insurance customer sees him/herself as part of a community of policyholders and if he or she knows that every successful fraudulent claim is paid for at the expense of other insurance customers, he will find it harder to inflate a claim or to lie when describing the course of events. Checks and heavier punishments are obviously less effective for preventing these offences because they come into play after the fraud has taken place. Stronger checks also lead to mistrust among insurance customers and can trigger reactions – by way of revenge – in the form of policy cancellations or even fraud.

After analysing his series of experiments, Dan Ariely came to a similar conclusion: We need to appeal to the honesty of the (mostly) honest individual. If an insurance customer has to sign **before** he fills in the claim form to confirm that the following statements reflect the true facts, he is more likely to answer truthfully than if he is not required to sign until **after** he has written his answers.

Transparent policies, fast, personal, friendly customer communications and customer relations that are designed to inform the customer and "appeal to his honour" can be important steps in preventing the mass insurance fraud phenomena of "redefining" and "exaggerating". Grouping insurance customers into "micro collectives" that receive a bonus if no claim is made by anyone in the group over a specified period can also reduce the individual's motivation to commit fraud.

Recommended reading

Ariely, Dan (2012) The (Honest) Truth About Dishonesty, HarperCollins, New York

Ariely, Dan (2010) Predictably Irrational. The Hidden Forces That Shape Our Decisions, Harper Perennial, New York

Kahneman, Daniel (2011) Thinking, Fast and Slow, Farrar; Strauss and Giroux, New York

Kahneman, Daniel, Tversky, Amos (2000) Choices, Values, and Frames. Cambridge University Press, New York

Köneke, Vanessa, Müller-Peters, Horst, Fetchenhauer, Detlef (2015) Versicherungsbetrug verstehen und verhindern, Springer Gabler, Wiesbaden [Understand and prevent insurance fraud, only available in German]

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