CPCU SOCIETY INSURING YOUR SUCCESS

Cutting Edge

IT

Volume 10 Number 1 April 2003

Sys Out

by Patricia L. Saporito, CPCU

Patricia L. Saporito, CPCU, chairman of the IT Section, is a senior property-casualty insurance consultant for NCR Corporation where her responsibilities include business development, business strategy consulting, and strategic alliances in the property and casualty area.

This issue's article on ROI could not be more timely. In almost every customer and prospect discussion I've had in the last year, a business case with at least a 12-month and preferably a six-month ROI seems mandatory. Because of the increased focus on ROI, we have created business impact models (BIMs). A BIM is a calculated projection that uses a company's specific performance measures and metrics to quantify the value of a technology expenditure. We use these metrics not only to justify the initial expenditure based on an expected return but also post implementation to measure the actual return. Frequently the BIM is part of a business discovery engagement to prioritize initiatives; the discovery looks at an initiative's relationship to corporate and departmental goals, strategies, and plans. The post-implementation engagement is a business value assessment.

Since our focus is on data warehousing and analytics, we've developed some specific data warehousing technology models such as Data Mart Consolidation, which looks at the cost of maintaining multiple data marts versus consolidating them into a single enterprise data warehouse. But we also have a portfolio of BIMs that address a wide range of insurance industry-specific issues including customer acquisition and retention, claims management, fraud, and pricing. Bottom line, regardless of whether you are in IT or on the business side of the house, you are likely to be asked to participate in a similar process for any technology expenditure. So I encourage you to read the ROI articles in this issue and also invite you to visit our web site to learn more about ROI and our business impact modeling process at www.teradata.com. ■

What's in this Issue?

From the Editors

by Mary Moore-Campagna, CPCU, CPIW, Lamont D. Boyd, CPCU, and Robert L. Siems, J.D., CPCU

- **Mary Moore-Campagna, CPCU, CPIW,** is a senior consultant with (MC)2 Insurance Training & Consulting in Soda Springs, CA. Moore-Campagna is a member of the CPCU Society's Information Technology Section Committee and the Golden Gate Chapter.
- **Lamont D. Boyd, CPCU,** is director of business development, global financial services, for Fair, Isaac & Company. In this capacity, he is responsible for the identification of client and partnership opportunities that make use of Fair, Isaac's predictive technology and e-commerce products and services for the insurance industry. He previously managed insurance regulatory affairs on behalf of Fair, Isaac and its more than 300 insurance industry clients.
- **Robert L. Siems, J.D., CPCU,** is in private practice with the Law Offices of Robert L. Siems, P.A. He is founder and president of GF Practices, Inc., a consulting company specializing in litigation and risk management to the property and casualty industry as well as other businesses experiencing litigation exposures.

This first newsletter of 2003 focuses on two topics. Return on investment (ROI) in Information Technology (IT) is the subject of one article that we have been allowed to reprint. The prominence of ROI analysis in your daily business is highlighted in the column from our chairman, Patricia L. Saporito, CPCU. Federal Reserve Chairman Alan Greenspan recently echoed the relevance of ROI to the IT industry in his semiannual monetary policy report to Congress on February 11. He remarked that until the unsettled nature of the economy improves, spending on IT would be light. Spending on hardware and software for the fourth quarter of 2002 was 5 percent; he does not foresee improvement.

A second article is on use of IT to combat fraud.

We have included summaries of the seminars sponsored by our section at the Annual Meeting and Seminars in Orlando: Practical Applications of Credit-Based Insurance Scoring, and Electronic Evidence and Discovery Issues. Thanks to Lynn M. Davenport, CPCU, Dale M. Halon, CPCU, CIC, and Dan Blodgett, CPCU, AIM, for those excellent contributions.

Planning is underway on our topics for our next issue. Data warehousing will probably be one of two or three. Consideration for the others is being given to cybercrime and cyberterrorism, data mining, the future of legacy systems, customer's relation's management (CRM), XLM standards, or agents and brokers' use of IT. *Cutting Edge* is your newsletter. To make it more valuable, please take a few minutes to direct your criticism and ideas for future editions to Mary Moore-Campagna (mary@mc2itcs.com), to Lamont Boyd (lamontboyd@fairissac.com) and/or to me (bobsiems@lawrls.com or bobsiems@gfpractices.com).

We welcome Lamont D. Boyd, CPCU, as our newest co-editor! Lamont generously accepted editorial responsibilities immediately after he finished his term as our IT section chairman. He provides great wisdom and energy to our section.

We hope many of you were able to attend the Annual Meeting and Seminars in Orlando. The opportunity for seeing old friends and meeting new ones was enjoyable and educational. The seminars were excellent. Thanks to the panel of William T. Atkins, CPCU, CIC, from the Personal Lines Section Committee; Lamont D. Boyd, CPCU, of Fair, Isaac & Company and our former IT Section Committee Chairman; Gary E. Skerl from Progressive Insurance Company; John Wilson of ChoicePoint, Inc.; and Greg Antenen of Convergence Data for the presentation on credit-based insurance scoring. We are grateful to Eric J. Schwartz, SCERS, and H. Kirke Snyder, J.D., from Forensic Technology Consulting for the presentation on electronic evidence and discovery issues.

IT continues to play a principal part in current events. In late November, Goldman Sachs Group, Inc., Morgan Stanley, The Solomon Smith Barney Unit of City Group, Inc., the U.S. Bancorp Piper Jaffray Unit of U.S. Bancorp, and the Securities Unit of Deutsche Bank AG tentatively agreed to pay fines totalling $8.3M for allegedly failing to keep e-mails and produce them in regulatory investigations according to *The Wall Street Journal*. Federal courts across the country are implementing an electronic filing system known by the acronym: CM/ECF. Docket sheets and unsealed documents filed in civil cases will be accessible through this system. Doing business without leveraging information technology is simply ineffective. In the same report by Alan Greenspan identified in the first paragraph, he stated that innovative technology is a prime factor in increasing workers' efficiency and it is integral to growing this economy. We will continue to use this newsletter as a vehicle in communicating to the section and to the rest of the CPCU Society membership about contemporary issues and better business efficiencies. ■

Return on Information Technology Investments

Editor's note: The following article is comprised of three sections of an August 1996 technology report of the Office of the Inspector General, Legal Services Corporation, and it is reprinted with their kind permission. The work of Jeffrey Barlow, as more specifically referenced in three endnotes, is acknowledged. Those endnotes are not reprinted. To see more on this report, visit www.oig.lsc.gov/tech/tech.htm.

Phases and Returns of Technology Investment

Phase I Technical Proficiency: *Installation and training*. Negative return on investment is expected as up-front costs are incurred.

Phase II Task Automation: *Technology-driven vision focusing on personal productivity at the task level*. Modest 10 to 20 percent return is expected as tasks such as word processing, project management, forms generation, basic statistics are automated. Although successful completion is a formidable challenge, benefits rarely justify major technology investments.

Phase III Business Process: *Tactical business vision drives use of technology*. Returns of up to 300 percent are expected as technology is used for integrating project management and financial systems, providing constant and current executive information, and providing direct customer access from remote locations.

Phase IV Business transformation: *Strategic business vision drives restructuring of business processes using technology*. This, the true "Reengineering" phase, offers almost unlimited returns on information technology investment, as businesses move to eliminate unnecessary tasks and use: just-in-time scheduling, joint marketing partnerships, intra-industry partnerships, and seamless integration with suppliers and customers.

Task automation of functions such as word processing and case management achieves a modest ROI (10 to 20 percent) from the increased speed of the task. An example is automating a court's case docket so that the clerk can look up information faster. The next phase occurs when information technology is applied to a business process rather than a single task, and can return up to three times the investment cost (300 percent). Using the same example, information technology is used to provide direct public access to court records, eliminating the need for the clerk to be involved in retrieving the information. Michigan's 36th District Court gives users direct access to court records by integrating its online records system with a touch-tone telephone system, and Oregon courts now provide public access terminals that allow anyone to "see" court records.

Business transformation occurs when technology is used to restructure the core business itself, to innovate rather than automate. The potential ROI is almost unlimited. Utah state courts have embarked on an experiment that will require all court case documents to be filed electronically. All necessary data will be extracted and entered into court records automatically, and rule-based software will perform scheduling and work routing. Electronic filing yields important benefits: data entry is transferred to the document creator; the courts and its customers no longer have to pay for mail or courier service; and "hypertexting" legal citations to an online database simplifies legal research. Equally important, the court's customers will acquire a research capability not previously available, meaning that the courts will have improved the quality of its service as well as having reduced its cost. It also means that the court system will have greatly expanded its caseload capacity with little or no increase in staffing. ■

Entries Open for Best's 2003 E-Fusion Insurance & Technology Award

A.M. Best Co. is now accepting entries for the 2003 E-Fusion Award. The award is designed to highlight outstanding, resourceful uses of technology in the insurance industry. The final recipient will be announced at the 2003 E-Fusion insurance and technology conference, set for September 28–30 in Philadelphia.The 2002 E-Fusion award recipient was Arthur J. Gallagher & Co., a national insurance brokerage, for its CIPWORKS submission. The Gallagher project enables the company to centrally manage its construction wrap-up unit and provide greatly improved management reports to clients. In 2002, more than 60 insurers, agencies, brokerages, and technology providers submitted projects for the E-Fusion judging. Details and entry forms are available at ***www.efusion2003.com****.*

Practical Application of Credit-Based Insurance Scoring

Seminar Notes from October 20, 2002

by Dale M. Halon CPCU, CIC, and Dan Blodgett, CPCU, AIM

Dale M. Halon, CPCU, CIC, is chairman of the Personal Lines Section Committee.

Dan Blodgett, CPCU, AIM, is a Personal Lines Section Committee member.

Editor's note: This article originally appeared in the CPCU Society's Personal Lines Section newsletter, *Personally Speaking*, Volume 4 Number 4, November 2002.

The following is a summary of the panel presentation entitled "Practical Application of Credit-Based Insurance Scoring" at the CPCU Society's 2002 Annual Meeting and Seminars in Orlando, FL. The Personal Lines interest section sponsored this workshop in cooperation with the Information Technology Section.

Credit-based insurance scoring has been widely accepted in the industry and is being used for underwriting acceptability, premium determination, payment plan offerings, and targeting of potential customers. Companies and producers are faced with consumer questions, unusual score results, inconsistent application of scoring strategies, and redundant processes.

Moderator William T. Atkins, CPCU, CIC, and Personal Lines Section Committee member, explained that credit-based insurance scoring is not well understood by the public. There has been recent backlash from regulators, resulting in the introduction of legislation restricting its use in 30 states. Media attention is negative to say the least.

Lamont D. Boyd, CPCU, of Fair, Isaac & Company agreed that using credit scores to develop risk is not new to the insurance industry. Many insurers have used credit scores for years. So why is this a topic of current debate and controversy? Boyd explained that credit scores used by banks and insurance-based credit scores are different. Banks look at your financial situation as it relates to your ability to pay bills. Insurers look at your score as it relates to your probability of being a higher risk.

Years ago, Fair, Isaac & Company provided insurance regulators with data from its proprietary score model. Regulators questioned the fairness of using score and whether or not it would unfairly discriminate against certain groups of society. In reply, Fair, Isaac & Company had an independent study done by Tillinghast. This study confirmed that Fair, Isaac & Company's model did indeed demonstrate the value of consumer credit in predicting insurance profitability. Today, most regulators now believe there is a correlation of credit and risk. There is still some disagreement as to whether insurance-based credit scoring results in unfair discrimination against specific groups.

What can you do to improve your score? "Pay your bills on time," says Lamont.

Panelist Lamont Boyd with moderator William Atkins.

"Improving your credit management is key to keeping or improving your good score."

Gary E. Skerl, senior analyst in product development for Progressive Insurance Company, also served on the panel. Interestingly, Skerl is a relative newcomer to insurance and credit and came into the industry as a skeptic. Since, ". . .seeing, touching, and feeling . . ." credit-based models, he has become convinced of the correlation and risk management properties of credit and insurance. Concerned about losing the use of score, his company has been actively involved in the public policy debate.

Progressive has its own credit model using only nine variables. Every consumer starts with a score of 100 and has points added or subtracted based on these variables. The higher the score, the higher the risk. The lower the score, the lower the risk. In addition, it has ways of handling risks with no credit score (no hits) or insufficient data (thin files).

Having no score has statistically shown higher-than-average loss ratios. However, there has been pressure from state regulators to not let no hits hurt the consumer. Many states require no hits to be handled in different ways. Progressive has found that older drivers with no hits are better risks than younger drivers with no hits. Adapting products to this data is a key issue.

Progressive also has a Credit Assistance Team. This team is available by a toll-free telephone number in which customers (not agents) can air concerns about their score and its impact on rates. The team helps resolve errors, makes exceptions for extraordinary life events, and provides a personalized credit report. The report tells them how they rate on all the variables used to calculate scores using Progressive's model.

Panelist John Wilson, ChoicePoint, Inc. stressed the importance of using a score model that can be easily understood by carriers and policyholders. The first models used were overly complicated, and state-specific models have to be developed due to regulatory requirements.

Panelists Gregg Antenen, John Wilson, and Gary Skerl.

ChoicePoint would prefer that a single model be used in all states to avoid confusion with agents and consumers. It has a CD score-training program that is a self-executing PowerPoint presentation. It is used by agents to educate themselves and explain insurance-based credit scoring to their customers.

To gain regulatory support, ChoicePoint fully discloses the score model while visiting with the Departments of Insurance and state legislators. In addition, it provides factors that have the most negative impact on the score to consumers. "We want to be helpful to consumers so they can tell what they can do to improve their score," says Wilson. Consumer disclosure is very important. Letting the consumers see the information that affected them and giving them the opportunity and process to correct their credit are vital.

The Fair Credit Reporting Act (FCRA) provides important consumer protection. Wilson said it is in everyone's best interest to keep the use of credit scores honest. ChoicePoint developed a process where consumers can get their own credit report along with the score. He noted that this may not be the score used by that particular policyholder's insurance carrier since many companies use proprietary models. However, it does give the consumer a good idea of what is on his or her report. He reminded us that the main role of credit is to tell us about the personal characteristics of the applicant's financial situation. Other things can be used to disclose risk such as prior loss experience, other lines of business, and prior coverage with other carriers.

Gregg Antenen, of Convergence Data, specializes in finding data that is not normally used for insurance and brings it back repackaged for insurer use. Two types of data were mentioned, check-writing and sub-prime data. To use these, Convergence had to prove the data was predictive, had a decent "hit" rate, and worked in conjunction with the credit score. It focuses on the no-hit and thin-file market segment as well as consumers that have a tendency for a worse loss ratio.

Check-writing data is just what the title implies, information on the checks we use for a payment method. About one-third of consumer spending is done via check. These checks are scanned and registered by the retail operation. Telecheck service, which has more than 300,000 retail locations, tracks this data. A "check-writing score" is developed into Convergence's model. How many checks do we write? What is the total dollar amount? Do we bounce checks? Antenen says, "By taking your credit score and factoring the check-writing score, a predictive model is built."

Sub-prime credit data can be best

Continued on page 6

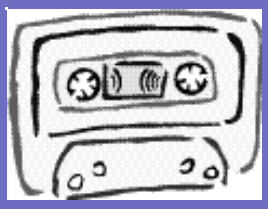
Practical Application of Credit-Based Insurance Scoring

Continued from page 5

explained by an example: Have you seen the advertisements offering to give you a short-term loan based on your paycheck stub? How about your car title? This is sub-prime credit and is monitored by Teletrack. The sub-prime credit bureau does not provide data to the other bureaus used for normal credit scoring. However, there is a large volume of data collected from the areas mentioned earlier as well as check cashing, used cars, rent-to-own furniture; there are 37 million records annually per Antenen.

There are links with insurer risk and check-writing/sub-prime factors when combined with your credit score. The benefits to combining this data to a no-hit or thin-file credit score can greatly assist carriers. By adding missing or enhancing data, they can improve loss ratio at most score levels. Antenen said that they find additional credit data on 47 percent of the orders. From a regulation viewpoint, you can treat traditional no hits just like a hit if you have supplemental data; however, state exceptions do apply.

In closing, the panel believes that as an industry we have not done a good job of educating agents or the public about insurance-based credit scores. We all have the opportunity to take action and change opinions. You can create better credit for yourself by reducing balances and paying your bills. Although you cannot change your past or predict upcoming catastrophic life events, you can live up to the obligations of your credit. ■



Thanks to The Sound of Knowledge, Inc., CPCU Society members are able to order audio tapes and CDs of most Annual Meeting seminars and general sessions. Tapes are available for purchase through The Sound of Knowledge web site, www.tsok.net.

New Look for Newsletter

This issue premieres a new look for your section newsletter. This modern, dynamic design maximizes the space on each page while preserving an easy-to-read format. And keeping in line with our concern for the environment, the newsletter is printed on recycled paper.

Insurance Institute of America AIT Program a Success!

AICPCU IIA Succeeding together.
EDUCATION • RESEARCH • ETHICS

Martin J. Frappolli, CPCU, AIS, Director of Curriculum for the American Institute for CPCU and Insurance Institute of America has provided this breakdown on AIT students by employer:

Insurance Company/Group:	86%
Reinsurance Company:	1%
Agency/Brokerage/MGA	5%
All Others:	8%

The student body is overwhelmingly from insurers. The strong agency automation focus of AIT 132 is new and useful information for insurance professionals, both those working with carriers and those working with agencies and brokers.

The job code breakdown for students employed by insurers follows:

Home Office Technical:	38%
Field Office Technical:	15%
Technical Support:	13%
Manager:	7%
First-Line Supervisor:	8%
Account Exec.:	4%
Entry Level/Trainee/Student:	4%
Secretarial/Clerical:	10%
All Others:	2%

Marty observes that two-thirds are employed in "tech" positions. The program is aimed at "tech" professionals and non-tech professionals. The former are shown how the insurance business ties in to the technology. The non-tech insurance professionals are taught the inevitable and unavoidable technology principles. Waivers for MCSE and other certifications are offered.

The AIT program is grounded in the Institute's philosophy: Consistent with our belief that professionalism is grounded in education, experience, and ethics, we are committed to providing relevant educational programs and to conducting research on significant public policy and ethical issues essential to persons working in risk management and insurance. The Institutes provide leadership in expanding knowledge through education, publications, and research for risk management and insurance professionals of tomorrow.

For more information on the AIT program, please visit www.aicpcu.org. ■

For What It Is Worth

Informationweek.com has shared a list of ". . . inexpensive products that let you, and the employees you manage or support, do more, or better, or both." This editor makes no representations on these products. After you have pushed through our contents on ROI, maybe it will be fun to check these items out:

- *Radio userland 8.0—Userland Software: www.userland.com*
- *Voice-data cell service—Sprint: www.sprint.com*
- *Matador 1.0—Mailfrontier: www.mailfrontier.com*
- *Instant messenger—AOL: www.aim.com*
- *Web conferencing—WebEx: www.webex.com*
- *Thumbdrive storage device—Trekstor USA: www.thumbdrive.com*
- *Security software—Solarsoft: www.madesafe.com*
- *Google search engine—Google: www.google.com*
- *T720 Voice-data cell phone—Motorola: www.motorola.com*

If you are interested in the article from Informationweek.com, the title is "Do More for Less," and the publication date is Dec. 9, 2002.

Information Technology and Fraud Prevention

by Robert L. Siems, J.D., CPCU

Robert L. Siems, J.D., CPCU, is in private practice with the Law Offices of Robert L. Siems, P.A. He is founder and president of GF Practices, Inc., a consulting company specializing in litigation and risk management to the property and casualty industry as well as other businesses experiencing litigation exposures.

A recent survey conducted by Accenture Ltd. reveals that almost one of every four Americans believes it is acceptable to defraud an insurance company! The Insurance Services Office Inc. estimates that property and casualty insurers lose 24 billion dollars a year to fraud. The Coalition Against Insurance Fraud estimates fraud at 80 billion dollars annually when including healthcare. Why such a flood of fraudulent claims? Explanations turned up in the survey include the simple response that it is because claimants can get away with it (49 percent of those who responded), because claimants needed the money (30 percent), and because they believed their premiums were too high (24 percent). Ironically the majority of those surveyed believe that insurers should go after fraudulent claimants. That is good news, but brace yourself for some more bad news: 39 percent of the respondents were not likely to report a fraudulent claim. What is an insurer to do? How does the industry respond to the many issues raised by the subject of fraudulent claims?

Last month, Fair, Isaac & Company published two white papers on detection of fraud: *Prepayment Fraud and Abuse Detection* and *Automated Exception Management for Efficient Claims Processing*. The analysis and the solutions in these papers are summarized as one company's IT answers to these two questions.

First-Party Health Claims

The Centers for Medicaid and Medicare project 2.6 trillion dollars in health-care expenditure in 2010. A reasonable estimate that the cost of fraud is between 3 and 10 percent of these expenditures leads to a projected cost from fraud of between 78 billion dollars and 260 billion dollars in 2010.

The first white paper referenced above, *Prepayment Fraud and Abuse Detection*, is focused on effective pre-payment fraud detection. Predictive analytics are recommended, and these three requirements are identified:

1. Dynamic profiling—mathematical functions used to condense vast amounts of detailed data to its central informational value, which is dynamically updated on a real-time basis.
2. Advanced analytic modeling—techniques that use advanced statistical methods to identify claims patterns and compare incoming claims transactions against these patterns to assess fraud risk.
3. Ranked scoring—a scoring system is implemented so that suspicious claims are identified and automatically routed to an investigative staff, and the system generates reason codes to help the investigative staff prioritize their work on the claims.

The dynamic profiles are intrinsically objective because they are created from the data. Rule-based systems are written by people and therefore more subjective. Intelligent pre-payment systems are able to compliment rule-based, post-payment systems. The former provide more efficient and timely detection—before checks are cut—and avoid the expenses associated with trying to recover money that has already been paid. The former also minimizes false positives.

Property and Casualty Claims

As we go to press, *The New York Times* reports the indictment of 48 individuals in New Jersey for staging automobile accidents and filing more than $500,000 in false medical claims. The insurer is reported to have paid out $150,000 of the $567,940 in personal injury claims when it noticed similarities in the types of claims and the medical providers, and turned it over to the criminal authorities.

In the second white paper, *Automated Exception Management for Efficient Claims Processing*, the authors focus on the use of technology to improve claims services and what is known as exception management technology. The focus is to identify the exceptional claims. Once identified, they receive the additional attention they require. Processing of routine claims is accelerated.

The application of exception management technologies to potential fraud in property and casualty claims share many characteristics of the technologies for first-party health claims. The most basic is rule-driven detection. Next in order of sophistication is rule-based detection with identity/similarity searching. More sophisticated is predictive analytics.

Rule-driven detection is based on identifying claims, which depart from normal standards. The software applies an IF/ THEN approach. For example, the program design provides that IF more than x claims are filed within one month for auto accidents in the same block of Trenton, New Jersey, THEN those claims should be referred to an internal or outside special investigation unit (SIU). Rule-based detection with identity/ similarity searching goes further and may check this increase in auto accidents within the one block of Trenton against the National Insurance Crime Bureau database, against a medical providers' databases and/or against other outside sources. The authors identify predictive analytics as the technology of choice, and its requirements are previously described in more detail. The pluses and minuses of the respective technologies are more fully explored in the white papers.

Summary

Whether technology is specifically designed for first-party health insurance claims or property and casualty claims, the benefit is significant. Casual fraud is deterred. The number of legitimate claims that are delayed for investigation are reduced. The claims against insurers for bad faith because of delay in payment are less likely.

Like other industries, insurers and related businesses succeed and fail from competitive advantage. Implementation of information technology that identifies and prevents fraud creates competitive advantages. Fair, Isaac recommends its Payment Optimizer as a state-of-the-art technology for healthcare pre-payment fraud detection and its Claim Advisor for Exception Management for property and casualty claims. The company's predictive analytics have been used successfully in real time in the credit card industry for nearly a decade. The product, Falcon Fraud Manager, is used to screen 85 percent of United States' credit card transactions for fraud. ■

Electronic Evidence and Discovery Issues

by Lynn M. Davenport, CPCU

- **Eric J. Schwarz, SCERS,** is a director of FTI Consulting's practice in Houston, Texas. With more than 10 years of experience in the field, he is a nationally recognized expert on computer forensics and cyber crime. He has led both national and international forensic and litigation engagements for clients based in the United States and abroad and has been qualified and testified as an expert in computer forensic science. Schwarz holds a B.A. in economics from the University of Western Ontario and an M.B.A. from Boston University and is certified as a SCERS (Seized Computer Evidence Recovery Specialist) and as a CIAA (Computer Investigations in an Automated Environment) by the Federal Law Enforcement Training Center.
- **H. Kirke Snyder, J.D.,** is managing director of FTI Consulting's EEC (Electronic Evidence and Consulting) practice, which specializes in electronic media discovery and electronic fraud detection in support of litigation and financial investigations. He has earned a J.D. and master's degree in legal administration and is an adjunct professor of law and ethics for Regis University's M.B.A. program in Denver, Colorado.

On October 20, 2002, at the Annual Meeting and Seminars, our section was fortunate to have Eric J. Schwarz, SCERS, and H. Kirke Snyder, J.D., from FTI Consulting, present an excellent seminar on electronic evidence and discovery issues.

Presenters Schwarz and Snyder focused on electronic evidence and e-discovery—acquiring and preserving the evidence, restoring deleted files, eliminating duplicates, and producing documents to opposing parties, and electronic fraud detection—insurance claim and expense fraud, anomaly investigations, fraud detection experience, report profiling and ranking, and a demonstration of capabilities.

Electronic Discovery Issues

Electronic discovery impacts all organizations today and this will continue into the foreseeable future. The more "stuff" people keep around, the more risk they expose to litigation and class-action lawsuits. Enron changed the role of electronic evidence in litigation. Spoliation (the destruction of evidence) can cause an organization to lose a case if it is inferred that the organization deleted something relevant to the case.

> *. . . "We didn't see that e-mail" doesn't get an organization or management off the hook.*

In reality, saying "We didn't see that e-mail" doesn't get an organization or management off the hook. If even one document is alleged to exist, the defendant must pay for an expert to find it. A good example of the high cost of poor preparation is the *Ford v. Firestone* case. After being put on notice of a lawsuit against them, Ford did not capture e-mails related to the two troubled models during prior years, and those e-mails went through the normal destruction process. A resulting punitive order against Ford cost an estimated $20–$30 million to retain all e-mail until the litigation was over.

A critical need for a defendant subject to discovery is to be able to testify that the electronic information has not been altered. This is a problem because in Microsoft Outlook, a common e-mail platform, you can't tell a memo has been edited unless you access the memo's electronic file. A few tips:

- When in litigation, consider immediately taking images of personal computers and Palm Pilots because employees can delete files that are critical to the electronic discovery; the cost to preserve or create a copy of one average computer is approximately $500–$1,000.
- Be careful about wiping hard drives clean after an employee leaves the company.
- If you anticipate litigation, start the preservation process of electronic evidence early.

Preserving electronic evidence is a new cost of litigation that is here to stay. Many courts today are ruling that printouts of electronic information are not good enough. Managing your electronic evidence is a cost of doing business in today's world. Organizations can manage this new cost by using electronic preservation as a *strategy* to control higher costs that could develop from discovery requests for electronic information that cannot be located.

Fraud in Today's Environment

News headlines throughout 2002 have highlighted fraudulent activities: Enron, Global Crossing, Merrill Lynch, Sunbeam, WorldCom, and Xerox. These organizations reflect a culture of fraud within companies that hired M.B.A.s from respectable schools. What

happened? The environments of these organizations have one common element: bright people competing with each other (rank and pay based on performance, often with the lowest 10 percent being terminated) and a performance measure that focuses on the wrong thing ("to make stock go up").

In his *Model of Moral Development*, Lawrence Kohlberg identifies three stages of ethical maturity:

- Preconventional—Punishment and obedience enforce moral decisions, and people do the right thing to avoid punishment.
- Conventional—Interpersonal concordance exists, and people do the right thing because it's the right thing to do.
- Postconventional—Universal ethics principles come into play, and people do the right thing because of their own internal principles.

Employees in fraud-ridden organizations tend to experiment with "fudging" on expense sheets and statistics, continually getting away with it and reinforcing the preconventional stage. Most litigation related to these fraudulent activities falls under directors and officers (D&O) insurance and related e-mail is part of the discovery.

Electronic discovery and Enron has *changed our world* and the cost of litigation. Organizations (and the insurance companies covering them with D&O policies) need a plan up front to produce electronic information in the event of litigation, or the costs skyrocket later.

Fraud Management Warning Signs:

- management bonus is tied to achievement of certain targets
- management (executive board) is controlled by a single person or very small group (no diversity of interests)
- management officers fail to correct known internal weaknesses
- high upper management turnover

Fraud Financial Warning Signs:

- irregular transactions
- no supporting documentation of transactions
- reconciliation difficulties
- unexplained adjustments

Employee Warning Signs:

- expensive lifestyle
- debts
- gambling
- personal loss

Fraud Deterrence:

- top-down corporate culture against fraud
- fraud awareness program within the organization
- zero-tolerance fraud policy
- employee background checks
- fraud detection mechanisms performed by outside specialists who don't report to someone within the company and can be impartial

The Electronic Fraud Detection Process

The vendor performing the review obtains data from the organization's automated systems, and goes through a series of tests to check for fraud indicators. The vendor customizes the tests to the organization and works with the IT Department to extract and verify data. Then the vendor works with management to fine-tune and evaluate the results.

Through a systems analysis, anomalies in disbursements can be detected and evaluated. Organizations with automated data management rather than manual data controls inherently contain more fraud checks—these systems generate exception reports, flag duplicate entries, and use standardized names/addresses. There is less control over fraud with manual data entries, and anomalies can be explained as "errors" or "duplicates." Areas of potential concern identified by an automated system review of invoicing and employee records include:

- wrong vendor listed on the same invoice
- frequently late payments issued to a particular vendor when payments are otherwise normally made on time
- checks written by an employee on Sundays
- checks written to inactive vendors
- shared vendor addresses
- employee and vendor addresses are the same

Review of these red flags is necessary to truly determine whether there has been fraud or not. Combinations of red flags require further review; multiple red flags cause greater concern. Eighty percent of fraud comes from "ghost" employees and "ghost" vendors, with information manually entered in the system to create accounts and payments.

Warning Signs within a Claims Organization:

- claims repeatedly paid late by a particular employee
- payee address or names are similar to an employee's name and address
- high number of claim payments issued near employee's authorization limits
- insureds linked to one another
- a particular body shop only receives payments from one particular employee ■

Do You Want to Be All That You Can Be?

Advance Your Career.

And Become the Leader You've Always Wanted to Be!

CPCU Society National Leadership Institute 2003

Spring 2003 CPCU Society National Leadership Institute

May 8-9, 2003

Tampa, FL

"Insure Your Success" with the National Leadership Institute (NLI), the CPCU Society's premier educational program offering specialized career and leadership training *for* insurance industry professionals *by* insurance industry professionals. The Spring 2003 NLI will feature:

- The five core NLI certificate courses on communication, facilitative leadership, finance, project management, and resilience.
- Four new career and leadership development courses in time management, negotiation and conflict management, coaching, and building relationships.
- Not one, but two keynote Leadership Luncheon speakers!

Register Today!

Attend the Spring 2003 CPCU Society NLI to develop the skills you need to distinguish yourself from the rest and succeed in today's competitive marketplace! To learn more, log on to the CPCU Society web site, www.cpcusociety.org, or refer to your NLI brochure included in the February/March 2003 issue of the *CPCU News*. For more information, please contact the Member Resource Center at (800) 932-CPCU, option 4, or at membercenter@cpcusociety.org.

Cutting Edge
is published four times a year by and for the members of the Information Technology Section of the CPCU Society.

***Cutting Edge* Co-Editor**
Lamont D. Boyd, CPCU
Fair, Isaac & Company
PMB 214 Suite 45
4727 E. Bell Road
Phoenix, AZ 85032-9380
Phone (602) 485-9858
Fax (602) 485-9874
E-mail: lamontboyd@fairisaac.com

***Cutting Edge* Co-Editor**
Mary C. Moore-Campagna, CPCU, CPIW
(MC)2 Insurance Training & Consulting Services
PO Box 609
Soda Springs, CA 95728-0609
Phone (530) 426-0646
Fax (530) 426-9503
E-mail: mary@mc2itcs.com

***Cutting Edge* Co-Editor**
Robert L. Siems, J.D., CPCU
Law Offices of Robert L. Siems and GF Practices, Inc.
3683 Clipper Mill Road
Baltimore, MD 21211-1900
Phone (410) 366-3796
Fax (410) 366-4613
E-mail: bobsiems@gfpractices.com

Information Technology Section Chairman
Patricia L. Saporito, CPCU
NCR Corporation
6B, 250 Gorge Road
Cliffside Park, NJ 07010
Phone (201) 941-2330
Fax (201) 941-2994
E-mail: patricia.saporito@ncr.com

Sections Manager
John Kelly, CPCU, AIT
CPCU Society

Managing Editor
Michele A. Leps, AIT
CPCU Society

Production Editor/Design
Joan Satchell
CPCU Society

CPCU Society
PO Box 3009
Malvern, PA 19355-0709
(800) 932-2728
www.cpcusociety.org

CPCU Society Insuring Your Success

Cutting Edge

IT

Volume 10 Number 1 April 2003

CPCU Society
720 Providence Road
Malvern, PA 19355-0709

PRSRT STD
U.S. POSTAGE
PAID
BARTON & COONEY