Quantifying the Value of Counter Fraud Analytics in Insurance

Putting the Business Impact of Insurance Fraud in Perspective

The prevailing wisdom seems to be that insurance fraud costs a company, on average between 5% and 10% of annual revenue. But averages can be misleading and inconsistent formats can make such estimates difficult to interpret.

To help address these issues, Aberdeen Group has applied a simple but highly effective analytical approach to evaluate the cost of insurance fraud and to quantify the value of investments in counter fraud analytics capabilities in order to reduce your risk exposure.

Focus of Aberdeen's Analysis: Property & Casualty Insurance

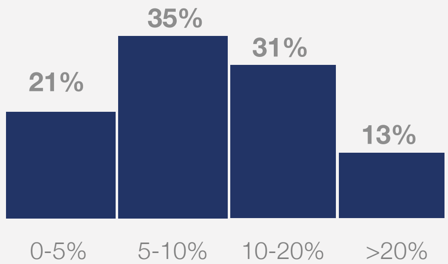
Aberdeen's focus for this analysis is the fraud risk impact within **property and casualty insurance**, which is designed to protect policy holders against:

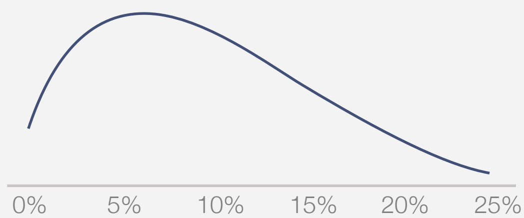
Property losses to vehicles, homes, or businesses

Legal liability as a result of injury to others, or damage to the property of others

Annualized Cost of Fraud in Property and Casualty Insurance as a Percentage of Top-Line Revenue — Empirical Data and Distribution for Aberdeen's Monte Carlo Analysis

Estimates for the annualized cost of fraud in the property and casualty insurance industry, as a percentage of top-line revenue, range from 0% to more than 25% (ACFE 2016 Global Fraud Study). Aberdeen's Monte Carlo model uses a probability distribution that closely mimics this empirical data.





Source: Adapted from FICO Insurance Fraud Survey 2013; Aberdeen Group, November 2016

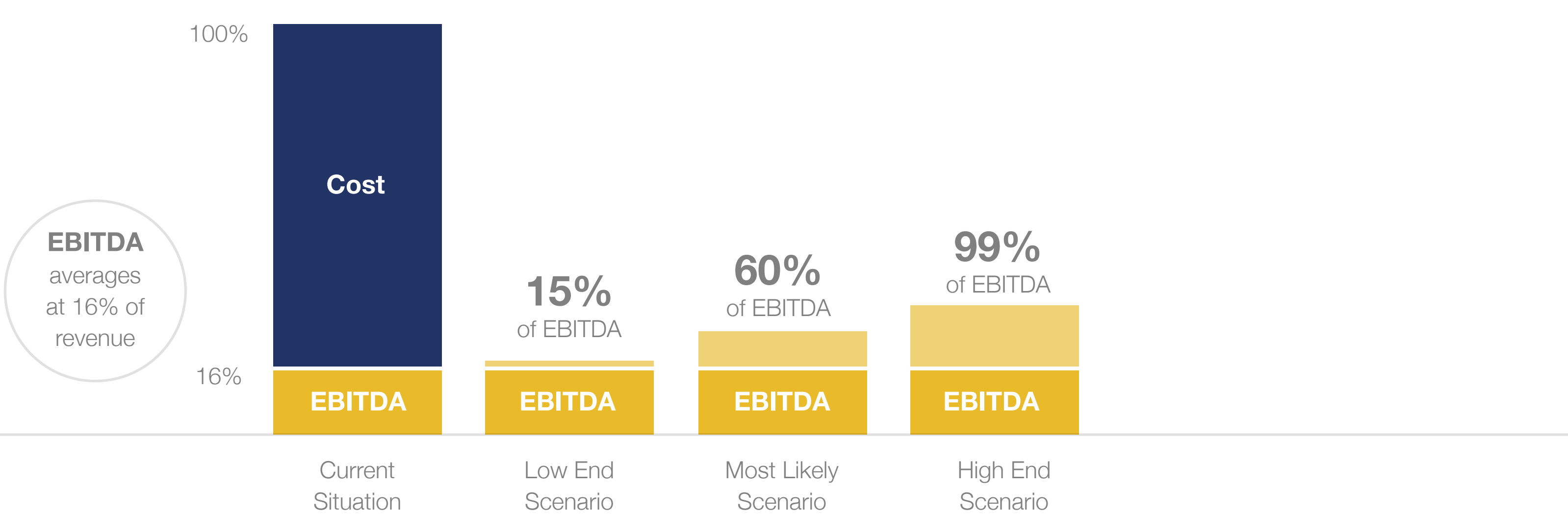
A Closer Analysis of the Business Impact of Insurance Fraud: Is This Really an Acceptable "Cost of Doing Business"?

Some may argue that the cost of fraud is already baked into the property and casualty insurance industry's operating models as "a cost of doing business." This cost is reflected in higher cost structures for insurers and higher premiums for the insured. Even so, fraud remains a drain on profitability — and a reduction in fraud goes directly to the organization's bottom line.

To put this point in perspective, consider the average **earnings before interest, taxes, depreciation, and amortization (EBITDA)** for the property and casualty insurance industry. Over the past five quarters, the annualized (based on the trailing twelve-months) EBITDA ranged between **11.85%** and **18.95%** of top-line revenue (CSImarket.com, October 2016).

By incorporating this empirical data into its simple Monte Carlo model, Aberdeen's analysis shows that the annualized cost of fraud has a significant business impact. For **every dollar** of profitability in the property and casualty insurance industry's profitability, the annual cost of fraud under the status quo is most likely to be about **60 cents**, with a 10% likelihood that it will equate to **nearly an extra dollar of cost.** Is this really an acceptable "cost of doing business?"

Common-Size Income Statement

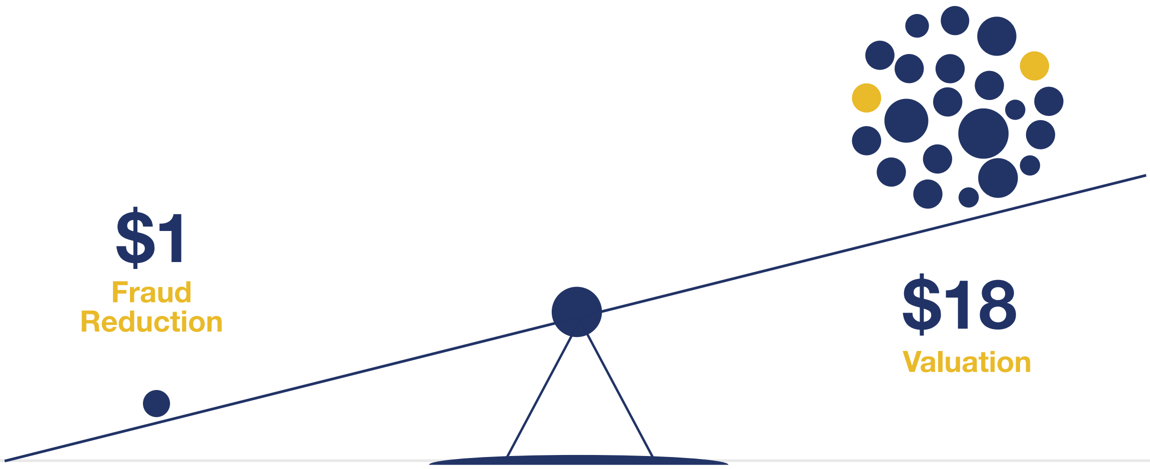


By fighting fraud and reducing the cost of fraud, organizations can potentially achieve **1.6x** the in current profitability levels, i.e., increase their profitability by **60%**.

Taking the Analysis to the Next Level: From Profitability to Market Value

To take this analysis of the business impact of fraud to the next level, consider the **price to earnings (P/E) ratio** for the property and casualty insurance industry. Over the past five quarters, the P/E ratio ranged between **5.70** and **29.59** (CSImarket.com, October 2016).

By incorporating the P/E multiples for the property and casualty insurance industry into its Monte Carlo model, Aberdeen's analysis further illustrates the significant impact of fraud: under the status quo, **every $1 in fraud reduction** that falls to the bottom line would in turn translate to an increase of **$10.80 to $24** in market valuation, with a median of about **$17.70**.



Again, this raises the question: Is this really an acceptable "cost of doing business?"

Counter Fraud Analytics Solutions: It's About Time

The primary value of counter fraud analytics solutions is realized in **detecting fraud sooner** — before fraudulent claims are paid. Under the status quo, companies consistently report that fraud is being committed for up to **five years or more** before being detected, with a **median duration** of about **20 months** (ACFE 2016 Global Fraud Study).

By taking full advantage of the advanced capabilities currently being offered by leading counter fraud solution providers—especially when integrated with **predictive analytics** and **cognitive computing capabilities**—the enterprise counter fraud department can significantly reduce the time it takes to identify, investigate, and shut down fraudulent activity. This drives a proportional reduction in business impact. Twice as fast = half the risk.

Investments in counter fraud solutionscan help enable:

- Swifter detection and investigation of fraudulent activity
- Lower fraud losses, higher profitability, and higher market valuation, as illustrated by Aberdeen's analysis
- Lower operating costs for counter fraud activities
- Improved productivity for counter fraud activities, which frees up resources for other strategic tasks
- Competitive advantage, e.g., keeping insurance rates low
- Superior Customer Service, eg., minimal delay in handling legitimate claims

How Should Business Leaders in the Insurance Industry Respond?

Business discussions about fraud in the insurance industry need to begin by fully appreciating the significant impact of fraud, not only in terms of the cost to the insurer, which is increasingly unaffordable, but also in terms of the social impact of fraud, which is increasingly unacceptable.

By taking full advantage of the integration and advanced capabilities currently being offered by leading counter fraud solution providers—including predictive analytics, cognitive computing, link analysis, and social media data mining—enterprises in the insurance industry can expect to achieve significantly better outcomes.

Learn about IBM counter fraud analytics for insurance