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Turning Risk Into Wealth

Strategies for banks in the fight against consumer fraud

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In an era where digital payments reign supreme, the battle against consumer fraud has become a paramount concern for leadership within banks, fintechs and credit unions. The rise of sophisticated scams, coupled with the increasing digitization of financial services, has created a fertile ground for fraudulent activities, leaving both financial institutions and consumers vulnerable to financial losses and legal battles.

Alloy's 2024 State of Fraud Benchmark Report sheds light on the gravity of the situation. With nearly 60 percent of financial institutions reporting over \$500,000 in direct fraud losses in 2023 alone, it's evident fraud remains a persistent threat demanding urgent attention. Moreover, the report highlights a concerning trend: Over two-thirds of respondents reported an increase in fraud attempts in consumer accounts over the past year. This surge in fraudulent activities not only erodes trust but also imposes significant financial burdens on banks and their customers.

In the wake of this mounting threat, as a bank executive, you undoubtedly find yourself confronted with the formidable challenge of fortifying your institution's defenses against fraud while navigating the intricate landscape of liability and litigation. Consider the recent ordeal of Alice Lin, a senior residing in Los Angeles, who fell victim to a fraudulent scheme known as pig butchering. This

insidious confidence trick and investment fraud gradually enticed Lin into making substantial contributions, resulting in the loss of \$700,000 from her life savings.

Lin's subsequent lawsuit against Chase Bank underscores the gravity of the situation, alleging Chase overlooked several warning signs. In January, Lin initiated legal proceedings against her longtime banking institution, asserting it failed to take adequate measures to safeguard its most vulnerable clientele — senior citizens. Such incidents not only inflict financial harm but can also tarnish the reputation of your bank, eroding the trust and confidence of their customers.

Addressing consumer fraud risk

The evolving landscape of fraud presents multifaceted challenges that require a holistic approach to risk management. From the proliferation of phishing attempts leveraging generative AI to the emergence of real-time payment rails fraught with vulnerabilities, banks like yours face a formidable adversary that adapts and evolves at an alarming pace. As highlighted in the latest NICE Actimize Fraud Insights report, the transition from cash to cashless payments has paved the way for new opportunities for fraudsters, with payment fraud increasing a staggering 22 percent globally.

Many banks are deploying a range of strategies in response to safeguard their financial interests and protect consumers from fraud. Advanced fraud detection systems powered by artificial intelligence, stringent customer verification protocols and the adoption of EMV chip technology are just a few examples of the proactive measures being taken. Moreover, banks are bolstering their defenses through education and awareness initiatives, equipping customers with the knowledge and tools to identify and thwart fraudulent schemes.

Despite these efforts, you may still be grappling with gaps and limitations in your defenses against fraud. Traditional insurance policies, while offering a degree of protection, often fall short in fully covering the extensive losses in

the wake of large-scale fraud incidents. Policy exclusions, coverage limits and disputes over claims can leave you exposed to financial liabilities and legal battles, further exacerbating the challenges you may face. Enter captive insurance — a strategic tool holding the promise of addressing some of the shortcomings of traditional insurance arrangements.

How captive insurance poses a unique solution

By establishing captive insurance subsidiaries, your bank can tailor coverage to specific needs, access reinsurance markets to spread risk and gain greater control over insurance programs in the following ways:

- **Tailored coverage:** With captive insurance, your bank can have greater flexibility to tailor insurance coverage to specific needs and risk exposures. Unlike traditional insurance policies with standard terms and conditions, captive insurance allows your bank to customize coverage limits, policy terms and coverage extensions to address the unique risks associated with consumer fraud.
- **Access to reinsurance markets:** Captive insurance companies can access reinsurance markets to spread risk and obtain additional coverage beyond their own capacity. Reinsurance provides an extra layer of protection against large losses, enabling captive insurers to mitigate the financial impact of catastrophic events such as widespread consumer fraud.
- **Cost savings:** By retaining and managing insurance risks through a captive insurance structure, your bank may realize cost savings over time compared to purchasing traditional insurance policies. Captive insurance allows your bank to capture underwriting profits, investment income and risk management efficiencies that would otherwise be retained by commercial insurers.
- **Risk management integration:** Captive insurance encourages closer integration between risk management and insurance functions within your bank. By assuming a portion of the insurance risk through your captive, your bank has a vested

interest in implementing robust risk management practices to reduce the frequency and severity of consumer fraud incidents.

- **Enhanced control and transparency:** Captive insurance provides your bank with greater control and transparency over their insurance programs. Your bank can directly manage claims handling, underwriting decisions and investment strategies, leading to more efficient and responsive risk management practices.
- **Regulatory benefits:** Depending on the jurisdiction and regulatory environment, captive insurance arrangements may offer certain regulatory benefits or incentives to your bank, such as favorable tax treatment or exemptions from certain insurance regulations. These regulatory advantages can further enhance the appeal of captive insurance as a risk management tool for your bank.

Additional consumer fraud risk considerations

As banks like yours navigate the complex landscape of fraud liability, regulatory compliance remains a critical consideration. While regulatory frameworks such as Regulation E under the Electronic Fund Transfer Act impose responsibilities on banks to protect consumers from fraud, the evolving nature of fraud demands continuous adaptation and vigilance. With liability shifts and regulatory reforms on the horizon, banks must stay attuned to emerging trends and best practices in fraud prevention to safeguard their interests and uphold the trust of their customers.

The fight against consumer fraud requires a collaborative and forward-thinking approach transcending traditional boundaries. By leveraging innovative technologies, implementing robust risk management practices and exploring strategic insurance solutions such as captive insurance, your bank can bolster its defenses and protect both financial interests and the interests of your customers. In an ever-evolving landscape fraught with challenges and uncertainties, proactive measures and strategic partnerships will be key to securing a safer and more resilient future for all stakeholders.

A risk manager, Christopher Gallo joined Knoxville, Tenn.-based insurance company CIC Services in 2020, and directly consults with business owners, CEOs and CFOs in the formation, and as a regulatory liaison, of captive insurance programs for their businesses. He is leading CIC's launch of BankInsure this year, which will provide comprehensive insurance for small to mid-sized banks.