

KPMG FORENSIC: MONEY LAUNDERING AT AGNES INSURANCE

R. Chandrasekhar prepared this case under the supervision of Professor Abhijit Gopal solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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INTRODUCTION

Richard Blake, chief financial officer, Agnes Insurance Co., felt drained. His late Friday evening meeting with Chris Moratti, vice-president, KPMG Forensic, had staggered him — he could never have imagined that a company like Agnes, which put the highest value on probity and integrity, would be playing host to a money laundering operation. The person who had engineered this ‘operation’ had been with Agnes for years, had seemed entirely above reproach; now it looked as if the money laundering might have been going on undetected for years.

Blake knew he was going to have to shake off the shock of it all and decide how to proceed. It was not merely a matter of deciding what action to take against the employee — though even that, as Moratti had soberly impressed upon him, was not going to be a simple disciplinary matter. In the wrong hands, the entire episode could rock the very basis of trust on which Agnes Insurance was founded. True, none of its clients’ interests had been compromised, but that appeared to be the only redeeming factor so far in the entire episode.

Blake found himself struggling once again to get beyond his emotional response. He would have to talk to the chairman first thing on Monday and lay out a plan of action. Should he offer to resign? All this had happened, after all, on his watch. Yet, that sort of move could put the company on even more slippery footing,

sending out potentially wrong signals as well as undermining the company's capability to mount a sober and reasoned response. Then there were the issues of what to do with the company's information systems in order to avoid any such occurrence in the future, as well as winning back the confidence of stakeholders.

It had all begun with a call he had made a month ago to Moratti.

After the preliminaries, Blake commented,

We've been talking to a U.S. insurance major about a possible joint venture, we're excited about the obvious synergies. Agnes will have access to technology and scale; the U.S. major will strengthen its portfolio with our niche products and incorporate some of our agility. We're still in preliminary talks, but my counterpart wants to be sure that our internal business processes are 'squeaky-clean,' as he puts it. In fact, he suggested we get a 'Fraud and Misconduct Diagnostic' done by you. I believe that's your area of expertise. How do we go about it?

THE COMPANY

Agnes was a medium-scale player in Canadian health insurance. Its products had gained wide acceptance for three reasons: They were basic, sans frills. They were easy to understand. And the pricing was attractive. The products fell into two broad categories: the Company Plan and the Personal Plan.

The Company Plan, which contributed to 80 per cent of turnover, was targeted at small and medium enterprises that employed between 50 and 500 people. Premiums were deducted at source by individual companies and credited directly to Agnes fortnightly or monthly, depending on the pay period. The Company Plan had several advantages for Agnes: it ensured a captive pool of customers, the revenue stream was regular and cash flow was even.

The Personal Plan was targeted at a wide range of customers — self-employed professionals, owners of proprietary businesses, wage earners in low-income families, contract workers, retirees and those on extended periods of layoff. Premiums ranged between \$17 and \$65 per month, depending on age, single/family options and specific coverage needs. Individual policyholders paid by cash or cheque at predetermined intervals. Payments were fairly regular and, thanks to excellent service from Agnes, defaults were less than five per cent.

DIAGNOSTIC

As he set about conducting a formal survey, the first thing that impressed Moratti about the company was the informality that prevailed in its corridors. With only four hierarchical layers, people had easy access to one another. Equally evident was a strong customer focus. Support services and other backroom operations were exemplary. Most employees had been with Agnes since its inception two decades ago. So had its customers, which reflected the long-term nature of the insurance business.

Moratti was, however, surprised to find that Agnes did not have an operating manual. Although it was not a statutory requirement, an operating manual served as a safety net, in a financial services company in particular, by formalizing, in writing, the limits of responsibility and authority for each type of financial transaction. “We don’t have an operating manual because,” Blake explained, “we’ve never felt the need for one, at least so far.” He was, however, quick to point out that, if necessary, he could have one written in a week.

Blake went on,

You know, Mr. Moratti, this issue came up during our joint venture talks. Agnes is a company with a soul. We’ve worked hard, even as we’ve grown, to preserve that core. We don’t want to become a large, faceless bureaucracy. We know our customers. They know us. Their transactions are predictable. We trust them. They trust us. In fact, it’s on mutual trust that we’ve built this business.

The first alarm bell went off for Moratti as he quickly suggested that Blake get the manual ready at the earliest.

Process Mapping

Moratti began to map the various internal processes at Agnes. A major process was the receipt, storage, transportation and deposit of cash and negotiable instruments.

The process was simple as far as the Company Plan was concerned. There was no physical handling of cash or cheques. Payroll deductions at the client companies were being credited directly to Agnes. Besides, Blake had access at his terminal to the Company Plan account with the bank. The CFO could look over credits in real time. Accounts between Agnes and the bank were being reconciled within two working days.

The process was, however, not as simple for the Personal Plan. Premiums for the Personal Plan were received at Agnes in three ways. Some policyholders had

arrangements with their banks for direct deposits at fixed intervals of a month or a fortnight. Some others mailed their cheques. The rest visited the Agnes office in person and paid by cash or cheque for which they collected an official receipt on the spot. The company had two receipt books — one for cash and one for cheques. Each book was serially numbered.

Blake had access at his terminal to both receipt books. All receipts by mail and in person were updated before 3 p.m. daily. The cash and cheques were deposited at 4 p.m. every day at the neighborhood bank.

The system appeared robust, but what made Moratti uncomfortable was that activities that required bifurcation for reasons of security were combined into a single role performed by a single individual. There were no firewalls between the functions of receipt and deposit. The individual who received the cash and cheques, by mail and in person, and held them for a while, was also the one who deposited them at the bank every evening.

Blake admitted,

True, there is a potential conflict of interest in that role, but, you know, health insurance is a competitive business where margins are thin. Securing consistently high levels of productivity from every single resource deployed in operations is a major concern among insurance managers. Cost cutting is an ongoing drive. When we see deadwood, we chop it. Laying off people whose roles have become redundant is common. We're always alert to opportunities to combine several roles into an individual job. In fact, multi-tasking is a skill we value and nurture at Agnes. We run a tight ship.

"You need highly driven people in this business," agreed Moratti.

"That's where nurturing comes in," said Blake. "Edward Fraser, the accountant who mans our cash counter in his primary role, has been with us 15 years. Ed is honest and reliable. He's trustworthy."

The alarm bell sounded again for Moratti.

Pieces of a Puzzle

A few days later, as he walked into his transit office at Agnes one morning, Moratti noticed a person waiting at the cash counter with a cheque in hand. The accountant was away from his desk. Moratti asked if he could help. "I'm waiting for Ed," the visitor said. "I need to pay my premium." Moratti asked, casually, to

see the cheque. It was for \$67.50 and bore the name of Richard Crasta. Moratti made a mental note of the information.

Later in the evening, he logged on to the update. There was indeed an entry of \$67.50 against Richard Crasta, but it had been made in the cash receipt journal, not in the cheque receipt journal. When three other similar discrepancies occurred over the next few days, Moratti knew it was not a clerical mistake. It was deliberate. It showed a pattern. A closer look was in order. He decided to have a chat with Fraser before going any further.

Fraser was friendly. He had an easy manner. He seemed to like his job and he knew the business. The two spoke about common interests in sports and theatre. It was evident that Fraser had an uncanny ability to inspire trust and confidence in people who dealt with him.

But Moratti was a veteran investigator. Before joining KPMG Forensic three years earlier, he had been with the Royal Canadian Mounted Police for over two decades and had participated in an international money laundering sting operation. He had played the role of a money launderer himself in a cover that had put him at personal risk, but had helped various governments identify and arrest several operatives and seize their assets.

Moratti had a feel for “trouble spots.” His instinct suggested that Fraser was a trouble spot at Agnes. It was unlikely, however, that anyone at Agnes, including Blake, would believe this. In any event, he could not bring it up without tangible evidence. He started to probe.

Falling Into Place

It was only two weeks later that Moratti met with Blake for a long session. It was late on a Friday evening and people had left for the day.

Moratti began,

Let me thank you for playing out the game that we had agreed on at the beginning of this assignment, this investigation would not have been possible if you had mentioned to your colleagues that I was here to conduct a Fraud and Misconduct Diagnostic. Ed would have been on guard and we would never have known.

“Ed?” asked Blake, surprised. “What about him?”

“Brace yourself for this, Mr. Blake,” said Moratti. “Ed has been using Agnes to launder money.”

“Launder money?” asked Blake, shocked. “This is a respected institution, Mr. Moratti, not a gambling den. Ed? Are you sure?”

“Unfortunately, yes,” said Moratti. “I wouldn’t have noticed either but for a chance encounter I had with one of your depositors at the cash counter one morning . . .”

Laundering

Moratti continued,

This is what’s happening. As part of his job, Ed has been receiving cash and cheques towards premiums every day from individual depositors who walk up to your cash counter. Of course, each receipt is being accounted for through a serially numbered receipt book. As CFO, you also have ready access to the receipt book at your own terminal. But what Ed has been doing is to issue a cash receipt for a cheque once in a way and deposit an equivalent amount in cash at the bank. You have no way of knowing it because the receipt books are serially numbered and, in any case, the amount is fully accounted for in the individual’s account.

“Why would he do that?” asked Blake. “I mean, where does he get the ‘equivalent’ cash from, as you call it? And what does he do with the cheque?”

Moratti replied,

Ed brings in his own money. It is obviously illegal money earned in cash. He introduces it into the mainstream financial system, in bits and pieces, to make it legal. That is the first stage of money laundering. It’s called placement (see Exhibit 1 for a depiction of the money laundering process). It’s like a gateway. Once the money gets in, its future passage becomes easier. It also becomes progressively more difficult for an investigator to trace its origin.

He continued,

As for the cheques he has bypassed, Ed takes them to a moneychanger. You know, of course, buying cheques and other negotiable instruments from an individual in urgent need of cash is the legitimate business of a moneychanger. After deducting a nominal commission, the moneychanger either pays cash up front or issues a cheque which can provide instant credit. Ed collects a cheque. Once the cheque is deposited into a valid bank account and the proceeds duly credited, it masks the original source of money

with a new layer. This is the second stage of money laundering. It's called, well, layering. From here on, it is recycled into various bank accounts and subject to a series of layerings so as to distance it from the original source as far as possible. Are you with me?

"Yes," said Blake. "But I am wondering how our internal controls failed."

Moratti went on,

That is where the processes in your Personal Plan fit Ed's plan nicely. The cheque amounts are small enough to go unnoticed. And Ed does it for customers whose pattern is predictable, as you once told me. He does it for customers who trust him so much that they do not even bother to collect a receipt when they hand over the cheque. In fact, I heard one of them say, "It's okay, Ed. I'm in a rush." In any case, they know that the amount shows up as payment in their bank account sooner or later. And it does, soon after the money changer collects his proceeds from that particular cheque.

"It doesn't gel somehow," said Blake. "Ed, a money launderer? He's a hard worker, he hasn't had a vacation in years."

Moratti replied,

Well, there might be good reason for that, you may also be wondering why, if Ed's rolling in money, he's still hanging on to his job here. It's simple. Agnes provides a front. And Ed himself is a front for a money launderer who happens to be his uncle.

"Uncle?" asked Blake.

"Yes," Moratti continued,

In fact, that was how the pieces of the puzzle started falling into place. I once had a chat with Ed and he mentioned that his uncle was a partner in a money exchange firm in Toronto. I recalled that we had built a dossier on this person at the force. We had suspected his involvement in money laundering. We covered the trail and we knew. But securing evidence that can stand the test of a courtroom trial in cases like these is extremely difficult. For example, an investigator is meant to trace all suspicious transactions backwards and create a funds flow statement. This is the way to connect the dots in a manner that provides shape and substance to the prosecutor's case. Tracing these transactions appears simple on the surface but, at the ground level, it's daunting.

One comes across dead-ends so often. That's why defendants often get sentenced for lesser crimes while the grand conviction that the investigator is after falls flat on purely technical grounds. Remember Al Capone? He was the biggest money launderer of his time. But all that he could be convicted for finally was tax evasion.

Besides, there is also the matter of the productivity of public funds. It takes time and financial resources to pursue a case to its logical end. This is often the biggest disincentive for prosecution.

"Ed in the same league as Al Capone!" exclaimed Blake, wondering whether Moratti was going overboard after all.

Retrieving a document from his desk, Blake went on,

We're doing our annual appraisals right now and I happen to have Ed's dossier here with me. He came to us through a placement agency which, one would imagine, had done the necessary background check. There is no mention here of what his uncle does or what Ed does with his uncle. Frankly, it's not relevant. What is relevant is that Ed has a good track record at Agnes. He's clean, as far as the information here goes.

"He's clean all right," echoed Moratti. "In fact, he's squeaky clean. I pulled some strings at the force and ran him through official files. He has no criminal record. He doesn't even have a traffic ticket."

The sense of relief that Blake felt was only temporary. There were three overarching issues. Fraser had misused his position at Agnes to facilitate a criminal activity. There was a systems failure at Agnes. And Blake had lost control over his turf. Clearly, as the chief financial officer (CFO), Blake was now accountable.

"I've always been hands-on. How could this happen?" Blake asked, putting aside the dossier.

Moratti said,

When you work closely with a person day-to-day for years and develop a mutual comfort level, you ignore the trees for the wood. For me, it started off as a hunch. I simply followed it. When you're in the fraud detection business, you develop, over the years, a certain gut feel that you begin to trust. In fact, I was proving myself right with Ed every step of the way.

Blake was suddenly annoyed.

If fraud detection is all about trusting one's instincts, I would be as wary of it as you would be about people trusting their colleagues in a workplace. I mean, Mr. Moratti, how are you so sure that Ed has been laundering money? And how come, as an outsider, you detected it while, internally, we didn't?

"Good questions," said Moratti. "Let me explain."

Once I spotted the misdirected entries in your receipt books, I started examining the volume of cash deposits over the last five years. Thanks to the access to passwords and protocol that you had given me, I was able to do it on my own without letting any of your colleagues get wind of it. I deployed special diagnostic software to track all the variables in your cash transactions — depositor profile, amount of individual deposit, frequency and time of deposits, etc. I was looking for a pattern. And the system was throwing up a mismatch. Take, for example, the trend in the volume of cash deposits and the volume of cheque deposits in your Personal Plan. It should have been consistent with your customer profile and the predictability of their payments. It was not. A person habituated to making cheque payments, even if in person, would not switch, out of the blue, to cash payments. It was that kind of mismatch that prompted me to dig deeper.

"So the software can help us fix the problem," Blake interrupted, suddenly seeing at least a glimmer of hope for the future.

Moratti said,

It can help, but you will have to know what to do with all the data the system generates. You'll have to make sure you don't lose your way in the information jungle. You need specific leads to follow. You need a track to run on. That's where instinct and training come into play.

Incidentally, I noticed that the contribution of the Personal Plan to Agnes revenues has been declining over the last two years."

Blake commented,

That's because the revenues from the Company Plan are rising faster. It's part of our corporate strategy. The cost of servicing the Individual Plan is higher than the cost of servicing the Company Plan. So our marketing is focused on the Company Plan where the margins are higher. In fact, we foresee the contribution of the

Individual Plan at Agnes coming down gradually to about 10 per cent. We will not, of course, dispense with the Individual Plan. I think it fulfils an important customer need, particularly in light of rising costs of private medicare in North America. In fact, it's impressed the U.S. major with whom we're partnering, so much that they want to replicate the model in their U.S. operations.

"I thought so," said Moratti.

Blake continued,

Let's go back to what you were saying. A policyholder comes to the Agnes office and hands over a cheque. He does not bother to collect a receipt because he knows it comes up in his bank statement after the cheque is cleared. I see two inconsistencies here. First, when a cheque is routed through an intermediary, the payee must first endorse it. Without the endorsement, the intermediary will neither accept it for payment, whether by cash or cheque, nor deposit it in his own account. The title must be clear. But, the endorsement would be faulty in this case. The cheque is in the name of Agnes, and only an authorized official of Agnes can endorse it. In fact, I have a feeling that the instrument would not have been endorsed at all because Ed is neither an authorized official nor would he place his signature on something so potentially incriminating.

"The only person who could question the validity of an endorsement is the intermediary," said Moratti, "and the intermediary, in this case, would not do so because it is in his own interest to process the negotiable instrument."

Blake continued resolutely,

Second, when the cheque comes back to the Agnes customer after clearance, anyone in his normal senses would notice that the cheque has been routed through a third party. He would immediately check with his bank. He would also check with Agnes. But we've had no such enquiries of that kind so far at Agnes.

Moratti replied,

This is where Ed has done his homework thoroughly. He is targeting only those individuals who have a bank account book and therefore do not get back their cheques post-clearance. The book merely records the serial number of the cheque and the date of clearance. It makes no mention of the name of the person or the

company in whose favor the cheque had been issued. Ed has completely avoided individuals, like self-employed professionals, who get a statement of account from their bank together with their cheques post-clearance. Ed knows your customers. He knows many of them on a personal level. He knew who was getting back cheques, post-clearance. He's covered his tracks all right.

I've traced 25 individual cheques so far over the last four-month period — right from misplaced entries in the receipt books to their final destination at a bank in Mauritius. I've had to use my network. I know there are more such entries. I also know it all goes back a long way. We can trace them all. It takes time. It takes resources. But it is possible.

"A bank in Mauritius?" asked Blake.

Yes, it is part of what is called integration. It is the last lap of money laundering. After a series of layerings, the sole purpose of which is to cover tracks and mislead an audit trail, the money is finally integrated into the financial system. It becomes difficult at this stage to distinguish between legal money and illegal money. The money can now be invested anywhere. That is when the money has been successfully laundered.

Blake said,

In all my years as a career professional, I could never imagine that I would be held accountable some day for something as sinister as money laundering. That is something I will have to deal with on my own. But what do you think we should do with Ed?

"There are two options," said Moratti. "You can fire him. But given that he's unionized, I'm not sure that's going to be easy."

Blake remarked,

Firing Ed is the most logical thing to do. I'm sure the union will also realize that we have little choice but to get rid of him. But I don't think we should let him get away with this. He must be prosecuted. We have to make an example of him.

Moratti agreed.

That's the second option. You can file a case against him. But given the time and resources required for a trial, and the negative perceptions it will create among the various constituents of Agnes, I'm not sure if you want to even consider that option. Besides, as of

now, I'm not sure if we have a case against Ed that is strong enough to stand the test of law. We need to build a proper case. It needs, as I said, time and resources. What I have uncovered is only the tip of an iceberg. The amount involved so far is about \$1,500 over the four-month period. If we were to go back right to the beginning, it could be huge — I'm not sure I could even hazard a guess about the amount. You should also remember that the fact that Ed has no criminal record can be used to advantage by a defence attorney. The ring of Al Capone all over again.

Blake looked at his watch. It was close to midnight.

I'll be here at the office tomorrow for a few hours making sense of these printouts, I need to inform the chairman first thing Monday morning. It's going to be tough on everyone. Agnes will have to do some soul searching as a company. At a personal level, I'll have to deal with concerns about my professional competence and leadership ability. Clearly, the buck stops with me and I'm taking personal responsibility for this. I'll offer to resign.

Moratti said,

It's your call, but you don't have to take that extreme step. You can treat this as a wake-up call. You could begin by incorporating anti-money laundering software into your IT architecture. It will generate exception reports from which you can choose areas that need to be examined in detail — but don't depend on the software solving the entire problem for you. It's also likely that the regulators will want to come in for a probe. In that case, KPMG can help you with the defence. We'll steer you through the official investigation. Of course, you may have to put the joint venture talks on hold . . .

A TORRID WEEKEND AHEAD

Blake realized it was a good 30 minutes since Moratti had left. Shaking off his torpor with a visible effort, he began to jot down the issues he would have to deal with prior to Monday morning. He would begin by identifying the repercussions of each issue and then working through the courses of action available. He felt a little more composed now that he had identified something to do. He would have to identify responses on a number of fronts. But what were all those fronts? And what were the potential responses? What was the extent to which the software would help to fix the problem? And was the problem really as big as it was sounding to him right now? It was not going to be an easy weekend. He was glad Moratti had left behind his home phone number.

Exhibit 1

MONEY LAUNDERING

