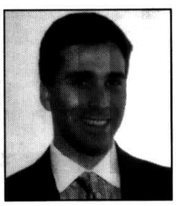
So You're Covered for Financial Documents?

Don't Bank On it!



by Peter Schlactus, CIC, AAI

If you move financial documents for banks or other financial institutions, do you ever get that queasy feeling that if something *really* bad happened you might not be fully protected?

If you do *not* engage in financial transit, but have thought about going after those big contracts, has the daunting task of securing the right insurance coverage made you pause?

If you are like most courier executives we speak with, the answer is "Yes!"

Actually, most bank managers should worry, as well — even ones from institutions that use a formal bidding process and contract. Based on our experience, over 90 percent of courier work for financial institutions moves without proper protection against loss, destruction and theft. While this puts the courier in a bad position, the bank is the one with the most at risk.

The Hazards

How can it be that so many financial documents are transported without proper protection? Isn't it somebody's responsibility to make sure the public's money is safeguarded?

Ask any individual involved in the process, and you are likely to be directed to someone else, who points you to someone else ... who sends you back to the person with whom you began! In truth, all parties share in the responsibility. To be fair, however, all parties are coping with sophisticated risks, and resources are limited by low margins and tight budgets.

In general, we can identify six trends that make your company vulnerable to disaster: consolidation of duplicating facilities; faulty contractual requirements; scarcity of affordable insurance; over-reliance on bankers' bonds; inattention to regulatory responsibilities; and poor communication, the great 'disconnect.'

Downgrading Duplication

Back in the 'old days,' deposited checks and other financial documents were microfilmed at branch offices prior to transport. While one still had to worry about legibility or equipment malfunctions, losses were generally limited to reconstruction costs. While these could sometimes stretch into six digits, you were protected against the multi-million-dollar losses that occur today.

During the nineties, financial institutions have shifted check duplication to regional facilities, leaving only the most rudimentary registers at the branch level.

The potential for drawn-out reconstruction efforts (which entail a loss of interest to the bank) has grown, as well as the likelihood that substantial numbers of checks will not be reconstructed successfully. Where reconstruction is not possible, banks look for reimbursement of the face value (which registers *do* show) and this can send claim costs rocketing upwards.

The shift to centralized check duplication has upped the ante with respect to financial transit security and insurance.

Contractual Conundrums

Financial institutions have recognized the increased risks they face as a result of, among other things, centralized check duplication. Their legal departments have swung into action with far-reaching contractual clauses designed to pass along as much of the risk as possible to couriers. Insurance companies, seeing their claims costs rise, have charged accordingly.

At the same time, operations managers — conscious of their shrinking budgets — have balked at paying couriers more for the costs of obtaining the necessary insurance. In many cases, this has led to their watering-down insurance requirements and informally agreeing to 'waive' contract provisions ... or even the contract itself.

Rarely, however, does the courier receive actual legal releases. Therefore, the 'benefits' of such arrangements are a mirage. You remain stranded in the desert of legal liability. Indeed, you are often worse off since the manager probably believes he can pay you less now!

Courier companies find themselves trapped in the middle. With or without a contract, couriers face extensive liability for losses.

With no contract, a courier must anticipate being sued ... not only by the financial institution, but also by the institution's insurance carrier. The carrier may step in to pay a loss but will then move against the 'guilty' party. As for contracts, many contain 'indemnification' clauses that, in essence, make the courier responsible for *all* losses, whether insured or not.

Assume a contract requires you to have reconstruction coverage only. After a loss, it turns out that many checks cannot be reconstructed. Contractually, the bank often can hold you responsible for face value and lost interest costs ... even though insurance for these items wasn't required.

This may provide comfort to the legal department, but the financial institution must ask itself, "How are we going to collect?" After all, most courier companies' hard assets are quite limited. The bank may seem to have its bases covered on paper, but in practice it faces substantial legal costs with very uncertain prospects of recovery. Someone will have to face the consequences later, but no one is facing facts now.

From the courier's point of view, it's "sign on the dotted line" or risk losing the work. However, many of the most successful financial transit specialists we know take an active role in negotiating contract terms. It can be done.

The Insurance Crunch

When a courier company and its financial institution customer can certify that financial documents are copied or microfilmed prior to transport, extensive insurance protection is available at moderate cost. After all, reconstruction should be successful and straightforward in almost every instance. The remaining uncertainties are what insurance companies are there for.

When, instead, underwriters began to learn that courier companies had agreed to transport and be responsible for checks where the financial institution had failed to take these critical precautions, they charged more dearly. Underwriters felt that, in many cases, checks would prove unreconstructable and they would have to pay large face values. Also, without copies, the reconstruction process takes longer. Until checks are deposited with the Fed, the financial institution loses the interest value of the money.

Compounding the increased operational and legal risks is the fact that comprehensive insurance protection often seemed out of reach.

Baring the Bond

At some point someone reached the dangerous conclusion that, if all else fails, a financial institution can fall back on its bond, commonly referred to as bankers' bond. This bond is how the financial institution demonstrates to federal regulators that it can meet its obligations to depositors in the event of a catastrophe.

The bankers' bond has very high limits, but also very high deductibles. Multi-million-dollar deductibles are not uncommon and $500,000 is generally the minimum. In other words, to 'rely' on this bond means paying at least $500,000 out-of-pocket and probably much more! For the largest banks, $500,000 is no catastrophe, but larger banks have larger deductibles.

Another factor is that these incidents must be reported to the bond insurance carrier. After interviewing several bond underwriters, we know that they do not expect to have their policy called upon to pay for financial transit losses. While coverage is probably there, claims will likely lead to higher rates. These rates

What is Financial Transit?

Financial transit is the pick-up and delivery of specialized documents and other items from such financial institutions as banks, mortgage companies and credit unions. Transported items consist mainly of canceled or deposit checks, along with inter-office mail and pieces of equipment. Checks are generally non-negotiable and couriers rarely transport cash or similar items.

We strongly recommend that you not agree to be responsible for anything more than token amounts of cash or negotiable securities. That's what armored car services are for.

The classic Financial transit scenario involves a local or regional bank network. A courier picks up checks from several bank branches and delivers them to a regional processing center. This may occur several times each day, and the courier also may drop off mail and other items at branch offices. Later on, the courier may deliver a large batch of checks from the processing center to the nearest Federal Reserve office.

Despite the growing use of electronic payments, Financial transit work remains a vibrant niche within the courier industry. Some bank contracts are quite large, and this attracts ambitious courier companies to bid on them. However, the work is quite distinct from standard, on-demand local delivery.

First, almost all of the work is routed, with scheduled pick-ups and deliveries at set times each day. Second, vehicles generally make several pickup stops before proceeding to their final destination. This means that vehicles are left unattended regularly. Third, unlike most documents transported these days, canceled checks cannot simply be reprinted from a word processor. The reconstruction process can be complicated and, if no copies were made prior to transport, incomplete.

Finally, bank work has a reputation for being a low-margin affair. Competition for work is fierce and financial institutions are under growing pressure to operate more efficiently. Problems arise when the push for short-term savings takes precedence over preparation for a major loss. As a result, the bank risks losing years of cost-control gains and the courier company owners face the prospect of losing the contract or worse: their business!

would apply across the board to the entire bond ... and the resulting additional costs could be substantial.

Clearly, the bond is a false solution. Couriers who can present solutions that reduce the chance of a financial institution having to "bare its bond" should be able to capture the attention of at least the better-run institutions.

The McFadden Act

Mention the McFadden Act to your contacts at financial institutions.

If they return a blank stare, it means you need to extend your contacts deeper. If they seem a bit alarmed, it may be because they know that the way most banks contract out their financial transit work leaves them in violation of this law. If you know it, too, you can help them to solve the problem.

At the risk of oversimplifying a complex piece of legislation, the McFadden Act requires financial institutions to apply consistently high standards of care in safeguarding its depositors' money and financial documents. This applies not only to bank premises, but off-premises and in-transit as well. One could even argue that if banks protect financial documents in the branch using vaults and armed guards, then they must do the same in transporting those documents.

Over time, regulations have been promulgated and interpretations accepted that release banks from sending all documents through armored car services. However, the minimum standards to ensure compliance are having 'all-risk' insurance in place to cover the face value of lost or stolen checks, in addition to reconstruction costs. Whether the insurance is maintained by the bank or the courier company matters not.

What matters is that so few financial institutions — and courier companies doing work for these institutions — maintain this coverage.

The Great 'Disconnect'

We live in the telecommunication age, yet the largest stumbling block remains effective communication. There is a great disconnect within and among the three principal players: financial institutions, courier companies and the insurance industry.

Much of the above discussion centers around communication problems. Confusion over contracts, the insurance industry's perception that few controls are in place, the ducking of regulatory requirements all are perpetuated — or at least aggravated by — the fact that the parties involved don't communicate well enough.

We seem to save the thorny issues and tough communication until after a disaster, by which time it is largely too late.

Financial institutions fail to clarify contractual liabilities. They rarely check compliance with insurance requirements beyond perhaps a generic 'Certificate of Insurance,' which completely omits most critical policy terms and conditions.

For their part, couriers are often loathe to ask tough questions about check duplicating practices, for example. You hesitate to recommend better but more costly 'best practices' for security. You assume that acting more professionally may well cost you your contract, that the lowest — albeit less responsible — bidder too often wins.

Internally, financial institutions suffer from 'disconnects' among their mailroom and operations managers, their legal departments and their risk managers. These divisions must work together to promote the institution's overall interests. Price cannot be the overriding concern to the exclusion of all else. The stakes are too high. Competitors who pinch pennies here will likely pay several times over the their mistake when that big loss hits.

Finally, both financial institutions and couriers seem to despair of finding affordable insurance coverage although such insurance is now increasingly available. While true protection is not without cost, parties should no longer be afraid to raise or enforce proper standards of accountability for fear of setting the bar too high. Having to resort to costly legal battles or one's bankers' bond (with its high deductibles) will prove far costlier in the end.

So, grease the wheels of communication. Start today. Set a date to meet with your counterparts to discuss loss control, insurance, liability and all the other 'dirty words.' The time is right; you have more options than ever. You might as well be the one who earns the credit for preventing disaster and for finding solutions.

A Better Way

Powerful forces are conspiring to prevent you from attaining desirable levels of security in your financial transit work. Your only chance to prevail, other than relying on fickle luck, is to marshal equally powerful weapons of your own. Specifically, you need better communication, better insurance and better loss control practices.

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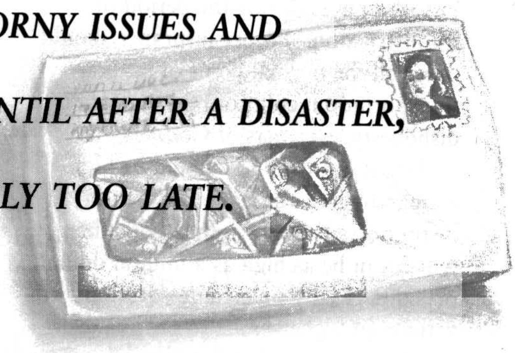

Bridging the Great 'Disconnect'

Hope begins and ends with better communication. To bridge the great disconnect, there must be candid discussions of issues other than optimal routing and contract price. Otherwise, couriers will continue to believe that they have to be the lowest bidder *at any cost*, and bankers will remain skeptical that couriers should be treated as professional service providers.

Internally, financial institutions must better coordinate their mailroom and operations managers with their legal and risk management departments. No one division can fully appreciate how best to serve the institution's overall interests.

Couriers can be instrumental in bringing these parties together by insisting that thorny liability and security issues be addressed and resolved. According to our clients, by taking a proactive, professional stance, you can get operations people to consider factors beyond punctuality and price. At the same time, legal and risk managers must acknowledge the importance of maintaining efficiency.

Insurance Solutions

The delicate task of improving communication, relationships and trust requires a solid foundation. Comprehensive, affordable insurance protection can provide the mortar with which to fill the cracks of the great disconnect.

With proper insurance in place, couriers and financial institutions can leave behind the anxiety and resignation that lies at the root of so many of the system's problems. It is time to focus, instead, on the true sources of efficiency and cost-reductions, such as security and loss control.

Couriers need to offer — and banks need to require and verify — insurance covering not only document reconstruction costs, but also the face value of checks that cannot be reconstructed and the bank's loss of interest during the period of reconstruction. Proper insurance should cover all the normal perils of transportation: collision, theft, courier dishonesty, even acts of God.

Limits of insurance should be high enough to cover at least the financial institution's bankers' bond deductible, which can be as high as a million dollars or more. Many financial institutions will want even higher limits to protect their bond from losses that it was never meant to cover and which could lead to sharply higher premiums.

Finally, both sides should look beyond superficial certificates of insurance and examine policy terms ... especially exclusions. For example, many insurance companies are reluctant to insure against such sloppy practices as leaving unattended vehicles unlocked. They do not wish to remove your incentive to enforce basic security measures. Yet there is a world of difference between a policy exclusion for unlocked, unattended vehicles and one that simply excludes all unattended vehicles. Certificates of insurance are useless here.

You cannot expect to analyze insurance like an expert, but why not have your broker review the policy with you? Better brokers can help you improve ties with banks by discussing coverage options with their key personnel and working with them to design the proper program. We are called regularly into meetings and conference calls with our courier clients' bank customers ... to explain, to obtain their feedback, and to reassure.

The insurance is available. Indeed, these days finding a policy is not nearly so hard as finding partners — both brokers and insurance companies — with the specialized experience and client focus to avoid injurious policy provisions and properly handle claims.

Large financial transit losses are complex affairs. Many take months to settle. Legal, financial, and regulatory issues may come into play.

As financial institutions attempt to substantiate their losses, they need to know that claims adjusters understand their issues and speak their language. You need to know that the financial institution's reconstruction efforts will be monitored effectively so that the final cost of the claim is contained.

Procuring proper financial transit insurance is more possible than ever, but still no easy task. Remember the fundamentals: insist on comprehensive coverage, consider high limits, partner with specialists, and review the details. Above all, use insurance issues to test the professionalism of your counterparts and to showcase your own.

Beyond Insurance: Loss Control

The subject of controlling and preventing financial transit losses deserves an entire article of its own. Efforts to improve the current financial transit system should focus on reaching the point where discussions about security focus *not* on liability issues, *not* on contract language and *not* on insurance.

Rather, we should focus our time and energy in deciding how to invest wisely to prevent catastrophic losses from occurring in the first place ... or to minimize their impact if they do occur.

For loss control efforts to succeed, both the courier company and the financial institution must cooperate. I suggest the novel approach of sharing deductibles 50/50. If the courier can provide insurance that removes the bank's fear of having to pay its huge bankers' bond deductible, then the bank should reciprocate. This arrangement helps create a truer partnership, with both sides equally invested in promoting security.

Numerous loss control options are available: better record keeping of checks at the branch level, improved bags and locks, more thorough signing procedures, vehicle tracking, courier screening, mandatory car alarms. What would be so difficult in having the courier call ahead to each branch so that a bank employee could step outside and watch the vehicle while the courier is inside?

Until recently the insurance crunch often made it uncomfortable to talk about risk-related issues. Now that insurance solutions are available, the way is clear for properly insured courier companies to further distinguish themselves by establishing 'best practices' that prevent and minimize loss.

Due to their professional standards and superior track records, these same couriers will also gain access to the best and least expensive insurance coverage. One competitive edge begets another.

Conclusions

The financial transit system is overdue for a correction. The 'disconnect' among industry players has widened into a crevasse, waiting to devour the unwary and distracted. A few more catastrophic losses could spark major changes.

Couriers and bankers can position themselves to weather — and even profit from — the storm ahead by adopting more professional standards. Couriers should communicate frankly with financial institutions about security and insurance issues. Instruct your salespeople to target those institutions willing to support your efforts to improve security and maintain professional standards.

Financial institutions must ultimately raise the bar and put security first. The tyranny of the lowest bidder must give way to a more enlightened selection of the best value. Only in this way can you really control costs.

Finally, in support of these partnerships, the insurance industry must step up to the plate with more comprehensive yet affordable protection. I am confident that innovative solutions are at hand.

Those of us who work together to nurture a better financial transit system will be the winners as others falter. You can bank on that! **CM**

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