RISK MANAGEMENT LETTER

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LOWERING YOUR FINANCIAL INSTITUTION BOND COST

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Usually, the largest part of a community bank's insurance program is its financial institution bond premium. While there aren't many ways to lower this premium, many banks to not take advantage of the opportunities that are available to them; thus, they lose the chance to lower their premiums significantly.

Insurance companies differ somewhat in the credits they apply to their rates, but most base their premiums on limit size, coverage selected, deductible size, loss experience, type of CPA audit, number of employees, number of locations, and financial condition.

CHOOSE LIMITS CAREFULLY

While the Surety Association and the FDIC require certain basic limits, the other limits of the financial institution bond policy are up to the individual needs of the bank.

"Forgery D and E" limits should be carried in no less than the amount of the bank's largest outstanding loan. Carrying less than this amount courts disaster, and having much more than this can be expensive.

"Kidnap and Extortion" is a costly area on any bond. Lloyds of London offers an excellent policy in this area with rates very competitively priced with the coverage offered in the bond.

In short, limits on the bond should be chosen to fit the bank's exposure and not merely selected at random.

The type of coverage chosen also can be critical to the bond premium. Many banks will leave significant areas of exposure uninsured while insuring other areas which face slight or even nonexistent exposure.

For example, if your bank has its own computer for data processing, it has little need for EDP coverage but a great need for computer coverage. Unless the bank does its own electronic funds transfers (not through a correspondent), it has little need for this coverage. If you do need EFT coverage, be sure it covers telephone transfers without limitations.

DEDUCTIBLE MAY NOT BE SIGNIFICANT

On the other hand, contrary to what many bankers believe, the size of the deductible does not directly affect the bond premium a great deal. For example, raising your bond deductible from $25,000 to $50,000 may only reduce your overall premium by $1,000 or $2,000. This is very little return for the bank to absorb an additional $25,000 of risk.

However, "Indirectly" the deductible can be very significant when loss history is taken into consideration.

GOOD LOSS HISTORY IS ESSENTIAL

The bond is experience-rated; that is, credit is given for few losses, and debits are charged for frequent and/or severe losses.

It is important to remember that a severe "shock" loss is not as significant as frequent small losses. The bank that has frequent teller embezzlement, small burglaries or robberies, or loan frauds will find its bond premium excessive or unobtainable at any price.

Most banks with good experience (no losses) have a 40 to 50 percent credit applied. Should a "shock" loss occur, they may lose this credit. However, if there is a history of frequent losses, the bank will not only lose its credit, it may suffer as much as a 75 to 100 percent debit as well! Helpful hint – Try to get your bonding carrier to waive your obligation to report losses under your deductible. In today's competitive market many companies are willing to do this, and the benefit when determining loss history credits is obvious.

GOOD FINANCIALS ARE IMPORTANT

The importance of good financials can not be over emphasized. Capitalization of 8% or more is a plus. Non performing loans less than 3% of total loans and an actual positive ROE and ROA will get positive insurance bond premium results. Insurance companies are VERY interested in writing profitable banks. So, if you are, brag about it! It ain't bragging if it's a fact!

Ok, so what do you do if your financials are something less than "Gold Standard"? Make sure you have a plan for correcting your situation. Explaining why you are in this situation is important but a plan of specific action may get the insurance company's underwriter's pencil a little sharper.

OTHER FACTORS

Two other areas, number of employees and number of locations, are also significant factors. Always state the number of part-time employees when completing bond applications. Some insurance companies do not count these as strictly as they count full-time employees. Also, new locations or branches are usually not figured in the bond premium until the renewal.

"PREPAID" ARE BACK!

Bonding companies are starting to offer a discounted three year prepaid bond premium credits. A 10% credit, or a factor of 2.7 times the annual premium, is the industry standard. However, be careful that the annual premium is competitive before you lock yourself in for 3 years.

COMPETITION CAN SAVE YOU MONEY

Perhaps one of the more significant methods of reducing your bond cost is proper bidding of your program. Competition is always healthy. Done properly and at the right time, significant reductions in premiums and increases in coverage can result. However, the bidding procedure is a whole different subject in itself.

In conclusion, if bank management takes the time to analyze its institution with its bond in mind; chooses proper limits, coverage, and deductibles; keeps its losses down; and exercises good financial management, it should be able to lower its bond premium significantly.

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