



On Loss Prevention—

Avoid losses, retain profits, and increase your net income.

The case for loss prevention versus recovery in the financial arena is a powerful one, yet it is largely ignored or at best misunderstood. Losses that are avoided eventually translate into retained earnings and increased profits, and that's the reason to be in business isn't it? To succeed in loss prevention we must first define what we want to achieve and how to accomplish it.

Losses occur in many forms in the banking community and they are labeled and defined differently by each institution facing them. The basic premises are, however, universal. Dollars are missing, where in a perfect world they shouldn't be. Along with the actual funds that have been lost, there is inherent damage, trouble and deprivation. Losses that occur not only result in reductions to earnings as direct write-offs, but they also become "seed costs" for the added expenses of accounting, investigation, collection and litigation that follow.

If we prevent the losses instead of accepting them as a "cost of doing business," what will that do to a bank's bottom line net earnings, profitability and share value? These are questions to be reflected upon and answered in light of the big picture that is basic economics, or profit and loss.

As we all know, there are only a few sources of positive cash flow to increase net income and profitability. Some of these are practical and can be obtained while others are impossible and are out of our control. Most operating expenses are essential to the business and make an appropriate positive contribution to overall performance. Expenses that don't are usually eliminated quickly. Decreasing unnecessary expenses is one of the fastest ways to impact the bottom line, yet it often goes unconsidered. But expenses such as non-credit losses are pure deductions that

produce only negative impacts to the operation. Yet, traditionally such expenses have been considered "breakage" or a "cost of doing business," and are simply accepted as being unavoidable. There simply hasn't been a way to

detect and prevent these losses that is both cost-effective and efficient.

Such a tradition is hard to change, especially when a belief structure and culture have developed around it. We begin to think that there is no other way. And we learn to tolerate some losses, like certain types

of fraud. But, the real problem is that many of these losses result from vulnerabilities in our operating processes that should be fixed. By continuing the assumption that these losses are inevitable, we perpetuate the weaknesses, perhaps allowing them to become more deeply rooted. Eventually a weakness is attacked and a serious loss occurs, finally bringing into question the possibility of prevention. More often than not, we reassure ourselves that there was nothing we could have done, and go back to business as usual.

What if most of the non-credit losses were actually avoidable? And, what if the cost of preventing losses were significantly less than the amount of the losses prevented? That is, we could reliably produce a net addition to the bank's earnings. Should tradition change? And, what would the change entail? Who should initiate it, and where should the new process reside? Let's assume that preventing losses is achievable, the right thing to do and we've made it a management objective, how do we proceed?

First, we have to consider the kinds of losses that occur in the banking community. There are losses caused by non-repayment of NSF's, various bookkeeping losses, stolen checks and incorrect forecasting of new business generation. Loan investment losses add up to some significant dollars for banks that have aggressive philosophies. New account and fraud losses can add up to substantial amounts, even for small banks in rural communities, and they increase every year. Every bank's environment is different, and the combination of customer risk and operating vulnerabilities are always unique. As anyone can see, we have a significant opportunity for improvement.

As we consider the problem of implementing a prevention program, both of these types of losses must be included. Fraud results from intentional attacks against vulnerabilities in the bank's process, while non-fraud losses result from a combination of high-risk customer behavior and process inefficiencies. All losses are our target for prevention. But how can we create a process that produces enough savings and other benefits to be justifiable? What makes this possible now?

Modern technology and the rapidly advancing power of the PC have made practical and cost effective loss prevention a reality. We still have to rely on mini or mainframe computers for core transaction processing and accounting functions, but PCs are more available than ever to absorb many of the additional tasks, like risk analysis.

The type of analysis required to combat non-credit losses is complex. It requires sophisticated processing that can be carefully controlled to produce both accuracy and productivity. The PC environment lends itself to this task for several reasons. First, the speed and capacity of PCs continues to rapidly increase, while actual system costs decline. Second, the huge size of the PC market makes available a wide variety of cost-effective tools and utilities for software development and system operation. This means that development and maintenance of the systems can be significantly cheaper than if they were built for a mainframe environment.

Third, by performing the analysis separately from the bank's primary transaction system, there is no additional load on the production process.

The analysis that is performed is vastly superior to that which has normally been performed in the traditional exception review process. The speed of the process produces two benefits: the number of accounts that can be reviewed is significantly increased and the level of detail that can be included is far greater. A standard PC, can accomplish this complex analysis more than 800 times faster than it would take a human just to read through the transactions!

There are two obvious benefits of a prevention process. Initially, it should tell us, which accounts pose risks today, in time for loss avoidance decisions and actions to be implemented. Then, it should inform us if those risks occurred as the result of a weakness or vulnerability in the bank's personnel, procedures, policies or systems. So, a good loss prevention process is able to monitor both the performance of customer's accounts and the quality of the bank's operation.

Change is an inevitable fact of life and, given all the above, it's obvious that the time has come for a departure from traditional methods of dealing with losses. We've been hearing the call for "proactive" and "preventative" methods for a few years now, and the bridge from the past to the future is there. How do we cross it, and who should lead the way?

Each bank, regardless of type and organization, has functions for managing operations, risk, auditing, systems and security. Depending on the bank's organization, the role of loss avoidance can fall into one, or more, of these departments. The operations department will usually be directly interested in the losses incurred to their profit center. Risk management personnel will usually be concerned with the overall containment of risk and compliance. The audit department will have responsibility for monitoring overall profitability and loss behavior in accordance with regulatory needs. Security has traditionally been responsible for investigating fraud cases, but in some instances may also be focused on the prevention process. Each of these areas of the bank can operate the loss avoidance program, or it can be shared among two or more areas. Each bank will be slightly different and a good loss avoidance system can be readily adapted to the unique needs of the bank.

It is clear that there is a better alternative to continuing business as usual. Both competition and risks of loss are increasing, and it's time to begin the future. The benefits of before-the-event prevention are substantial, and directly affect a bank's bottom line net income and profitability. Losses are after all, not obligatory write-offs, but lost profits. An effective prevention program can preserve and restore profit and have a significant impact on operations and customer relations. By pursuing a concept focused on true prevention, we can produce a win-win result: we can improve profit and improve competitiveness and efficiency.

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