THIRD-PARTY RISK

2013-2014 BANKER OUTREACH

Overview

- Definitions
- Common Third-Party Relationships
- Benefits of Third-Party Relationships
- Potential Risks Arising from Third-Party Relationships
- Board and Management Responsibility
- Risk Management and Compliance Examination Process
- Resources

Board Responsibility

“The Board of Directors and senior management are ultimately responsible for managing activities conducted through third-party relationships as if the activity were handled within the institution.”

A bank can outsource a task, but it cannot outsource the responsibility.

FIL 44-2008 “Guidance for Managing Third-Party Risk”

Definitions

- <u>Third Party</u> – is broadly defined to include all entities that have entered into a business relationship with the financial institution, whether the third party is a bank or a nonbank, affiliated or not affiliated, regulated or non-regulated, or domestic or foreign.
- <u>Third-Party Risk</u> – the potential risk that arises from financial institutions relying on outside parties to perform services or activities on their behalf.

Definitions (Continued)

- Third-Party Relationships – parties that perform functions on a bank's behalf, provide access to products and services, market processes and activities for which the bank has particular capacities and competencies, use the bank's charter or legal powers, perform monitoring or audit functions.

Common Third-Party Relationships

- Core Systems
- Credit Card Provider
- Stored Value Card Provider
- Loan and Deposit Documentation Platforms
- Audit Firms
- Deposit Add-On Product
- Mortgage Servicing

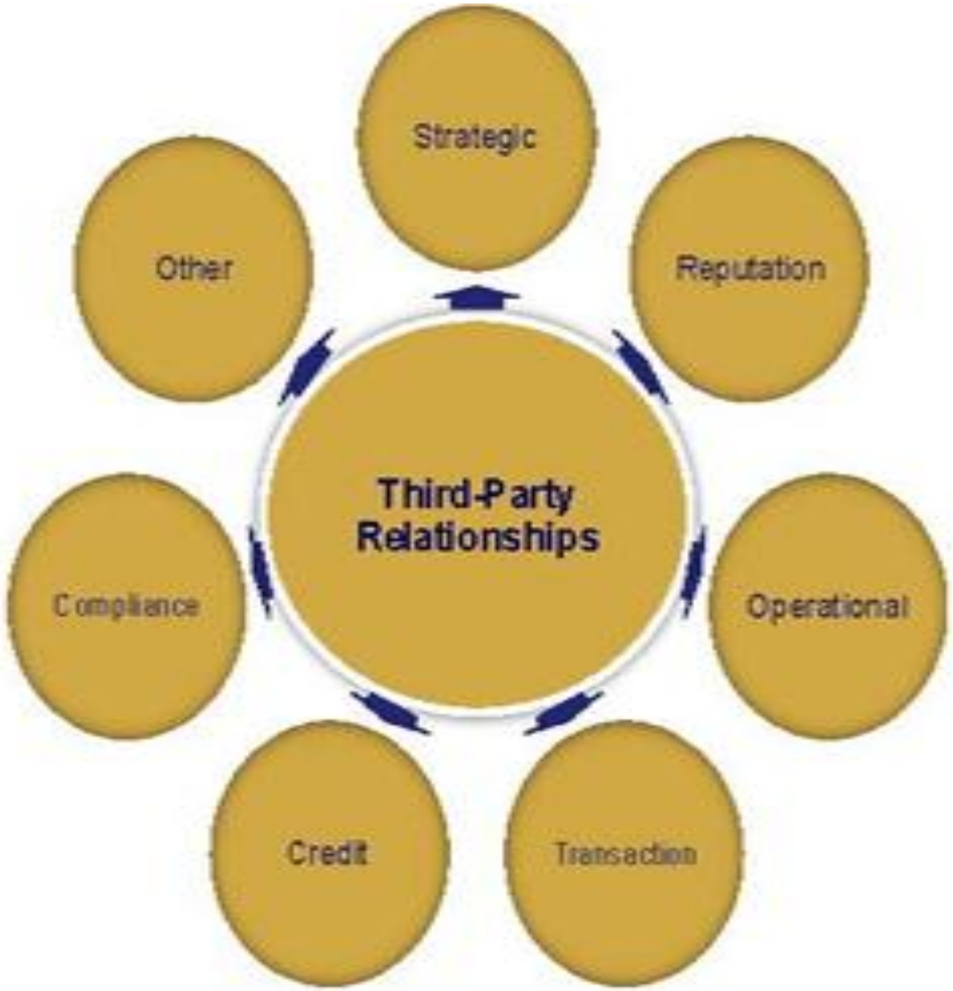
Common Third-Party Relationships

- **Any other parties that:**
  - Perform functions on the bank’s behalf.
  - Provide access to products and services
  - Market processes and activities for which the bank has particular capacities and competencies.
  - Use the bank’s charter or legal powers.
  - Perform monitoring or audit functions.

Benefits of Third-Party Relationships

- Expertise
- Enhanced Products
- Marketing
- Operational Efficiency
- Legal Guidance
- Increased Revenue

Risks Arising From Third-Party Relationships



Board and Management Responsibility

- **Risk Management Processes:**
  - Due Diligence – Initial and Ongoing
  - Risk Assessment
  - Contract Structuring and Review
  - Oversight

Board and Management Responsibility

- **Due Diligence – Initial and Ongoing:**
  - Determine scope and depth of due diligence necessary in relation to the importance and magnitude of the relationship
  - Review qualitative and quantitative aspect

Board and Management Responsibility

- **Risk Assessment:**
  - Relationship is consistent with overall business strategy
  - Cost/Benefit Analysis
  - Estimate the long-term financial effects of the proposed process/activity
  - Knowledgeable management to provide oversight

Board and Management Responsibility

- **Contract Structuring and Review:**
  - Prior to entering into the contract, ensure expectations and obligations of both parties are properly outlined in a written contract, obtain Board approval, ensure appropriate legal counsel reviews significant contract.

Board and Management Responsibility

- **Oversight:**
  - Board established program
  - Define management responsibilities
  - Ensure management conducts appropriate due diligence
  - Approve policy and appropriate limits
  - Annually review significant third-party arrangements

Risk Management and Compliance Examinations Process

- **Similarities:**
  - Due Diligence, Contract Structuring, Oversight
- **Potential impact for weak controls:**
  - Inclusion of commentary in the Report of Examination
  - Potential impact on rating
  - Informal/formal enforcement actions
  - Civil Money Penalties
  - Impact to assessments

Risk Management Examination Process

- **Examination Procedures:**
  - Review of the Board and management, due diligence, ongoing monitoring systems

- **Specialty Examinations:**
  - Suspicious Activity Monitoring systems
  - IT monitoring functionality of third parties

Risk Management Examination Process

Third-Party Payment Processors

- Expectation is to perform proper risk assessments, conduct due diligence to determine merchant customers are operating in accordance with applicable law, and maintain systems to monitor relationships over time.
- Financial institutions need to assure themselves that they are not facilitating fraudulent or other illegal activity.
- FDIC's examination focus is on assessing whether financial institutions are adequately overseeing activities and transactions they process and appropriately managing and mitigating risks.
- Financial institutions that have appropriate systems and controls will not be criticized for providing payment processing services to businesses operating in compliance with applicable law.

Risk Management Examination Process

- **Examples**
  - Stored Value Card Provider
    - Issues Identified: lack of due diligence, suspicious activity monitoring, contract review
  - Third Party Payment Processor
    - Issues Identified: lack of due diligence, IT system functionality issues, lack of Board oversight and risk assessment

Compliance Examination Process

- **Examination Procedures**
  - Pre-Examination Planning
    - Identify Bank’s Third-Party Relationships
    - Review Policy and Procedures
    - Evaluate Board and Senior Management’s Involvement – Board and Committee minutes
    - Review Provided Disclosures
    - Review Complaints

Compliance Examination Process

- **Examination Procedures**
  - Onsite
    - Additional review of disclosures
    - Interview Management
    - Review high-risk contracts
    - Preliminary exam results

Compliance Examination Process

- **Regulations often correlated to third-party risk:**
  - Unfair or Deceptive Acts or Practices
  - Truth in Savings
  - Truth in Lending
  - Electronic Fund Transfers Act
  - Equal Credit Opportunity Act (discriminatory violations)
  - Real Estate Settlement Procedures Act

Compliance Examination Process

- **Additional Examples**
  - High Interest Checking
  - Identity Theft Protection
  - Debt Collection

Compliance Examination Process

- **Other common identified third parties:**
  - Flood Determination
  - Mortgage Servicing
  - Indirect Auto Lending
  - Third Party Payment Processor Relationships
  - Indemnity agreements

Overview – QUESTIONS?

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WHAT QUESTIONS DO YOU HAVE?

Action Items

- **Action Items for the Board:**
  - Require management to maintain an updated list of all third-party relationships and review the list periodically.
  - Be involved in the risk management process for significant or complex third-party relationships.
  - Take appropriate action with any relationship that presents elevated risk.

You can outsource a task, but you cannot outsource responsibility.

Resources

- FIL-44-2008 entitled, “Third-Party Risk: Guidance for Managing Third-Party Risk” (June 6, 2008)
- Supervisory Insights Article, “Third-Party Arrangements: Elevating Risk Awareness” (2007)
- FIL-127-2008 entitled, “Guidance on Payment Processing Relationships” (November 7, 2008)
- FIL-3-2012 entitled, “Payment Process or Relationships Revised Guidance” (January 31, 2012)
- FIL-43-2013: FDIC Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities (September 27, 2013)
- Supervisory Insights Article “Managing Risk in Third-Party Payment Processing Relationships” (Summer 2011)
- Website: http://www.fdic.gov