Third-Party Risk
“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.

Scope of Discussion

- Definitions
- Common Third-Party Relationships
- Potential Risks Arising from Third-Party Relationships
- Risk Management Process
- FDIC Review of Third-Party Relationships
Definitions

**Third Party** – 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.

**Third-Party Risk** – the potential risk that arises from financial institutions relying upon outside parties to perform services or activities on their behalf.
Common 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.
Third-Party Relationship Considerations

Third-Party Relationships:

- Can aid management in attaining strategic objectives by increasing revenues, reducing costs, or expanding the customer base.
- Can enhance competitiveness, provide diversification, and strengthen the safety and soundness and compliance management system.
- May reduce management’s direct control and can present risks if not properly managed.
Potential Risks Arising from Third-Party Relationships

- Strategic
- Reputation
- Operational
- Transaction
- Credit
- Compliance
- Other
Strategic Risk

- Adverse business decisions.
- Appropriate business decisions not properly implemented.
Reputation Risk

- Negative public opinion.
- Negative publicity involving the third party, whether or not the publicity is related to the institution’s use of the third party.
Operational Risk

- The risk of loss resulting from inadequate or failed internal processes, people, systems, or external events.
Transaction Risk

- Problems with service or product delivery.
- A third party’s failure to perform as expected adversely impacting customers or the institution.
Credit Risk

The inability of a third party to meet the terms of the contractual arrangements or financially perform as agreed.

Use of third parties that market or originate certain types of loans, conduct underwriting analysis, or set up other products/programs for the institution.
Compliance Risk

- Arises from violations of laws, or regulations, or from noncompliance with internal policies, procedures, or business standards.
- Increases when an institution has inadequate oversight, monitoring, or audit functions over third-party relationships.
Other Risks

Includes:
- Liquidity
- Interest rate
- Price
- Foreign currency
- Country
- Legal

Third-Party Relationships

- Strategic
- Reputation
- Operational
- Transaction
- Credit
- Compliance
- Other
Managing Third-Party Risks – Four Elements

- Risk Assessment
- Due Diligence
- Oversight
- Contract Structuring and Review

Risk Management Process
Risk Assessment

- Ensure the proposed relationship is consistent with the overall business strategy.
- Conduct Cost/Benefit analysis.
- Ensure management has the knowledge and expertise to provide adequate oversight.
- Estimate the long-term financial effect of the proposed relationship.
Due Diligence

- Determine scope and depth of due diligence in relation to the importance and magnitude of the relationship.
- Review qualitative and quantitative aspects.
Managing Third-Party Risks – Four Elements

Risk Assessment

Due Diligence

Risk Management Process

Oversight

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 contracts.
Managing Third-Party Risks – Four Elements

- Risk Assessment
- Due Diligence
- Risk Management Process
- Oversight
- Contract Structuring and Review
The Board must:

- Establish an oversight program and define management responsibilities related to verifying compliance with contracts, regulations, and internal policies and procedures.
- Approve and review at least annually significant third-party arrangements and oversight program performance.
# FDIC Review of Third-Party Relationships

## Examination Procedures
- Risk Management Examinations
- Specialty Examinations
- Compliance Examinations

## Report of Examination Treatment
- Examination Ratings (CAMELS, Compliance, CRA, etc.)
- Applicable comments and recommendations

## Corrective Actions
- Formal Actions
- Informal Actions
- Other
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._

Supervisory Insights Article, “Third-Party Arrangements: Elevating Risk Awareness” (Summer 2007)


FIL-3-2012 entitled, “Payment Processor Relationships Revised Guidance” (January 31, 2012)

Supervisory Insights Article, “Managing Risk in Third-Party Payment Processing Relationships” (Summer 2011)

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