FEDERAL DEPOSIT INSURANCE CORPORATION

# Third-Party Risk

# 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.***

Financial Institution Letter 44-2008 "Guidance for Managing Third-Party Risk"

# 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:**

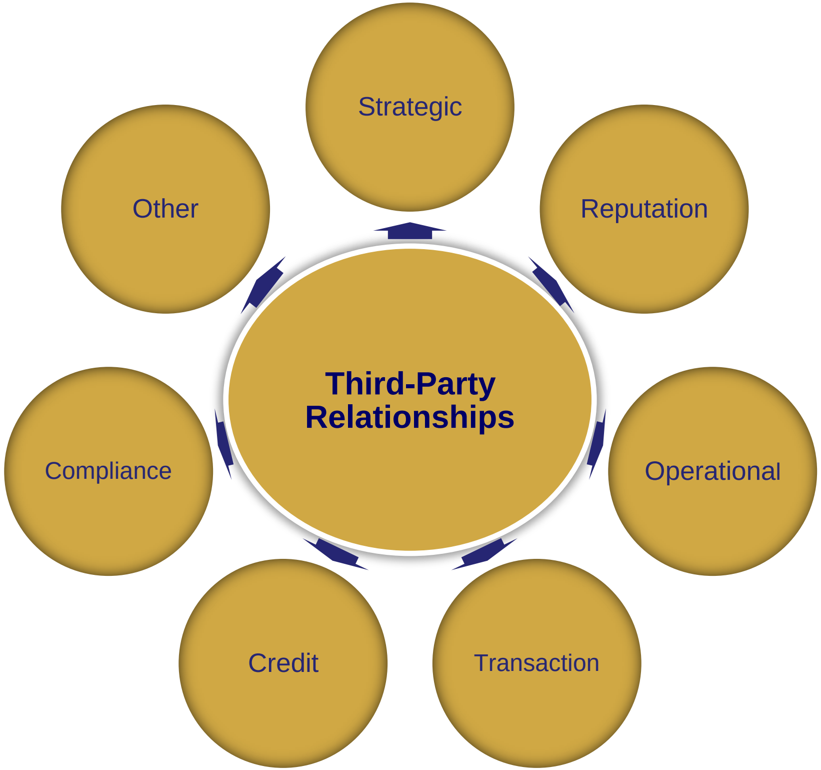
- Perform functions on a bank’s behalf.
- Provide access to products and services.
- Market processes and activities for which the bank has particular capacities and competencies.
- Use the bank’s charter or legal powers.
- Perform monitoring or audit functions.

# 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 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

# Managing Third-Party Risks – Four Elements

Risk Assessment

Due Diligence

Risk Management Process

Oversight

Contract Structuring and Review

# 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

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Contract Structuring and Review

# 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

# Oversight


**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

- **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” (Summer 2007)
- FIL-127-2008 entitled, “Guidance on Payment Processing Relationships” (November 7, 2008)
- 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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