# Third-Party Providers

# Benefits of Third-Party Providers

The use of third-parties can aid management in attaining strategic objectives by:

- Increasing revenues,
- Reducing costs, or
- Expanding the institution's customer base

Appropriately managed third-party relationships can enhance competitiveness, provide diversification, and ultimately strengthen the safety and soundness and Compliance Management System of the institution.

# Risks Associated with Third-Party Providers

- Third-party arrangements may reduce management's direct control. If not properly managed, third-party arrangements also present risks.
- Failure to manage these risks can result in significant violations of consumer laws and regulations and expose an institution to supervisory enforcement action, as well as financial, legal, and reputational risks.

# 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.

# Common Third-Party Arrangements

- Mortgage Lending Programs
- Credit card programs
- Payday lending and other alternative credit programs
- Debit card programs
- Rewards programs
- Deposit taking or affinity relationships
- Overdraft payment programs
- Audit programs of third-party relationships,
- Broker-dealer relationships for brokerage services
- Mortgage brokerage services
- Automobile dealer relationships
- Flood determination services

# Potential Risks Arising from Third-Party Relationships

- Compliance risk
- Strategic risk
- Reputation risk
- Operational risk
- Transaction risk
- Credit risk
- Country risk

# Compliance Risk

- Compliance risk is the risk arising from violations of laws, or regulations, or from noncompliance with the institution's internal policies or procedures or business standards.
- Compliance risk is exacerbated when an institution has inadequate oversight, monitoring, or audit functions over third-party relationships.

# Strategic Risk

- Strategic risk is the risk arising from adverse business decisions, or the failure to implement appropriate business decisions in a manner that is consistent with the institution's strategic goals.
- The use of a third-party to perform banking functions or to offer products or services that do not help the institution achieve corporate strategic goals and provide an adequate return on investment exposes the institution to strategic risk.

# Reputational Risk

- Reputation risk is the risk arising from negative public opinion.
- Examples include third-party relationships that result in:
    - Dissatisfied customers,
    - Unexpected customer financial loss,
    - Interactions not consistent with institution policies,
    - Inappropriate recommendations,
    - Security breaches resulting in the disclosure of customer information, and
    - Violations of laws and regulations.
- Any negative publicity involving the third-party, whether or not the publicity is related to the institution's use of the third-party, could result in reputation risk.

# Operation Risk

- Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, systems, or external events.
- Third-party relationships often integrate the internal processes of other organizations with the institution’s processes and can increase the overall operational complexity.

# Transaction Risk

- Transaction risk is the risk arising from problems with service or product delivery.
- A third-party's failure to perform as expected by customers or the institution due to reasons such as inadequate capacity, technological failure, human error, or fraud, exposes the institution to transaction risk.
- The lack of an effective business resumption plan and appropriate contingency plans increase transaction risk. Weak control over technology used in the third-party arrangement may result in threats to security and the integrity of systems and resources. These issues could result in unauthorized transactions or the inability to transact business as expected.

# Credit Risk

- Credit risk is the risk that a third-party, or any other creditor necessary to the third-party relationship, is unable to meet the terms of the contractual arrangements with the institution or to otherwise financially perform as agreed.
- The basic form of credit risk involves the financial condition of the third-party itself. Some contracts provide that the third-party ensures some measure of performance related to obligations arising from the relationship, such as loan origination programs. In these circumstances, the financial condition of the third-party is a factor in assessing credit risk.

# Credit Risk (continued)

- Credit risk also arises from the use of third parties that market or originate certain types of loans, solicit and refer customers, conduct underwriting analysis, or set up product programs for the institution. Appropriate monitoring of the activity of the third-party is necessary to ensure that credit risk is understood and remains within board-approved limits.

# Country Risk

- Country risk is the exposure to the economic, social and political conditions and events in a foreign country that may adversely affect the ability of the foreign-based third-party service provider (FBTSP) to meet the level of service required by the arrangement, resulting in harm to the institution.
- In extreme cases, this exposure could result in the loss of data, research and development efforts, or other assets. Contracting with a FBTSP exposes an institution to country risk, a unique characteristic of these arrangements. Managing country risk requires the ability to gather and assess information regarding a foreign government's policies, including those addressing information access, as well as local political, social, economic, and legal conditions.

# Addressing Third-Party Risks

Prior to entering a third-party arrangement, a bank should:

- Conduct a thorough risk assessment
- Conduct due diligence in selecting a third-party
- Review all contract structures and content
- Develop a monitoring program with appropriate reporting and exception tracking to ensure proper oversight

# Risk Assessment

Prior to entering a third-party arrangement:

- Ensure that the proposed relationship is consistent with the institution's strategic planning and overall business strategy
- Conduct a risk/reward analysis
- Ensure that management has the knowledge and expertise to provide adequate oversight
- Estimate the long-term financial effect of the proposed relationship

# Due Diligence

- The due diligence process provides management with the information needed to address qualitative and quantitative aspects of potential third parties to determine if a relationship would help achieve the financial institution's strategic and financial goals and mitigate identified risks.
- Not only should due diligence be performed prior to selecting a third-party, but it should also be performed periodically during the course of the relationship, particularly when considering a renewal of a contract.

# Contract Structuring and Review

- After selecting a third-party, management should ensure that the specific expectations and obligations of both the financial institution and the third-party are outlined in a written contract prior to entering into the arrangement.
- Board approval should be obtained prior to entering into any material third-party arrangements.
- Appropriate legal counsel should also review significant contracts prior to finalization.

# Oversight

- The board should initially approve, oversee, and review at least annually significant third-party arrangements, and review these arrangements and written agreements whenever there is a material change to the program.
- Management should periodically review the third-party's operations in order to verify that they are consistent with the terms of the written agreement and the risks that are being controlled.
- The institution’s compliance management system should ensure continuing compliance with applicable federal and state laws, rules, and regulations, as well as internal policies and procedures.

# Resources

The Following Financial Institution Letters provide additional guidance on managing third-party risks and are available at FDIC.gov:

- FIL-32-2009 Third-Party Referrals Promising Above-Market Rates on Certificates of Deposit
- FIL-44-2008 Third-Party Risk: Guidance for Managing Third-Party Risks