Vendor Risk Management – Compliance Considerations

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Vendor Relationships

Why banks use third party vendors?

- Reduce costs
- Enhance performance
- Obtain access to specific expertise
- Increase product offerings

Who requires oversight?

All third parties. Board and senior management ultimately responsible for all aspects of its operations, whether performed by bank employees or third parties. Good rule of thumb – Oversee vendors as you would any other division of the bank!!!

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Vendor Relationships *(Continued)*

What are common types of vendor relationships?

- **Outsourced bank/compliance functions** – Third parties to conduct compliance audits, fair lending reviews and compliance monitoring activity
- **Third parties to offer products** – Mortgage brokers, auto dealers, affinity card and credit card providers
- **Loan servicing providers** – Flood insurance monitoring, debt collection, loss mitigation/foreclosure activities
- **Disclosure preparation** – Disclosure preparation software, third party documentation preparers
- **Technology providers** – Software vendors, website developers

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What are the Risks?

- Reputation Risk
  - Dissatisfied customers
  - Violations of laws or regulations – public enforcement actions
- Operational Risk
  - Loss from failed processes or systems
- Transaction Risk
  - Problems with service/product delivery
- Credit Risk
  - Third party is unable to meet contract terms
- Compliance Risk
  - Violations of laws, rules or regulations
  - Non-compliance with policies or procedures
  - Examples:
    - Deceptive marketing
    - Discriminatory lending
    - Privacy

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Third Parties and UDAP Risk

- Compliance Risk and UDAP Risk Heightened with Use of Third Parties, as they:
  - May be positioned directly or indirectly between the bank and customer
  - May be deeply involved in delivery of products and services to consumer
  - May have unfettered access to bank's customers
  - May not be adequately monitored by the bank

- UDAP is not always apparent and may involve commonly accepted bank practices

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Flood Insurance Monitoring

Relationship: Vendor used to monitor flood insurance

Identified Issues:

1) Vendor does not have information necessary for them to do their job – multiple instances of insufficient coverage
2) Complete reliance on vendor – vendor activity is not monitored and no reviews of vendor activity are performed. Issues not self-identified

Results: Significant flood violations - civil money penalties

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Loan Modifications

Relationship: Third party used to process loan modification requests (e.g., Home Affordable Modification Program). Reliance on "experts to process requests"

Identified Issues:

1) Vendor not processing requests as expected (i.e., delays, processing errors, etc.)
2) Vendor perceived to be expert, so no monitoring of vendor activity was performed

Results: Significant examination findings; potential UDAP raised; extensive corrective action, including file search, re-solicitation of borrowers, and compliance program changes

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Credit Card Relationships

Relationship: Third parties used to help administer and market credit cards

Identified Issues:

Deceptive marketing – Third party used to market the product failed to properly disclose all fees (i.e., consumers not given enough info to make informed decisions when opening account)

Results: Enforcement actions can be issued, violations of UDAP, and CMPs issued.

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Disclosure Generation Software

Relationship: Third party software providers used to generate disclosures

Identified Issues:

1) Management relies on software provider to implement required disclosures changes
2) Limited to no tracking to verify changes are implemented and disclosures are in compliance

Results: Violations limited; however, compliance management programs criticized

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Third Party Payment Processors

Relationship: Bank customers who use accounts to process payments for merchant clients

Identified Issues:

1) TPPP initiated payments for merchants engaged in high-risk or illegal activity

Results: Institutions cited for failure to comply with Bank Secrecy Act (i.e., lax treatment of accounts belonging to third-party payment processors) - Consent orders issued requiring additional training, formalized processes to review TPPP transactions. Could also result in UDAP risk if merchants are engaged in deceptive practices.

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Revenue Enhancement

Relationship: Vendors are now offering “revenue enhancement” services

- Can apply to a variety of products and services
- Recommend bankers conduct due diligence, understand vendor activities, ensure technical compliance with all applicable laws and regulations, and know the impact to consumer – UDAP

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Common Themes

<u>Over Reliance on Third Party</u> - Sometimes complete reliance. Using third parties does not eliminate compliance responsibilities. How do you know you are in compliance?

<u>Failure to Understand/Retain Knowledgeable Staff</u> – Reliance on third party may result in institutions not retaining sufficient knowledge to understand and monitor risks. Is someone at institution sufficiently knowledgeable to understand and oversee vendor's activities?

<u>Failure to Monitor Vendor</u> – Need to monitor your vendor to ensure compliance. How is your vendor performing? Do you know what they are doing? Are you getting complaints?

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Common Themes *(Continued)*

Garbage In – Garbage Out – Vendor's performance only as good as information provided and/or the expectations set. **Are you giving your vendor the information necessary to do their job? Is the contract with the vendor clear on your expectations?**

Vendor's Activities Result in Violations - How are you verifying that your vendors' activities comply with the law?

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Best Practices

- Conduct thorough due diligence before selecting a vendor
  - References
  - Financial information
  - Background of third party principals
- Prepare a detailed risk assessment
- Ensure the contract with the third party includes expectations concerning compliance with consumer protection laws and regulations
  - Expectations should include specific terms based on risk assessment
  - Include the ability to request proof of compliance, e.g., vendor's audits, monitoring, etc.

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Best Practices *(Continued)*

- Implement a comprehensive monitoring program
  - Monitoring frequency and depth should be based on risk assessment
- Implement training for those conducting monitoring to ensure they understand the risks and receive regulatory updates
- Track consumer complaints
- Ensure board of directors receive third party due diligence, monitoring reports, and training to enable them to provide proper oversight of risks inherent in third party relationships

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Conclusion

- When outsourcing a function, ultimately responsibility for compliance cannot be delegated – remains with institution

- While vendor arrangements can provide valuable benefits, active role in risk management is required

- Ensure appropriate program is in place that includes
  - Due Diligence
  - Risk Assessment
  - Contract Structuring and Review
  - Oversight

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Federal Reserve Resources

- *Vendor Risk Management,* Outlook Newsletter Article, 2011

  http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2011/first-quarter/vendor-risk-management.cfm

- *Third –party service provider risk and the Unfair and Deceptive Acts and Practices rule*, Retail Payments Risk Forum (Federal Reserve Bank of Atlanta), February 2011

  http://portalsandrails.frbatlanta.org/third-party-service-provider/

- *Outsourcing Financial Services Activities: Industry Practices to Mitigate Risks,* Federal Reserve Bank of New York, October 1999

  http://www.ny.frb.org/banking/circulars/outsource.pdf

- *Interagency Review of Foreclosure Policies and Procedures,* The Federal Reserve Board, April 2011

  http://www.federalreserve.gov/boarddocs/rptcongress/interagency/interagency.htm

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Other Agency Resources

- CFPB Bulletin 2012-2 on Service Providers

  http://files.consumerfinance.gov/f/201204_cfpb_bulletin_service-providers.pdf

- FIL 44-2008 – Third-Party Risks: Guidance for Managing Third-Party Risk

  http://www.fdic.gov/news/news/financial/2008/fil08044.html

- OCC Bulletin 2001-47 – Third Party Relationships: Risk Management Principals

  http://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-47.html

- FTC Website

  http://www.ftc.gov

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Questions

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