RESCINDED

AL 2000–9

OCC ADVISORY LETTER

Comptroller of the Currency
Administrator of National Banks

Subject: Third-Party Risk

Replaced by OCC Bulletin 2013-29.

TO: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel.

PURPOSE

This advisory alerts national bank management and boards of directors to potential credit risks arising from arrangements with third parties (vendors, agents, dealers, brokers, marketers, etc.) and emphasizes the importance of thorough due diligence and control over such risks. Over the past 12 to 18 months a number of banks have suffered significant financial losses due to bank management's failure to exercise appropriate due diligence and risk analysis prior to engaging in certain credit-related activities involving third parties. In some cases, the losses led to the banks' insolvency. By not fully understanding the nature of the risks being introduced to the bank and not ensuring appropriate risk controls, management and boards of directors breach their most fundamental fiduciary responsibility to depositors and shareholders.

BACKGROUND

Vendors, brokers, dealers, and agents can offer banks a variety of legitimate and safe opportunities to enhance product offerings, improve earnings, diversify assets and revenues, or reduce costs. In most instances the fundamental risks associated with activities introduced by third parties are no greater or less than the bank would have incurred had the bank performed the activity on its own. Those risks, however, can be excessive if management and directors do not exercise appropriate due diligence prior to entering the third-party arrangement, and effective oversight and controls afterwards.

The following cases highlight some of the problems that national banks have encountered as a result of failing to perform adequate due diligence or otherwise exercise prudent controls over credit-related activities arranged through third parties. The Office of the Comptroller (OCC) has determined that these occur most commonly when management is overly focused on potential returns or cost savings, or when management lacks sufficient knowledge about the risks involved with a new product, business, or activity.

CASES

Case 1 **Vendor and Product Selection**

A number of banks have experienced significant financial losses and damage to their reputations because they failed to understand and control the risks associated with "credit repair" products sponsored by vendors and third-party marketers. The banks issued unsecured credit cards to "subprime" borrowers (borrowers exhibiting higher default risk characteristics than those of traditional borrowers) solicited by the vendor/marketer. In exchange for receiving the card, customers had to purchase the vendor's educational material about debt management. The cost of the product was immediately charged to the credit card and the vendor's account was credited for the product sale and related fees. The banks, in turn, received high fees and interest rates on the credit card receivables. Credit losses were inordinately high due to product returns and first payment defaults associated with product dissatisfaction or rejection of credit terms. Further defaults occurred due to the customers' inability to service the debts. Fees and interest associated with the product and credit card were excessive relative to the value received, and a significant number of customers complained about aggressive marketing tactics and inadequate disclosures. These additional factors severely damaged the reputation of the banks involved and exposed them to the risk of noncompliance with consumer protection and fairness regulations. Few, if any, customers "repaired" their credit standing by using these arrangements.

The banks involved did not apply their credit or business standards to credits referred by the vendors and did not conduct sufficient due diligence on the vendors' or marketers' reputations, products, or financial condition. In several of these cases, the losses were so significant that capital restoration by shareholders was required.

Case 2 **Purchased Receivables**

A number of banks have experienced financial losses related to factoring arrangements supported by vendor-supplied accounts receivable financing software. The vendors provided the banks with bookkeeping systems to manage the receivables and optional assistance acquiring customer accounts. The banks then purchased discounted receivables, generally with recourse to the seller. When the discounted receivables defaulted, the banks relied on the sellers to honor their recourse obligations, but in several cases the seller did not have the capacity to do so and the banks sustained significant credit losses.

The banks involved had little or no prior experience in managing the risks associated with factoring or receivables financing and failed to analyze the financial capacity of the sellers of the receivables to honor their recourse obligations. These banks' fundamental failure to understand the risks associated with the business they entered into resulted in significant loan losses.

<u>Case 3</u> **Loan Participations**

Relying on the reputation of a major money center bank, a bank purchased a number of participations in large, syndicated national credits. While the purchased credits helped diversify the bank's geographically concentrated loan portfolio and offered attractive yields, they also introduced significant credit risks that bank management neither understood nor could control. Several of the purchased loans were subordinate tranches of complex leveraged financing structures, and most of the purchased credits were to businesses in specialized industries with which bank management had little or no lending experience. The repayment of one loan was heavily reliant on optimistic cash flow and enterprise value assumptions for a company in an already troubled industry sector. When projected cash flows did not materialize, the borrower declared bankruptcy and the enterprise value of the company was significantly impaired. The bank's share of the resulting loan loss exhausted its entire allowance for loan and lease losses.

The bank did not perform sufficient independent due diligence to make a fully informed credit decision as required by OCC Banking Circular 181, dated August 2, 1984. (That banking circular states, "To make a prudent credit decision, a purchaser conducts an independent credit analysis to satisfy itself that a loan, loan participation, or loan portfolio is a credit which it would make directly.") Further, it engaged in highly specialized and high-risk lending activities without the required level of knowledge and expertise and failed to limit the size of acceptable exposures.

<u>Case 4</u> **Loan Administration**

One bank was rendered insolvent as a result of construction loan losses. The bank engaged a third party to monitor and control real estate construction loan disbursements for a residential development project. The third party did not exercise appropriate verification and control over construction loan advances, and the developer initiated numerous unchecked construction loan draws resulting in overfunding of the construction loans relative to the work performed. The developer absconded, leaving the bank to expend substantial additional funds to complete the project.

The bank entered into this agreement without performing any due diligence on the third party and without the benefit of a written contract. Further, the bank never verified whether the third party was performing the contracted services.

Banks face risks such as those described in the above examples when they fail to conduct adequate due diligence or place undue reliance on external third parties. Using vendors to design products or perform core bank functions, such as loan underwriting and credit scoring, without adequate controls and monitoring can increase transaction risk and reputation risk. The bank is responsible for the relationship with its customers and is ultimately accountable for its quality. The board and management must be mindful that although performance of duties may be delegated to others, ultimate responsibility for ensuring the bank is run in a safe and sound manner rests with the board. In fulfilling its responsibility, the board must ensure that policies, control systems, and management information systems (MIS) are well defined and management is competent.

RESCINDED

VENDOR MANAGEMENT PROGRAM

Credit services and products and the third parties that offer them continue to evolve. Although most vendors are reputable, their products may be unproven or the risks associated with the product/activity may conflict with bank safety and soundness or compliance considerations. Bank management cannot rely solely on third-party assertions, representations, or warranties when entering such relationships. Before entering into a major relationship with a third party, a bank should establish a comprehensive program for managing the relationship. Such programs should be documented and include front-end management planning, appropriate due diligence selecting a vendor, and performance monitoring.

Management Planning

When using a third party to enter new lines of business or expand existing ones, management and the board should undertake a rigorous planning process. Management's planning should include a cost/benefit analysis, evaluation of similar products, and development of risk limits and control processes. To gain a more balanced perspective, management should also analyze performance under adverse circumstances. Specific objectives should be established for concentrations, asset quality, growth, and profitability. Management should identify the MIS necessary to monitor adherence to established objectives and properly supervise the relationship. Internal audit should assist in analyzing the risks associated with the product/activity, and in establishing the necessary control and reporting structures. Existing policies should be reviewed and amended, as necessary, to ensure that control procedures cover the new product or activity. Management should maintain documentation of its planning efforts.

Due Diligence in Selecting A Vendor

Management and the board should conduct comprehensive due diligence to determine what third-party services or products can best help the bank achieve its goals. Initially, management must ensure that the service or product fits within the bank's overall business plan and within established risk parameters. Prior to entering into contracts with third parties all contracts should be reviewed by bank counsel. Additional due diligence efforts should involve a thorough evaluation of all available information about the third party, to include reviewing:

- Business reputation, complaints and litigation (references, Better Business Bureau, state attorneys general offices, state consumer affairs offices, etc);
- Financial condition of the company and significant principals;
- Qualifications, backgrounds, and reputations of company principals;
- Cost of development, implementation, and support;
- Internal controls and recovery process (where appropriate);
- Service agreements to determine if the level of support is reasonable;

- Vendor and bank management responsibilities; and

- Marketing materials to determine how the bank's name will be associated with the product.

Performance Monitoring

After entering into a contract or agreement with a third party, management should monitor its performance to ensure that committed goods and services are received. Management must dedicate sufficient staff to this process and ensure they are properly trained to perform their duties. Performance monitoring should occur routinely and include:

RESCINDED

- Reviewing MIS provided by the third-party;

- Reviewing the portfolio regularly to ensure
  - expected quality and returns are being achieved;
  - adherence to underwriting guidelines is maintained; and
  - deviations from established benchmarks are reasonable;

- Periodic, downside/sensitivity analysis;

- Analyzing the vendor's financial condition at least annually, and more frequently where increased risk is present;

- Evaluating the overall relationship costs;

- Reviewing independent audit reports of the vendor;

- Performing on-site quality assurance reviews, targeting adherence to specified policies and procedures;

- Testing vendor risk management controls; and

- Ensuring compliance with fair-lending and other consumer protection laws and regulations.

Documentation

One key to the success of managing third parties is the quality of documentation. The proper documentation will facilitate bank management's processes to monitor and manage the risks associated with third-party services and products. At a minimum, the following documentation should be maintained:

- A list of significant vendors or other third parties, *i.e.*, those that management spends substantial amounts of money with or those deemed critical to the operation;

RESCINDED

- Valid, current, and complete contracts that
  - describe the responsibilities of the third party and any product or service to be delivered;
  - clearly identify reporting requirements and, where appropriate, network security for the third party;
  - guarantee that services and products will operate within specified tolerances;
  - provide the bank with authority to conduct its own audits of the vendor's operation;
  - explain contingency plans for service recovery; and
  - outline training and problem resolution;

- Business plans for new lines of business or products that identify management's planning process, decisions, and due diligence in selecting a vendor or other third party;

- Regular reports to the board informing them of the findings discovered during the bank's ongoing monitoring; and

- Regular risk management reports received from the vendor.

CONCLUSION

The OCC encourages national banks to use third parties to avail themselves of the many legitimate and safe opportunities to enhance product offerings, improve earnings, and diversify assets and revenues. To benefit from third-party providers of credit services and products, banks must have an effective process for managing relationships with them. The value an institution will derive from its use of vendor services and products is directly proportional to the quality of management's due diligence efforts and risk control process.

Questions concerning this advisory may be directed to the Credit Risk unit at (202) 874-5170.

David D. Gibbons	Ann F. Jaedicke
Deputy Comptroller	Deputy Comptroller
Credit Risk	Supervision Support