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!!!
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
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
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
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
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.
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
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.
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
Common Themes

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

**Failure to Understand/Retain Knowledgeable Staff** – 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?**

**Failure to Monitor Vendor** – Need to monitor your vendor to ensure compliance. **How is your vendor performing? Do you know what they are doing? Are you getting complaints?**
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?
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.
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
Federal Reserve Resources

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

- **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


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

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Other Agency Resources

- CFPB Bulletin 2012-2 on Service Providers


- FTC Website
  http://www.ftc.gov

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