CALIFORNIA BANKERS ASSOCIATION

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New Interagency Guidance on Third-Party Risk Management, Compliance and Recent Consent Orders

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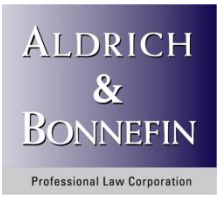
New Third Party Risk Management Guidance



Third-Party Risk Management Guidance

- *Interagency Guidance on Third-Party Relationships: Risk Management*

- Jointly issued June 6, 2023, by the OCC, FRB and FDIC

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Rescinds Certain Prior Guidance

- Guidance rescinds:
  - FRB Guidance on Managing Outsourcing Risk (FRB SR-13-19);
  - OCC Risk Management Guidance issued in October 2013 (OCC Bulletin 2013-29);
  - OCC Third Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29; and
  - FDIC Guidance for Managing Third Party Risk issued in June 2008 (FIL-44-2008)

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Other Guidance Not Rescinded

- Not all prior guidance on this topic has been rescinded
- For example, the following are not rescinded (not exhaustive list):
  - FFIEC IT Booklets
  - Agencies' recent "*Cyber-Security Incident Notification Rule*"
  - OCC's "*Model Risk Management*" booklet, which is part of Comptroller's Handbook series; and
  - OCC's "*Third-Party Due Diligence Guide for Community Banks*"

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Scope of New Guidance

- New Guidance is intended to provide "broad, principles-based approach"
  - Agencies stated they intentionally did not revise final Guidance to address "specific topics or types" of relationships

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Future Guidance

- Agencies indicated plan to develop
  - "..*additional resources to assist smaller, non-complex community financial institutions in managing relevant third-party risks*"

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Credit Unions

- New Final Guidance does not apply to credit unions
- NCUA's Supervisory Letter No. 07-01
  - Entitled, "*Evaluating Third Party Relationships*"
  - Issued in October 2007
  - Remains valid & applicable to FCUs

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Scope

- Guidance applies to “third-party relationships”
  - “..*addresses <u>any business arrangement</u> between a financial institution and another entity, <u>by contract or otherwise</u>*”
  - Not limited to arrangements where third party is performing critical/material functions

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Scope

- Examples of covered relationships:
  - Outsourced services
  - Independent consultants
  - Referral arrangements
  - Merchant payment processing services; and
  - Services provided by institution's affiliates & subsidiaries

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Level of Due Diligence

- Guidance does not require institutions to apply same level of
  - Rigor
  - Due diligence; or
  - Risk management procedures
  - To every third-party relationship
- Instead, consider the materiality of the relationship to categorize risk and apply due diligence based on institution's size, complexity & risk profile

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Critical Activities

- May include activities that could:
  - Cause institution to face significant risk if third party fails to meet expectations
  - Have significant customer impact; or
  - Have significant impact on institution's financial condition or operations

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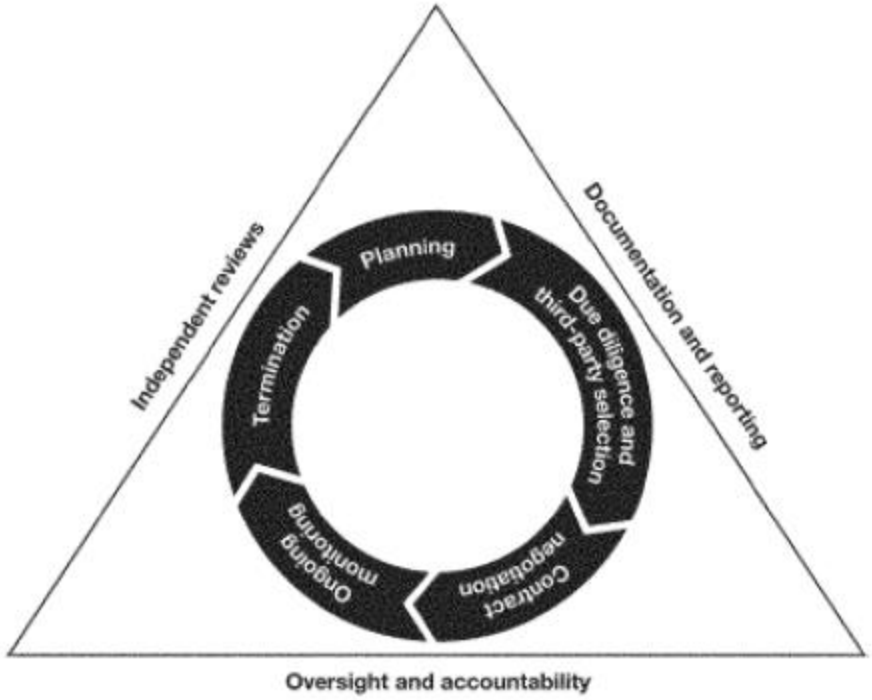
Figure 1: Stages of the Risk Management Life Cycle



Source: Board, FDIC, and OCC

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Stages of Third-Party Relationships

- Five stages of managing risks with third-party relationships:
  - Planning
  - Due diligence & third party selection
  - Contract negotiating
  - Ongoing monitoring; and
  - Termination

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Planning

- Institutions consider the following factors when developing a plan to address its third-party relationships:
  - Strategic purpose
  - Identification of benefits and risks
  - Nature of relationship
  - Expected costs
  - Impact on employees
  - Impact on customers
  - Information security implications
  - Physical security implications
  - Ongoing oversight; and
  - Contingency plans

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Due Diligence & Third-party Selection

- Due diligence at the selection phase may include review of third party's ability to:
  - Perform activity as expected
  - Adhere to policies related to activity
  - Comply with all applicable laws and regulations; and
  - Conduct activity in safe & sound manner

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Inability to Obtain Information

- When unable to obtain desired due diligence information from third party
- For example, third party
  - May not have long operational history
  - Prohibit on-site visits; or
  - May refuse to share information that institution requests

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Inability to Obtain Information

- In these situations, Guidance indicates it is important to:
  - Identify & document any limitations of its due diligence process
  - Understand risks created by those limitations; and
  - Consider alternatives as to how to mitigate risks

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Inability to Obtain Information

- For example, institution
  - May obtain alternative information to assess third party
  - Implement additional controls on or monitoring of third party to address information limitation; or
  - Consider using different third party

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Relevant Due Diligence Factors

- Institution would consider the following factors:
  - Strategies and goals
  - Legal and regulatory compliance
  - Financial condition
  - Business experience
  - Qualifications and background of key personnel
  - Risk Management
  - Information security
  - Management of information systems
  - Operational resilience
  - Incident reporting and management processes
  - Physical security
  - Reliance on subcontractors
  - Insurance coverage; and
  - Contractual arrangements with other parties

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Relevant Contractual Provisions

- Institutions consider a number of other factors when negotiating a contract:
  - Nature and scope of arrangement
  - Performance measures
  - Responsibilities for receipt and handling of information
  - Audit right and remediation
  - Compliance with applicable law
  - Costs and compensation
  - Ownership and license
  - Confidentiality and integrity
  - Operational resilience and business continuity
  - Indemnification and limits on liability
  - Insurance
  - Dispute resolution
  - Customer complaints
  - Subcontracting
  - Foreign-based third parties
  - Default and termination; and
  - Regulatory supervision;

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Ongoing Monitoring

- Effective third-party risk management includes ongoing monitoring throughout duration of third-party relationship
  - May be conducted on periodic or continuous basis
  - The greater the risk, the more frequent the monitoring

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Relevant Factors that Impact Ongoing Monitoring Activities

- The following factors when assessing appropriate ongoing monitoring activities to apply to its third-party risk management program:
  - Effectiveness of third party
  - Changes to third parties business strategy
  - Changes in financial condition
  - Insurance coverage
  - Audit results
  - Compliance with applicable law (…)

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Relevant Factors that Impact Ongoing Monitoring Activities

- Change to key personnel
- Subcontractors
- Training
- Incident response
- Confidentiality and integrity
- Business continuity
- External factors; and
- Customer complaints

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Termination

- Termination considerations may vary depending on degree of risk & complexity of relationship, and may include:
  - Transition options
  - Managing capabilities & resources
  - Costs
  - Data & systems control
  - Joint intellectual property; and
  - Failure by third party to meet expectations

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Oversight and Accountability

- Structure of third-party risk management processes may vary
  - Some institutions may disperse accountability for third-party risk management processes among their business lines
  - Others may consolidate processes under their
    - Compliance
    - Information security
    - Procurement; or
    - Risk management functions

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Discussion & Practice Points

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Discussion & Practice Points

- Due diligence documents vendors are reluctant to provide
  - Financials for private companies
  - Business continuity plans & tests
  - Audit reports (SOCs/SSAE)
  - Other security items

Penetration tests	Encryption policies
Security training	Third-party relationships

Discussion & Practice Points

- Vendor management process challenges
  - Scope of “business arrangements”
  - Business unit review/sign-off/approval
  - Complementary Entity User Controls
  - Cloud vendors
  - Ad-hoc vendors
  - Consultants
  - Certificate of Insurance v. Insurance Policy
  - 4th Party SOC Reports

Discussion & Practice Points

- Contract review
  - When does Compliance need to review?
  - When does Information Tech need to review?
  - When does Information Security need to review?
  - When does Legal need to review?

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Discussion & Practice Points

- Contract review
  - How much review does a new engagement for SOW require?
  - What about online agreements that vendor's change?
  - Dealing with a lack of negotiation leverage
  - How to cut ties with a bad vendor, mid-contract?

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Discussion & Practice Points

- Vendors who use Artificial Intelligence

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Noteworthy Resent Consent Orders

(Including Beyond Scope of Vendor Management)

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Noteworthy Consent Orders

- OCC American Express National Bank, Sandy, Utah (July 2023)
  - Consent Odder for engaging in unsafe or unsound practices regarding governance and oversight of its third-party affiliates
  - $15 million dollars in civil money penalties

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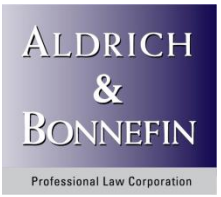
Noteworthy Consent Orders

- American Express National Bank, Utah, Failures
  - To properly govern and oversee third-party affiliate's call monitoring and documentation processes, including tracking and monitoring of customer complaints
  - To obtain EINs for certain small business customers and properly maintain records regarding compliance with CIP regulations; and
  - To properly maintain records related to its effort to retain such customers and, later, produce them in response to the OCC requests



Noteworthy Consent Orders

- CFPB Wells Fargo Bank Consent Order (Dec 2022)
  - $1.7 billion penalty (plus consumer redress)
  - Auto loan financing
    - Loan payments misapplied, erroneous fees/charges, incorrect repos, failed refunds on cancelled debt collection products
  - Home mortgage servicing
    - Qualified borrowers' modifications denied
  - Consumer deposit accounts
    - Improper freeze/closed, improper OD fees, failed to waive fees consistent with disclosures

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Noteworthy Consent Orders

- OCC MUFG Consent Order (June 2023)
  - $15 million civil money penalty
  - Alleged UDAP violations for fee waiver practices
  - Failed to disclose customer's affirmative request for waiver and corresponding account linking was condition precedent to waiver
- CFPB Supervisory Highlights (April 2023) noted recent fee waiver exam findings as raising UDAAP concerns, including back-end practices that did not match customer-facing disclosures

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Noteworthy Consent Orders

- CFPB and OCC Bank of America Consent Orders
  - CFPB and OCC assessed civil money penalties of $150 million and $60 million, respectively.
  - Alleged
    - “Multiple NSF” fees for same underlying transaction
    - Opening unauthorized consumer credit card accounts and deceptively advertising certain credit card-related rewards

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Noteworthy Consent Orders

- In summary….
  - Penalties are increasing
  - UDAP/UDAAP as basis for violations expanding
  - Back-end practices not mirroring front-end disclosures
  - Even with sufficient disclosure, the practice itself may be called into question under UDAP/UDAAP analysis
  - Emphasis on need for better oversight and controls

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We're adjourned!

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