

Community Bank Boards Must Involve Themselves with Third Party Vendor Management

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As credit quality issues have apparently stabilized, we are seeing a renewed focus on Bank Secrecy Act (BSA), compliance and third-party vendor criticism in recent exams that demands board attention. This new level of attention emerges against a background of increased reliance by community banks on outside vendors to handle many IT and compliance matters. Recent examinations have criticized third-party vendors despite these relationships having existed for several examination cycles without regulatory criticism. Gone are the days when a board of directors could rely on the CEO's recommendation of his friend and former colleague as the beginning and end of the due diligence review and the continued monitoring of third-party vendors providing critical bank functions. The board must take an active role in third-party vendor selection, monitoring and retention or risk inviting examination criticism.

Regulatory guidance on third-party vendors is consistent that this is a board level issue, not simply one for management. In a November 2001 OCC Bulletin, the OCC stated that it "expects the boards of directors and management of national banks to properly oversee and manage third-party relationships." (OCC Bulletin 2001-47.) Similarly, the FDIC's Compliance Manual indicates that "[t]he board of directors and management...are ultimately responsible for managing activities conducted through third-party relationships, and identifying and controlling the risks arising from such relationships, to the same extent as if the activity were handled within the institution." (FDIC Compliance Manual, December 2012.)

In addition to regulatory guidance, recent enforcement actions dealing with third-party vendors have taken aim at the board. For example, a Consent Order issued by the FDIC to a Pennsylvania institution in October 2012 recited weaknesses in board participation and oversight, BSA compliance and oversight and management of third parties. At issue with this bank was a third-party vendor that provided merchant processing services to bank customers. Importantly for this article, the consent order took direct aim not only at the bank's management, but also its board of directors with, among other provisions, the following

"The board shall increase its participation in ensuring that E-Payments Program risk is appropriately monitored and that all internal and external audit recommendations related to this activity and monitoring are addressed. Compliance with this subparagraph, at a minimum, shall include the following:

- (i) the BSA Officer and Information Technology Officer shall provide BSA reports to the Board at least monthly. The report shall include progress on correcting BSA deficiencies relating to the E-Payment Program activities; and

(ii) within 30 days from the effective date of this ORDER, the Board shall receive enhanced BSA training relating to the E-Payments Program. Such training must be designed to allow the Board to fully understand and appropriately accommodate the specialized risks of the E-Payments Program. Thereafter, annual training refresher courses shall be provided to the Board.”

Other provisions of this order, and others, are equally quotable, and strike a common chord: The board of directors bears ultimate responsibility for understanding the services provided by third-party vendors, and for their selection, monitoring and retention.

Given the clear focus on third-party relationships by regulators, and the risk of serious compliance issues posed by many vendors in any number of the alphabet soup consumer and other regulations, it is critical for community bank boards of directors to involve themselves in third-party vendor management. To this end, the board should ensure that its bank’s vendor management program includes the following minimum elements:

Risk Assessment – an initial, and then subsequent periodic risk assessments of the third-party vendor and the services to be provided by that vendor;

Due Diligence in Selecting a Third Party – procedures to conduct due diligence in selecting third-party vendors, including any subcontractors utilized by those vendors or customers being brought to the bank through those vendors;

Contract Structuring and Review – procedures to review contract terms with third-party vendors. As the FDIC states, a contract should act as a map to the relationship and define its structure, ensuring that the expectations and obligations of the bank and the vendor are outlined in writing; and

Oversight – effective oversight and monitoring of third-party vendors once they are engaged in the following areas: (a) financial condition of vendor, (b) controls and compliance, and (c) quality of service and support.

With credit quality issues demanding less time of regulators, a focus on bank operations has returned to the fore. Community bank boards of directors should expect their upcoming exams to highlight compliance issues, such as BSA and third-party vendor management. Including the above four elements in a bank’s vendor management program will go a long way to limiting regulatory criticism.

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