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BANK *Wire*

Regulators raise the bar on outsourcing relationships

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Regulators raise the bar on outsourcing relationships

Banking regulators have always had concerns about outsourcing. But in recent years they have raised their expectations about bank oversight of outside service providers.

If your bank outsources key functions to third parties, it's a good idea to review your existing relationships — as well as your policies, procedures and controls for managing those relationships — to ensure that they meet regulators' expectations. Failure to do so exposes your bank to a variety of risks, not to mention significant liabilities for penalties and restitution. (See "Recent enforcement actions take their toll" on page 3.)

Who's watching?

Over the last few years, just about every federal banking agency has issued guidance on managing third-party risks. For example, in April 2012, the Consumer Financial Protection Bureau (CFPB) issued a bulletin on oversight of service providers. And in October 2012 the Federal Financial Institutions Examination Council (FFIEC) published guidance on supervision of technology providers.

> Contracting with a third party doesn't relieve a bank from responsibility and legal liability for outsourced activities.

Then, in late 2013, three regulatory actions were initiated: The FDIC issued a Financial Institution Letter about payment-processing relationships with high-risk merchants, the OCC published risk-management guidance for third-party relationships, and the Federal Reserve Board released its *Guidance on Managing Outsourcing Risk*.

What are the risks?

Contracting with a third party doesn't relieve a bank from responsibility and legal liability for outsourced activities. At the same time, it reduces bank management's direct control over those activities, which can increase the bank's risks in several ways. If you outsource loan processing, customer service, telemarketing or debt collection, there's a risk that the provider will violate consumer protection laws by making misleading statements to your customers or prospective customers or by engaging in deceptive practices.

If you outsource data processing or IT services, there's a danger that the provider will fail to follow the latest cybersecurity guidelines. This could bare sensitive customer data to hackers or identity thieves.

These and other risks, if not properly managed, endanger your bank's operations and reputation, and expose it to potential liability for compliance failures.

What should you do?

To meet regulatory expectations, all banks should review the guidance mentioned above. The OCC guidance, which is the most detailed, directs banks to adopt risk-management processes that are in line with the level of risk and complexity of their third-party relationships.

Recent enforcement actions take their toll

Over the last two years, federal banking regulators have cracked down on banks that fail to adequately oversee third-party service providers. Following are a few examples. Although they involve large financial institutions, community banks also are at risk without appropriate planning.

First Bank of Delaware. The FDIC and the Financial Crimes Enforcement Network imposed a $15 million penalty against the bank for Bank Secrecy Act and Anti-Money Laundering (BSA/AML) violations. Among other things, the bank failed to sufficiently monitor the activities of third-party payment processors.

Discover Bank. The bank used outside telemarketers to sell add-on credit card products, including identity theft protection. The FDIC and Consumer Financial Protection Bureau (CFPB) imposed a $14 million penalty and at least $200 million in restitution, finding that the telemarketers had engaged in deceptive acts and practices that misled customers and that the bank failed to adequately supervise the telemarketers' activities.

American Express. The CFPB, OCC, Federal Reserve and state banking authorities imposed a $27.5 million fine and $85 million in restitution against American Express and certain subsidiaries for various violations of federal consumer laws involving the company's marketing, billing and debt collection practices. Most of these violations were attributable to "deficient management oversight of the bank's service providers."

Capital One. In 2012 the CFPB fined Capital One $210 million, holding it responsible for the actions of an outsourced call center. Call center agents engaged in deceptive marketing practices by falsely suggesting to customers that certain add-on products, including credit monitoring and payment protection, were mandatory or free.

Generally, the OCC wants to see more rigorous oversight of *critical* activities, such as payments, clearing, settlements, custody, IT or other activities that could have significant customer impacts or could cause significant harm to the bank if the provider fails to perform. To effectively manage third-party risks, take these specific actions:

- Develop a formal plan for managing third-party relationships.
- Conduct thorough due diligence on prospective providers, focusing on such factors as legal and regulatory compliance, reputation, qualifications of company principals, risk management, information security and reliance on subcontractors.
- Negotiate contracts that clearly spell out each party's rights and responsibilities — the guidance provides a detailed list of contract provisions, including performance benchmarks, information sharing, audit rights, compliance, confidentiality and indemnification.
- Monitor the relationship, including due diligence areas, on an ongoing basis.
- Conduct periodic independent reviews of your third-party risk-management process.

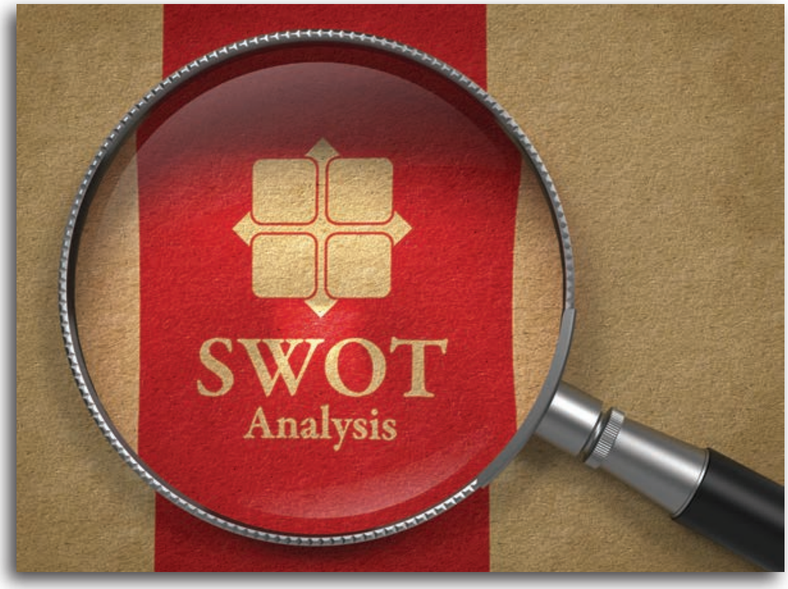
The guidance also discusses termination of third-party relationships, oversight and accountability, documentation and reporting, and the respective roles of the bank's board, management and employees.

Be prepared

If your bank uses third-party service providers, be prepared to have regulators scrutinize those relationships. The level of oversight required depends on the level of risk involved in your outsourced activities, so start by conducting a risk assessment of your outsourcing arrangements. ▲

SWOT analysis is solid "armor" for lenders

Uncover risks among your business loan customers



Police SWAT members put on protective gear before responding to risky situations. Similarly, lenders can protect themselves before approving commercial loans by conducting SWOT (strengths, weaknesses, opportunities and threats) analyses. Lenders also can use SWOT analyses in their discussions with borrowers on mitigating risks.

Examining strengths and weaknesses

SWOT analysis starts by identifying strengths and weaknesses from the customer's perspective. Strengths represent potential areas for boosting revenues and building value. These may be core competencies or competitive advantages. Examples might include a strong brand image, a loyal customer base or exceptional customer service.

It's important that you encourage weaker, less experienced borrowers to go through the SWOT exercise. The results may enlighten them.

It's important to unearth the source of each strength. Some may be tied to the company's key employees or owners — for example, a CEO with a high regional profile and a multitude of community ties. This is especially common among professional practices, such as accounting, law or advertising firms. But manufacturers and retailers may rely on key people, too.

When strengths are largely tied to people, rather than the business itself, consider what might happen if a key person suddenly left the business. Ask whether the borrower has key person life insurance, signed noncompete contracts, a buy-sell agreement or a formal succession plan designed to transition management to the next generation.

Weaknesses represent potential risks and should be minimized or eliminated. Often weaknesses are evaluated relative to the company's competitors. They might include high employee turnover, weak internal controls, unreliable quality or a location with poor accessibility.

Every business has its Achilles' heel. But when borrowers report the same weaknesses year after year, it's cause for concern. It's not enough to recognize a weakness — they need to take corrective action. Ask them to present their results.

Pinpointing external influences

The second part of a SWOT analysis looks externally at what's happening in the industry, economy and regulatory environment. Opportunities are favorable external conditions that could increase revenues and value if the company acts on them before its competitors do.

SWOT matrix

	Positive	Negative
Internal	Strengths	Weaknesses
External	Opportunities	Threats

For example, one auto dealer has responded to the strong market for new car sales by adding another franchise to his offerings. The dealer now sells Toyotas as well as Fords, giving him the potential to double business.

Threats are unfavorable conditions that might prevent an unwary borrower from achieving its goals. Threats might come from the economy, technological changes, competition and increased regulation. Here, the idea is to watch for and minimize existing and potential threats.

For instance, a competitor of the auto dealer above might lower new car pricing and aggressively advertise promotions and discounts offered by his Toyota franchise to maintain his Toyota-buying customers. The dealer who has just added a Toyota franchise will need to keep an eye on this and have proactive moves in place.

Working with your customers

Have your customers completed an in-house SWOT analysis? It's a proven management tool taught at business schools around the world. Strong borrowers will answer in the affirmative and discuss the results. But it's important that you encourage weaker, less experienced borrowers to go through the exercise. The results may enlighten them.

Typically presented as a matrix (see the chart above), a SWOT analysis provides a logical framework for understanding how a business runs. It tells what a borrower is doing right (and wrong) and predicts what outside forces could impact cash flow in a positive (or negative) manner.

Entrepreneurs love their work and rarely want to hear that their "babies" are ugly. If you have concerns about a risky borrower, a SWOT analysis can be an objective forum for discussing sensitive or negative issues.

Ask for it

Some lenders ask prospective borrowers to present the results of a SWOT analysis during the due diligence process. Take advantage of this potential weapon in your arsenal before taking decisive action on loans. ▲

5 tips for a successful succession plan

Community banks can't afford to be without a succession plan. There's no specific regulatory requirement that banks create a succession plan, but regulators generally view a formal plan as a best practice. The OCC, in its Spring 2014 *Semiannual Risk Perspective*, listed "planning for management succession and retention of key staff" as a key risk issue facing community banks.

Here are five tips for developing an effective succession plan. Although they focus on the CEO, it's a good idea to also have plans in place for other key executives and directors.

1. Look inward first

Although banks often consider external candidates to succeed the CEO, naming an internal successor may offer significant benefits. Internal candidates are ensconced in the bank's corporate culture, offering the advantage of continuity. When you bring in an outsider, there's always a risk that he or she won't blend into the culture. Plus, internal candidates are familiar with the bank's operations and strategies and the current CEO's agenda.

Training, mentoring and executive coaching can help you evaluate the potential of internal candidates and develop the skills they need to succeed in the CEO role.

Another advantage is that your directors — at least in theory — already know internal candidates and are familiar with their work. To ensure that's the case, invite candidates to present to the board and arrange other interactions between board members and potential successors.

2. Develop your talent

To increase your chances of promoting from within, have an active program for developing potential successors. Training, mentoring and executive coaching can help you evaluate the potential of internal candidates and develop the skills they need to succeed in the CEO role.

It's also important to manage candidates' expectations to avoid a mass exodus when one person is chosen as the successor. Rather than treating the process as a competition, characterize it as a developmental opportunity for all participants and have a plan for those who aren't selected.

3. Be prepared to look outward

Despite the advantages of hiring from within, in some cases it may be necessary or desirable to consider external candidates. Perhaps you don't have a suitable internal candidate. What if your current CEO dies or becomes disabled unexpectedly, and there's no time to groom an internal successor? Or maybe you feel that your bank would benefit from bringing in "new blood."

To prepare for such contingencies, it's a good idea to track potential candidates at other banks or even in other industries, possibly with the help of a recruiting firm.

4. Start early

Planning should ideally begin two to five years before a potential succession event. This gives you time to define the qualifications you're looking for, draft job descriptions, and evaluate internal and external candidates. It also gives you time to develop internal candidates and formulate a retention plan for those who aren't selected.

5. Review your plan frequently

A succession plan isn't a static document you can put on a shelf and forget until the time comes to put it into effect. It's critical to revisit your plan periodically to ensure that it continues to meet your objectives. You may need to adjust your requirements, for example, in the event of changes in your bank's strategies, regulatory environment or other circumstances. ▲

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IS YOUR BSA/AML PROGRAM UP TO DATE?

A bill introduced in Congress would make it easier for the government to hold individual bank officers and directors personally liable for a financial institution's Bank Secrecy Act / Anti-Money Laundering (BSA/AML) violations. Even if the bill isn't passed, the trend in recent years has been toward individual accountability.

Consider the recent enforcement action against MoneyGram International. In that case, the Financial Crimes Enforcement Network (FinCEN) notified the firm's former chief compliance officer that it planned to penalize him as much as $5 million for his role in the firm's BSA/AML lapses.

In light of these developments, all banks would be wise to conduct a BSA/AML risk assessment and review their compliance programs to be sure they have appropriate policies, procedures and controls in place. ▲

GET READY FOR NEW CAPITAL RULES

Starting in 2015, your bank will be subject to tougher, more complex capital requirements under the Basel III capital framework. As you prepare for the impact of the new requirements for your capital management program, don't overlook an important opportunity to reduce your capital's volatility.

Under the new rules, most of a bank's accumulated other comprehensive income (AOCI) will be included in regulatory capital, including unrealized gains and losses on available-for-sale securities. This requirement increases volatility and makes calculating your bank's capital much more complex.

Fortunately, banks with less than $250 billion in assets can make a one-time election to permanently opt out of this requirement. The election must be made by March 31, 2015, with your first quarter call report and, if applicable, your FR Y-9C, *Consolidated Financial Statements for Bank Holding Companies* report. ▲

CFPB PROVIDES A SNAPSHOT OF CONSUMER COMPLAINTS

In a recent report — *Consumer Response: A Snapshot of Complaints Received* — the Consumer Financial Protection Bureau (CFPB) summarized nearly 400,000 consumer complaints it handled between July 21, 2011, and June 30, 2014.

The largest percentage of complaints (34%) involved mortgages, followed by debt collection (20%), credit cards (14%), bank accounts and services (12%), and credit reporting (12%).

The report also lists the most common complaints in each category. For example, the most common mortgage-related complaints involved problems consumers faced when unable to make payments. They included issues regarding loan modifications, collections and foreclosures. And the most common bank account and service complaints involved matters related to opening, closing or managing accounts, such as account maintenance fees, changes in account terms, confusing marketing, early withdrawal penalties for certificates of deposit and involuntary account closures.

You can find the report at consumerfinance.gov under "Reports." ▲

P&G Associates

P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

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