

# SPECIAL COMPLIANCE ALERT

August 29, 2008

## CREDIT UNION VENDOR MANAGEMENT

Earlier this year NCUA announced its highest exam priority for credit unions - the risk management of third party relationships. NCUA's exam focus follows their *Guidance for Evaluating Third Party Relationship Risk* issued late last year (NCUA Letter 07-CU-13) (the "Guidance") which outlines how credit unions should manage the risks related to their significant third party relationships. Credit unions must now devote additional resources to expand their risk management functions. In this special feature we have provided a detailed overview of NCUA's Guidance and examination expectations and described a comprehensive solution Farleigh Wada Witt has developed for our credit union clients – *Credit Union Vendor Management Program*.

### Overview of NCUA Guidance for Managing Third Party Relationship Risk

NCUA's Guidance sets forth suggested risk management tools credit unions should consider and implement to manage the risks of third party relationships to the same extent such activities were conducted in-house. NCUA outlines four main components of a credit union's management responsibility over each significant vendor relationship from start to finish:

- Risk Assessment and Planning
- Due Diligence
- Contract Review
- Ongoing Monitoring and Oversight

**Is the Guidance a New, Required Regulation?** As with other NCUA's "guidance" rule making over the last 2 years, the Guidance in NCUA Letter 07-CU-13 is technically not a regulation. However, it might as well be. In April 2008, NCUA issued a new Examination Questionnaire for its field examiners to use in evaluating a credit union's management of its third-party relationships (NCUA Letter 08-CU-09). The Exam Questionnaire is a 2½ page document consisting of 39 questions that mirrors NCUA's Guidance. You can bet that failure to adhere to this "guidance" will result in negative examination feedback.

While NCUA's Guidance appears to be a further reaction to the failure of credit union vendors, such as Centrix, it is really not. The Guidance parallels similar guidance issued by the FDIC for banks and outlines fundamental business practices that many credit unions already follow.

The increased regulatory burden of this latest Guidance lies in the increased level of documentation a credit union is expected to create and maintain for its vendor relationships, as well as a more organized and thorough approach to due diligence and contract management. These requirements under the Guidance go far beyond a new Board policy; for many credit unions, they will require increased levels of staff time and effort, and changes to practices and systems.

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**We are completing our development of a Credit Union Vendor Management Program specifically designed for Credit Unions to meet NCUA's Guidance for Third Party Relationships. The Program allows Credit Unions to manage all vendor relationships from the most complex data processing relationships to the smallest, non-operational vendors.**

## CREDIT UNION VENDOR MANAGEMENT (CONT.)

**Guidance Applicable to “Significant” Vendor Relationships.** The Guidance is aimed at what NCUA considers “significant” third party relationships. A vendor relationship is deemed significant if it:

- Involves a new financial service activity
- Materially affects revenues or expenses
- Involves critical functions of the credit union
- Involves access, storing or transmitting sensitive member information
- Involves marketing of credit union products and services by a third party
- Involves subprime lending or card payment transactions
- Poses risks that could significantly affect earnings or capital

Based on the Guidance, all but the janitorial and landscape vendors seem to be covered. From a practical standpoint, the credit union’s risk management efforts should be commensurate with the financial and reputational risks involved and tailored to each vendor relationship as necessary and appropriate.

**Risk Management Components.** Credit unions outsource many operational functions and engage third parties to deliver financial products and services to the credit unions and their members. As expected, the reliance upon such vendors and the lack of direct control over such activities requires each credit union to effectively manage the risks related to its vendor relationships. This risk management begins at the planning stage and continues throughout the life cycle of each significant vendor relationship. NCUA expects credit unions to plan for and manage third party relationships just as if they were conducted in-house.

### Risk Assessment and Planning.

Management’s first step in evaluating a third-party relationship involves considering the prospective relationship within the credit union’s long term strategic and current business plans. In addition to this planning evaluation, the credit union must conduct a “risk assessment” of a wide variety of risk factors.

For example, expectations for the outsourced function and the criticality of outsourced function to the credit union’s operations must be reviewed. A financial cost/benefit analysis must be conducted. Also, management’s ability, expertise, and the necessary resources to oversee the vendor relationship must be reviewed. Many credit unions already conduct this type of planning, but the credit union must now systematically document this analysis for its significant third party relationships.

Due Diligence. NCUA’s Guidance requires a credit union conduct “due diligence” that is tailored to the complexity of the third party relationship. For larger relationships, the key goals of due diligence are to thoroughly know the third party organization, its business model and financial health, its strengths and weaknesses, its reputation, and its ability to meet the needs identified in the planning phase. This determination would include a review of the third party’s product and service expertise, experience, performance reputation, and internal controls through background references, on-site interviews and a review of external audits, SAS-70 reports, financing statements, and other supporting materials. Due diligence may also include an evaluation of alternative providers. In the past, credit unions have sometimes been reticent to push vendors for such information and have not been real successful in acquiring such information. Credit unions can now point to the Guidance and examination requirements to leverage greater due diligence compliance from vendors.

Contract Review and Negotiation. The heart of the third party relationship is the contract—and there is no such thing as a “standard contract.” The contract should clearly establish the scope and services and relationship, performance requirements and standards, compensation terms, confidentiality and security of information, time deadlines and term, use of and responsibility for subcontractors, indemnification, default, and termination rights and dispute resolution. The credit union should obtain a legal review of its significant third party relationships from a qualified attorney experienced in the area. Simply having staff complete a contract review checklist will not adequately protect the credit union with significant relationships, as it is not the existence of the contract provision that matters—it is the substance. Contract changes should be prioritized and negotiated.

## CREDIT UNION VENDOR MANAGEMENT (CONT.)

**Ongoing Monitoring and Oversight.** The third party risk management program should include ongoing monitoring of the vendor's service quality, and performance as well as contract and policy compliance. Periodically, the credit union should review the vendor's operations, controls, and financial condition. Under the Guidance, NCUA also expects the credit union to analyze and document the benefit and impact on the credit union's operations, including profitability. The results of management's monitoring activities should be reported to the credit union board, at least annually. Furthermore, any identified weaknesses need to be documented and promptly addressed. You can expect that the credit union's risk management and oversight will be a key examination focus.

### **Developing a Risk Management Program.**

NCUA's Guidance basically requires credit unions to develop and implement a vendor risk management program to address the issues as outlined in the Guidance. Simply preparing for or adopting the NCUA's Examination Questionnaire as a program will not get you there. Nor will mere adoption of a Board Policy statement satisfy the Guidance requirements. An effective risk management program obviously needs to address the goals and requirements of NCUA's Guidance for significant vendors, but it must also provide the operational organization necessary to manage all of the credit union's current and future vendor contracts and relationships.

The development and implementation of the Program tools must be tailored to each credit union's resources and practices. Once in place, significant resources will be required to input and organize the contracts and supporting documents of current vendor relationships. Then, the added documentation required by the Guidance for planning, risk assessments, due diligence, contract review, and oversight of significant relationships will require additional staff and management time and resources going forward.

**Effective Date.** NCUA's Guidance and Examination Questionnaire became effective when NCUA issued them to the exam field staff. We do not anticipate

NCUA examiners granting any type of grace period for credit unions to begin their efforts to conduct risk management of their third party relationships. In other words, if you have not started down this path yet, you will need to do so before your next examination.

### *Farleigh Wada Witt Credit Union Vendor Management Program*

At Farleigh Wada Witt, we regularly assist our credit union clients with vendor contract reviews and negotiations with numerous third parties, including the credit union industry's leading vendors.

We are completing our development of a *Credit Union Vendor Management Program* specifically designed for credit unions to meet NCUA's Guidance for Third Party Relationships. The Program allows credit unions to manage all vendor relationships from the most complex data processing relationships to the smallest, non-operational vendors. The Program will help your credit union move beyond spreadsheets and file cabinet record retention. The Program is built around contract management software for your credit union to document, manage, and report all aspects of your vendor relationships, supplemented with comprehensive forms and guidelines to satisfy the specific NCUA document requirements.

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**CREDIT UNION VENDOR MANAGEMENT (CONT.)**

**Key Features for Management and Compliance**

- Contract management software to organize and maintain a complete database of all existing and new contracts and relationships
- Scan and save all contracts and contract documents (RFPs, email, correspondence, legal review notes) for each vendor
- Create and save all required NCUA risk management documents:
  - Risk Assessments and Planning Forms
  - Vendor Due Diligence Reviews
  - Contract Review and Monitoring Checklists
- Track key contract terms, such as renewals, price increases, and notice requirements
- Organize and generate customized management reports for Board review and examination compliance
- Instant access to key information of every Credit Union contract relationship

**Credit Union Vendor Management Program**

There are very few vendor management programs available today—and many of those are expensive, with high upfront license fees and periodic maintenance fees. With the *Credit Union Vendor Management Program* you can implement a complete vendor risk management program in weeks (not months or years) with the following Program components:

- Board Vendor Management Policy
- Comprehensive vendor risk management policies and procedures
- Contract Management Software
- Comprehensive compliance tools to assure NCUA compliance
- Customize and organize your Program
- Training for Vendor Management Implementation

**Who stands behind  
your Credit Union  
compliance?**

Farleigh Wada Witt’s *Credit Union Vendor Management Program* ensures regulatory compliance, saves valuable credit union resources (staff time and money), and will increase credit union efficiency in managing all vendor relationships. Feel free to call or send us an email and we will provide you the Program information and cost.



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