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Federal banking agencies release community bank guide on third-party risk management

Initial perspectives related to the federal banking agencies' guide on appropriately identifying, assessing, monitoring, and controlling third-party risks

On May 3, 2024, the federal banking agencies released a guide to support community banks in managing risks presented by third-party relationships (Guide).[1] The Guide is intended to be a resource for community banks in providing considerations, resources, and examples through each stage of the third-party relationship. While assisting community banks in implementing their third-party risk management practices, institutions should keep in mind the federal banking agencies' June 2023 Interagency Guidance on Third-Party Relationships: Risk Management when leveraging the Guide. The Guide further emphasizes that engaging a third party does not diminish or remove a bank's responsibility to operate in a safe and sound manner and to comply with all applicable legal and regulatory requirements.

5 insights you should know

Planning: Planning is essential for community banks to assess risks prior to entering into a relationship with a third party and help establish appropriate oversight before continuing to the next phase in the third-party life cycle. Institutions should understand how the relationship aligns with the bank's strategy, what legal and compliance requirements will apply to third parties, and financial implications of such arrangements.

Due diligence: Community banks should prioritize carrying out leading due diligence practices when selecting third parties to perform services. This process assists in identifying third parties that possess required capabilities, adhere to regulatory requirements, and operate safely and soundly, thereby enabling the bank to engage with third parties that are within their risk appetite. If the bank cannot obtain desired due diligence information from the third party, the bank may consider alternative information, controls, or monitoring to be placed on the third party.

Contract negotiation: Community banks should negotiate contract provisions which establish clear expectations and responsibilities for both parties, and provides for safeguards in order to align with the community bank's business objectives, regulatory obligations, and risk management policies and procedures. Institutions should consider whether the contract negotiated would result in increased risk to the community bank and whether any residual risks are acceptable.

Ongoing monitoring: Ongoing monitoring enables community banks to determine whether third parties are meetings their contractual obligations and the banks' regulatory standards in a sustainable manner. As a result of ongoing monitoring, banks may adapt or otherwise refine their risk management practices, as needed, to maintain the relationship. Institutions may leverage regular auditing and testing to assess the third party's performance.

Termination: A community bank may choose to end its relationship with a third party for a variety of reasons, including failure(s) identified as part of ongoing monitoring or changes in the bank's needs. When this occurs, it is important for management to terminate such relationships in an efficient manner that mitigate costs and potential disruptions. Additionally, community banks should consider whether the terminated third-party relationship will result in the activities being transitioned to another third party, brought in-house, or discontinued.

5 considerations to evaluate

1. **Understand potential risks and roles when engaging with a third party:** In planning for a new third-party relationship, community banks should carefully evaluate potential risks and work out the key design elements. This should include a detailed understanding of the activities to be performed and the respective responsibilities of the bank and third party. Special consideration should be given to system access controls and customer relationships (e.g., complaint treatment).

2. **Conduct a detailed assessment of potential third parties:** Community banks should assess the third party's ability to perform the activity as expected, comply with the bank's policies and applicable laws, and conduct activity in a safe manner. This may include reviewing the third party's responsiveness to any past compliance issues, assessing their financial condition through audited financial statements, and evaluating the effectiveness of their overall risk management, including policies, processes, and internal controls.

3. **Carefully consider potential contractual obligations:** Community banks should establish clear contract provisions that establish roles and responsibilities, provide for timely access to necessary information for monitoring compliance, define protocols for addressing disruptions, and develop a clear termination process and business continuity plans. In difficult contract negotiations, including when community banks may have limited negotiating power, it is important for the organization to understand any resulting limitations and consequent risks.

4. **Continuously monitor risk associated with third parties:** Community banks should regularly assess the third party's performance under the contract, monitor changes in their financial condition, ascertain compliance with laws and regulations, and respond to significant issues or concerns when identified. This may include reviewing reports documenting the third party's performance and conducting periodic visits with third party management and key personnel.

5. **Develop a viable exit strategy:** Bank should consider the impact of a potential termination during the planning stage of the third-party relationship life cycle. As part of this planning exercise, community banks should assess the impact on operations and compliance, evaluate financial implications, identify alternative approaches to bring services in house or to another third party, address access control to the bank's systems and data, and maintain compliance with record keeping obligations.

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[1] Federal Reserve Board of Governors (FRB), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), "Third-Party Risk Management: A Guide for Community Banks," May 2024.