



World Council of Credit Unions Annual Conference

Credit Union Liability with Third-Party Processors

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Credit Union Liability with Third-Party Processors

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Fung hem

(Risk = Opportunity)



Credit Union Liability with Third-Party Processors

Agenda

- Why outsource?
- What are the responsibilities of your credit union?
- What are the risks?
- How should these risks be managed?
- What kind of policies and procedures are required to satisfy regulators?



Why Outsource?

Trends

- Competitive pressures are forcing many organizations to focus on their core competencies
- Financial services, in particular, are becoming commodities
- Major differentiation is service levels - not the products themselves
- Members and customers are interested in service/product delivery not back office operations



Why Outsource?

Trends (cont...)

- Costs and complexities of certain functions (such as Information Technology, credit cards, payment systems, etc.) may be beyond the capacity of some credit unions to manage themselves
- Outsourcing can level the playing field between very large institutions and smaller ones
- Rapid emergence of capable contractors accessible via the internet
- Externalization of processes once assumed to be untouchable



Why Outsource?

Result

- Huge increase in outsourcing – estimated at about \$200 billion annually in North America
- Information technology providers such as IBM, EDS are expanding their services
- Many credit unions have turned to this option in order to meet member needs, save costs and improve their value proposition



Why Outsource?

Examples of Outsourcing

- IT
- Third party ATMs
- Loan origination, administration, collection
- Credit card processing
- Statement printing
- Payment card processing
- Investment broker services



Why Outsource?

Examples of Outsourcing (cont...)

- Marketing/branding
- Deposit & mortgage brokering
- Wealth management
- Internal audit services
- Payroll
- Interest rate/Structural risk management
- Website



Why Outsource?

Benefits of Outsourcing for Credit Unions

- Ability to leverage supplier's scale, expertise and systems
- Ability to access supplier's lower capital and labour costs
- Ability to provide higher quality and more stable processes
- Allows credit union to focus on core business of providing member services



Why Outsource?

Challenge for Credit Unions:

“Turning suppliers/contractors into reliable strategic partners”

It’s all about managing the process!



What Are the Responsibilities of the Credit Union?

“Board and management are responsible for understanding the risks associated with outsourcing arrangements and ensuring that effective risk management practices are in place.”

*Guideline on Risk Management of Outsourced Technology Services
Federal Financial Institutions Examination Council, USA,
November 28, 2000*



What Are the Responsibilities of the Credit Union?

- Credit unions, their boards and management:
 - have a duty of care to their members
 - are vulnerable to be held jointly and severally liable for transmitting data to insecure back office operations under a “theory of negligent entrustment”*
- Direct and indirect liabilities
- A US entity cannot externalize its duty to secure confidential customer data by merely outsourcing it*

* Negligent Entrustment Liability for Outsourced Data, Suffolk University Law School, Research Paper 07-19, May 4, 2007 12



What Are the Responsibilities of the Credit Union?

- In the US, a number of class action lawsuits have been filed against financial and retail institutions including Visa, Mastercard, TJX (Winners)
- Data theft in 2005 placed personal information of more than 5 million consumers at risk *
- Large scale data thefts corrode consumer confidence even if they do not result in legal liability

* The Hidden Risks of Outsourcing: Is Your IP Safe Abroad?, C.L. Storey, 1 Am. U. Bus¹³ L. Brief 2005



What Are the Responsibilities of the Credit Union?

Data Protection Laws - Compliance

- International – OECD guidelines
- EU Data Protection Directive – requires each country to pass laws protecting privacy or personal data
 - e.g., Data Protection Act – Ireland, UK
- US – patchwork of federal and state laws (Federal Trade Commission, Fair Credit Reporting Act, etc.)
- Canada – Personal Information Protection and Electronic Documents Act (PIPEDA)
- New Zealand – NZ Privacy Act
- Australia – legislation under review



What Are the Risks?

- Strategic
- Reputation
- Compliance
- Transaction
- Credit
- Cost
- Service Quality
- Other risks



What Are the Risks?

Strategic Risks

- Risk to earnings or capital arising from adverse business decisions or improper implementation of decisions
 - Is the decision to outsource aligned with the credit unions' business strategy?
 - Does it provide an adequate return on investment?
 - Has adequate due diligence been performed?
 - Is the risk management framework sufficient to oversee the activity?
 - Does management have adequate expertise to oversee activities of third parties?



What Are the Risks?

Reputation Risk

- Risk to earnings or capital arising from negative opinion
 - Does the third party relationship meet the expectations of the credit union's members?
 - Is the arrangement exposed to poor service, disruptions, inappropriate sales recommendations, violations of consumer laws?
 - Is the arrangement consistent with the credit union's philosophy, policies and standards?



What Are the Risks?

Compliance Risk

- Risk to earnings or capital arising from violations of laws, rules, regulations, internal policies or procedures or ethical standards
 - Does the third party relationship meet the credit union's internal policies, procedures and ethical standards?
 - Does it meet the protection of privacy and other credit union laws and regulations?
 - Are conflicts of interest (in the case of affiliates) covered?



What Are the Risks?

Transaction Risk

- Risk to earnings or capital arising from problems with service or product delivery
 - Do the products, services, delivery channels and processes fit with the credit union's systems, services, member demands or strategic objectives?
 - Can the third party's inability to deliver products or services, whether arising from fraud, error, inadequate capacity or technology failure expose the credit union?
 - Are there effective business resumption and contingency planning processes in place?



What Are the Risks?

Service Quality Risk

- Risk to earnings or capital arising from significant problems in the quality of the services provided
 - How has the quality of service been assessed?
 - Are there benchmarks (i.e., % downtime acceptable) included in the agreement?
 - Does the agreement have any penalty clauses or termination options for poor service quality?



What Are the Risks?

Credit Risk

- Risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the credit union or otherwise to perform as agreed
 - Does the third party have appropriate processes and controls to limit the credit union's exposure to credit risk (i.e., underwriting, collections, administration, etc)?
 - Can the financial and operational strength of the third party be determined and monitored regularly?
 - Is there a contingency plan in the event of a third party's insolvency?



What Are the Risks?

Cost Risk

- Risk to earnings or capital arising from anticipated cost savings that do not materialize
 - Has the third party arrangement been fully and realistically analyzed to determine what the ROI will be?
 - Does the third party have a proven track record of delivering cost savings?
 - Are there any escalation clauses in the agreement?
 - Are there any possible contingent liabilities that may appear after the contract expires?



What Are the Risks?

Other Risks

- Liquidity
- Interest rates
- Foreign currency
- Country risk



How Should the Risks Be Managed?

Four Step Risk Management Process

1. Risk Assessment & Strategic Planning
2. Selection of Third Party and Due Diligence
3. Contract Issues
4. Oversight of Third Party Relationships



How Should the Risks Be Managed?

1. Risk Assessment & Strategic Planning

- Integration with strategic planning
- Expertise to oversee & manage the activity
- Cost/benefit relationship
- Member expectations



How Should the Risks Be Managed?

Risk Assessment

- Has the risk assessment identified performance criteria, internal controls, reporting needs & contractual requirements?
- Have internal auditors, compliance officers and legal counsel analyzed the risks & helped establish controls?
- Have clear objectives been set and third party activities evaluated?
- Has an appropriate exit strategy and contingency plan been developed?



How Should the Risks Be Managed?

Integration with strategic planning

- How does this relationship fit in with the credit union's strategic plan?
- What are the benefits, legal aspects, costs and risks?
- Has the credit union completed an assessment of its core competencies, managerial strengths & weaknesses and the credit union's values & goals to determine how the outsourcing can contribute to the credit union's success?



How Should the Risks Be Managed?

Expertise to Oversee & Manage the Activity

- Has management assessed its internal expertise to evaluate & manage the activity and the relationship?
- Have responsibilities for managing the relationship been assigned?
 - Senior officer sponsor
 - Responsible for due diligence, implementation, monitoring, reporting



How Should the Risks Be Managed?

Cost-Benefit Relationship

- Has an evaluation of the long-term stability and viability been completed as opposed to potential short-term profits or cost savings?
- Is the evaluation realistic given the known facts and situation?



How Should the Risks Be Managed?

Member Expectations

- Has consideration been given to how member expectations and understandings will be impacted by outsourcing or joint ventures?
- Have all issues with respect to products or services not originated by the credit union been identified?
- Have all potential reputational risk issues been identified?



How Should the Risks Be Managed?

2. Selecting a Third Party and Due Diligence

- Requires a thorough evaluation of a number of factors including but not limited to:
 1. Experience in implementing and supporting proposed activity
 2. Financial position of third party (audited financial statements of entity & principals)
 3. Business reputation – complaints, litigation, etc.
 4. Qualifications & backgrounds of principals



How Should the Risks Be Managed?

2. Selecting a Third Party and Due Diligence (cont...)

5. Internal control environment & audit coverage
6. Adequacy of management information systems
7. Business resumption, continuity, recovery & contingency plans
8. Technology recovery testing efforts
9. Cost of development, implementation & support
10. Insurance coverage



How Should the Risks Be Managed?

2. Selecting a Third Party and Due Diligence (cont...)

Other due diligence considerations:

- Third parties business strategies, human resource policies & practices, service philosophies, quality initiatives, cost management policies, values, culture & business style
- Use of experts or consultants to verify



How Should the Risks Be Managed?

3. Contract Issues (“the fine print”)

- Scope of arrangement
 - Specify the frequency, content & format of service or product
 - Assignment of contract to sub-contractors?
- Performance Measures & Benchmarks
 - Specify performance measures & benchmarks
 - Use industry standards
 - Rewards for outstanding performance
 - Penalties for poor or non-performance



How Should the Risks Be Managed?

- Responsibilities for Providing Information
 - Timely, accurate, comprehensive reporting to allow credit union to assess performance
 - Consider materiality when notifying of service disruptions, security breaches, etc.
 - Report catastrophic events, material changes in business or financial condition or staff
- Right to Audit
 - Ability to audit third parties or sub-contractors as needed to monitor performance
 - Periodic independent internal or external audit
 - Internal control environment & security program evaluation



How Should the Risks Be Managed?

- **Cost & Compensation**
 - Describe the compensation, fees, calculation for base services plus volume charges & special requests
 - Cost increases
- **Ownership & License**
 - Rights to use credit union's data, hardware, software, systems, intellectual property, logo, trademark, copyrighted materials



How Should the Risks Be Managed?

- Confidentiality & Security
 - Service providers must keep information confidential & secure
 - Agreement should prohibit disclosure except as necessary to provide services
 - Appropriate security measures in place
 - Disclosure of any material breaches & corrective action taken



How Should the Risks Be Managed?

Other elements of the contract:

- Business resumption & contingency plans
- Indemnification – hold credit union harmless for negligence of third party provider
- Insurance
- Dispute resolution
- Limits on liability
- Default & termination
- Member complaints – reporting
- Regulatory supervision – subject to oversight by regulator



How Should the Risks Be Managed?

- ### 4. Oversight of Third Party Relationships
- Monitor Financial Condition
 - Evaluate financial condition at least annually
 - Get audited financial statements
 - Review adequacy of insurance coverage
 - Compare actual earnings/costs with projections
 - Ensure sub-contractors being paid



How Should the Risks Be Managed?

Monitor Controls

- Review internal audit, control & security reports
- Perform on-site quality assurance reviews
- Review compliance with various laws
- Review business contingency planning and testing
- Monitor key changes in staff



How Should the Risks Be Managed?

Assess Quality of Service & Support

- Review performance reports
- Document and follow up performance problems
- Track complaints
- Use member satisfaction survey results, customer call back & mystery shopper techniques



How Should the Risks Be Managed?

Documentation

- Document oversight program
- Listing of significant suppliers
- Maintain current, complete sets of contracts
- Regular reports from third parties
- Regular reports to the Board or a delegated committee



What Kind of Policies & Procedures Are Required to Satisfy Regulators?

- Risk-based supervision is all about ensuring that credit unions manage their risks effectively
- Regulators seek assurances that a credit union has written policies and procedures in place, that they are appropriate for the size and complexity of the credit union and are being followed



What Kind of Policies & Procedures Are Required to Satisfy Regulators?

Board Policy for Third-Party Processors

- Policy Statement
 - background & purpose
- Authorities
 - Board, Audit Committee, size of contracts
- Measures
 - how activities will be measured



What Kind of Policies & Procedures Are Required to Satisfy Regulators?

Board Policy for Third-Party Processors

- Reporting
 - Frequency, type, responsibility
- Responsibilities for Oversight
 - Board responsibilities & how fulfilled
- Associated governance policies
 - Fiduciary and operational risk governance



What Kind of Policies & Procedures Are Required to Satisfy Regulators?

Board Policy for Third-Party Processors

- Management responsibilities
 - Establishing risk management processes, performance measures, reporting, etc.
 - Outline of Risk Management program for Outsourcing
 - Activities to be outsourced
 - Alternative service providers & selection process
 - Agreements
 - Monitoring performance



Sample – Matrix for Evaluating Risk & Materiality of Arrangement

| Criteria | Raw Score (% each) | Weight (%) | Weighted Score (%) |
|---|--------------------------------|-----------------------|-------------------------------|
| Importance of Business Function | H = 100% M = 50% L = 10% | 25% | |
| Significance of Outsourcing Arrangement to Credit Union | H = 100% M = 50% L = 10% | 20% | |
| Size of Contractual Expenditure | H = 100% M = 50% L = 10% | 25% | |
| Potential impact on members or credit union reputation | H = 100% M = 50% L = 10% | 30% | |
| Total weighted score | | 100% | |



Sample – Vendor Selection Criteria Weighting

| Rated Criteria | Weighted Points |
|-------------------------------|------------------------|
| Experience & Qualifications | 30 |
| Organizational Capacity | 15 |
| Proposed Approach/Methodology | 25 |
| Price | 30 |
| Total | 100 |

Source: Booker & Associates



Credit Union Liability with Third-Party Processors

Resource Materials

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|--|-----------------------------|
| World Council of Credit Unions | woccu.org |
| National Credit Union Administration (US) | ncua.gov |
| Office of the Controller of the Currency (US) | occ.treas.gov |
| Deposit Insurance Corporation of Ontario (Canada) | dico.com |
| Booker & Associates (Canada) | bookerandassociates. com |



Credit Union Liability with Third-Party Processors

Conclusions

- Recognize your responsibilities as a director or manager of a credit union
- Identify the risks & potential liabilities
- Make sure that the risks are appropriately managed
- Implement policies and procedures are required to satisfy yourselves as well as regulators



Credit Union Liability with Third-Party Processors

Questions & Dialogue