



The evaluation of new and current vendors could include different components based on the duration of the relationship. At a minimum, the due diligence review should take into account the critical nature of the service, the level of expertise exhibited by the vendor, staffing changes, economic and regulatory changes, and risk mitigation strategies associated with the vendor oversight.

If you have questions regarding the enclosed documents, please contact your district examiner, regional office, or state supervisory authority.

Sincerely,

JoAnn Johnson  
Chairman

Enclosure

# SUPERVISORY LETTER

NATIONAL CREDIT UNION ADMINISTRATION  
OFFICE OF EXAMINATION AND INSURANCE  
1775 DUKE STREET, ALEXANDRIA, VA 22314

**DATE:** October 2007 **Supervisory Letter No.:** 07-01  
**TO:** All Field Staff  
**SUBJECT:** Evaluating Third Party Relationships

To expand services and product offerings, credit unions increasingly outsource functions and programs through collaboration with third parties. Developing sound third party relationships and alliances can assist credit unions in meeting their strategic objectives. Properly leveraging the skills and experience of qualified third parties may enable credit unions to:

- Provide access to products and services through expanded delivery channels;
- Offer more cost-effective products and services; and
- Manage programs that would not be feasible without external expertise.

In many cases, third party relationships are essential in enabling credit unions to become their members' primary financial institution. While inadequately managed and controlled third party relationships can result in unanticipated costs, legal disputes, and financial loss, NCUA's role as a regulator and insurer is not to stifle the innovative use of third party relationships to meet member needs and strategic objectives. NCUA's goal is to ensure credit unions clearly understand risks they are undertaking and balance and control those risks considering the credit union's safety and members' best interests.

NCUA has previously issued several pieces of relevant guidance on managing third party risk and due diligence in recent years. Additionally, in June of 2006, NCUA amended NCUA Rules and Regulations, Parts 701 and 741, to address *Third Party Servicing of Indirect Vehicle Loans*. This letter sets forth supervisory principles derived and adapted from guidance issued by NCUA and other federal regulatory agencies.<sup>1</sup>

This Supervisory Letter summarizes existing guidance and regulations, and discusses the appropriate evaluation of third party relationships where credit unions outsource key business functions. If you have any questions on this issue, please direct them to your immediate supervisor or regional management.

Sincerely,

/s/

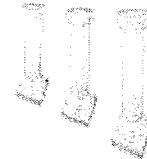
David M. Marquis,  
Director, Office of Examination and Insurance

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<sup>1</sup> Resources consulted on third party relationships are referenced in Appendix B of this Supervisory Letter.



# Supervisory Letter



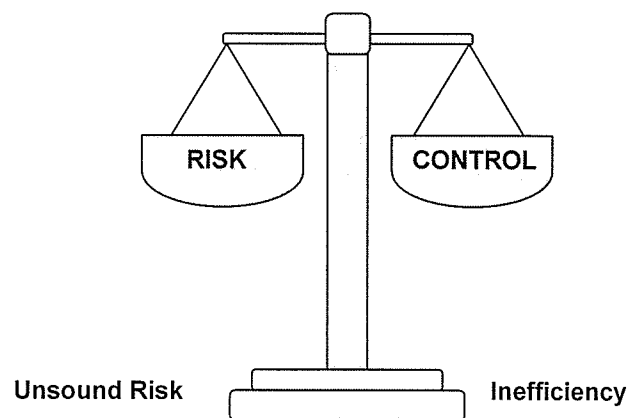
## Evaluating Third Party Relationships

### Third Party Relationships

In recent years, credit unions have increasingly developed third party relationships to meet strategic objectives and enhance member services. Properly managed and controlled third party relationships provide a wide range of potential benefits to credit unions and their members. Many credit unions have utilized third party arrangements to gain expertise, realize economies of scale, or even reach new members. Leveraging the talents and experience of third parties can assist credit unions in meeting their members' needs while accomplishing their strategic goals. In some cases, third party relationships are critical to the on-going success of a credit union. Credit unions taking the time to properly evaluate and cultivate their participation in third party arrangements can experience a high degree of success.

Collaboration with third parties has become more prevalent in credit unions due to increasing complexity of services and competitive pressures. In some third party arrangements, credit unions surrender direct control over one or more key business functions to a third party in exchange for potential benefits. As credit unions consider the potential benefits of third party arrangements, credit union officials and management (officials) are faced with a balancing act.

Officials must carefully consider the potential risks these relationships may present and how to manage them. As credit unions seek to manage risk, they should carefully consider the correlation between their level of control over business functions and the potential for compounding risks. Credit unions maintaining complete control over all functions may be operationally or financially inefficient. Credit unions outsourcing functions without the



appropriate level of due diligence and oversight may be taking on undue risk.<sup>1</sup> Ultimately, credit unions are responsible for safeguarding member assets and ensuring sound operations irrespective of whether or not a third party is involved.

Outsourcing complete control over one or more business functions to a third party amplifies the risks inherent in those functions. Additionally, credit unions trading direct control over business functions for third party program benefits may expose themselves to a full range of risks including credit, interest rate, liquidity, transaction, compliance, strategic, and reputation risks. Credit unions must complete the due diligence necessary to ensure the risks undertaken in a third party relationship are acceptable in relation to their risk profile and safety and soundness requirements. Less complex risk profiles and third party arrangements typically require less analysis and documentation. Further, where credit unions have a longstanding and tested history of participating in a given third party relationship, less analysis is required to renew the relationship.

Risks may be mitigated, transferred, avoided, or accepted; however, they are rarely eliminated. The risk management process involves identifying and making informed decisions about how to address risk. One of the best ways to employ the risk management process is to start small and gain experience over time. Less complex credit unions unfamiliar with analyzing third party arrangements may utilize this risk management approach by entering third party relationships with small, well-defined goals and expanding their exposure to third party risks as their experience grows.

When evaluating third party arrangements, examiners should ensure credit unions have addressed the following concepts in a manner commensurate with their size, complexity, and risk profile:

- Risk Assessment and Planning;
- Due Diligence; and
- Risk Measurement, Monitoring and Control.

The remainder of this Supervisory Letter outlines considerations for these concepts. The considerations discussed are not an exhaustive list of all possible risk mitigation procedures, but a representation of the considerations necessary when credit unions engage in significant third party relationships. The depth and breadth of due diligence required depends upon a credit union's complexity and risk management process. Smaller or less complex credit unions may develop alternative methods of accomplishing due diligence, while credit unions utilizing a time tested third party relationship may already have addressed these considerations over time.

## **Risk Assessment and Planning Considerations for Third Party Relationships**

Credit union officials are responsible for planning, directing, and controlling the credit union's affairs. Risk assessment and due diligence for third party relationships is an

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<sup>1</sup> Due diligence is the systematic, on-going process of analyzing and evaluating new strategies, programs, products, or operations to prepare for and mitigate unnecessary risks.

important part of officials' fiduciary responsibilities. Examiners should consider the following elements in evaluating the adequacy of credit unions' risk assessment and due diligence over third party relationships:

### Planning and Initial Risk Assessment

Before entering into a third party relationship, officials should determine whether the relationship complements their credit union's overall mission and philosophy. Officials should document how the relationship will relate to their credit union's strategic plan, considering long-term goals, objectives, and resource allocation requirements. Officials should design action plans to achieve short-term and long-term objectives in support of strategic planning for new third party arrangements. All planning should contain measurable, achievable goals and clearly defined levels of authority and responsibility.

Additionally, officials should weigh the risks and benefits of outsourcing business functions with the risks and benefits of maintaining those functions in-house. In order to demonstrate an understanding of a third party relationship's risk, the officials must clearly understand the credit union's strengths and weaknesses in relation to the arrangement under consideration. Credit unions should complete a risk assessment prior to engaging in a third party relationship to assess what internal changes, if any, will be required to safely and soundly participate.

Risk assessments are a dynamic process, rather than a static process, and should be an on-going part of a broader risk management strategy. Credit unions' initial risk assessments for a third party relationship should consider all seven risk areas (Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation), and more specifically the following:

- **Expectations for Outsourced Functions-** Credit unions should clearly define the nature and scope of their needs. Which needs will the third party meet? Will the third party be responsible for desired results? To what extent?
- **Staff Expertise-** Is credit union staff qualified to manage and monitor the third party relationship? How much reliance on the third party will be necessary?
- **Criticality-** How important is the activity to be outsourced? Is the activity mission critical? What other alternatives exist?
- **Risk-Reward or Cost-Benefit Relationship-** Does the potential benefit of the arrangement outweigh the potential risks or costs? Will this change over time?
- **Insurance-** Will the arrangement create additional liabilities? Is credit union insurance coverage sufficient to cover the potentially increased liabilities? Will the third party carry "key man" insurance or other insurance to protect the credit union?

- **Impact on Membership-** How will officials gauge the positive or negative impacts of the arrangement on credit union members? How will they manage member expectations?
- **Exit Strategy-** Is there a reasonable way out of the relationship if it becomes necessary to change course in the future? Is there another party that can provide any services officials deem critical?

Risk assessments for less complex third party arrangements may be part of a broader risk management program or documented in board minutes.

### Financial Projections

In evaluating the cost-benefit or risk-reward of a third party relationship, credit unions should develop financial projections outlining the range of expected and possible financial outcomes. Credit unions should project a return on their investment in the proposed third party arrangement, considering expected revenues, direct costs, and indirect costs. For example, when outsourcing loan functions, credit unions should not only consider the expected loan yield, but also the potential effect of borrower prepayments and third party fees on the overall return.

Officials should evaluate financial projections in the context of their overall strategic plans and asset-liability management framework before making a decision to participate in a third party arrangement. Examiners should evaluate these projections for reasonableness, considering historical performance, underlying assumptions, stated business plan objectives, and the complexity of the credit union's risk profile.

## **Due Diligence for Third Party Relationships**

When considering third party relationships, proper due diligence includes developing a demonstrated understanding of a third party's organization, business model, financial health, and program risks. In order to tailor controls to mitigate risks posed by a third party, credit unions must have an understanding of a prospective third party's responsibilities and all of the processes involved with prospective third party programs. Examiners should consider the adequacy of due diligence in the areas below, given credit unions' risk profiles, internal controls, and overall complexity. Due diligence should be tailored to the complexity of the third party relationship and may consist of reasonable alternative procedures to accomplish acceptable risk mitigation.

### Background Check

Credit unions should consider a third party's experience providing the proposed service or program. A well-respected third party may have little or no experience implementing and supporting a new service offering. In these cases, the qualifications, competence, and training of key individuals within the third party's organization become even more important to verify. While it would be tempting to rely solely upon the vendor's reputation alone, a more prudent practice would be to verify the expertise the vendor has obtained to provide this new service.