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Risk Management for Third Party Relationships - OCC Expectations for Wealth Management Activities

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Disclosure

The views and opinions expressed in this presentation are my own, and do not necessarily represent those of the Office of the Comptroller of the Currency, the Chief National Bank Examiner, or the Credit and Market Risk Division.

OCC Bulletin 2013-29 - Highlights

- OCC Bulletin 2013-29 – "Third-Party Relationships: Risk Management Guidance" Issued October 2013
- Provides OCC Expectations for
  - Risk management practices for third-party relationships involving critical activities.
  - Risk management practices throughout the lifecycle of a third-party relationship.
  - Board and senior management oversight.
- Sets general risk-based baseline standards for oversight of third party relationships. Some relationships, such as delegated fiduciary activities are subject to higher and/or specialized standards.

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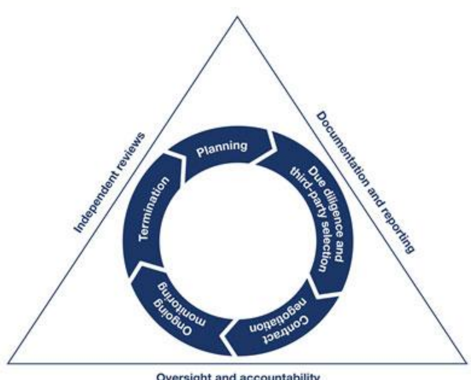
  - Risk management practices for third-party relationships involving critical activities.
  - Risk management practices throughout the lifecycle of a third-party relationship.
  - Board and senior management oversight.
- "A bank should adopt risk management processes commensurate with the level of risk and complexity of its third-party relationships."
- Applies to services provided by affiliates and subsidiaries

Reasons for Updated Third-Party Guidance

- Increasing risk and complexity of bank's use of service providers
- More outsourcing of critical bank activities
- Greater reliance by third-parties on subcontractors (often to foreign locations)
- Greater concentration for services provided by a single provider
- More interaction involving critical bank information and between third parties and customers
- Greater use of foreign service providers

Third-Party Risk Management Lifecycle



Source: OCC

Phases in the Lifecycle

Phase	Description	Guidance
Planning	Management planning is the first step in the lifecycle, particularly when critical activities are involved	Discusses what the management plan should address
Due Diligence and Third Party Selection	In-depth review of potential third parties prior to final selection and contract negotiation	Discusses the key factors to consider when conducting third-party due diligence
Contract Negotiation	Establishes responsibilities and performance requirements	Discusses key factors the contract should address
Ongoing Monitoring	Monitoring of performance and compliance throughout the duration of the contract	Discusses key areas of consideration in ongoing monitoring
Termination	Plans to cease the activity, bring the activity in house or move to another third party at the end of the contract or when circumstances warrant	Discusses what a termination plan should cover

Oversight of Critical Activities

- OCC expects more rigorous and comprehensive oversight of critical activities
- Applies to oversight of service providers that support significant bank functions, significant shared services, or other activities that
  - Could cause a bank to face significant risk if the third party fails to meet expectations
  - Could have significant customer impact
  - Require significant investment in resources to implement the third-party arrangement and manage the risk
  - Could have major impact on bank operations if the bank has to find an alternate third party or if the outsourced activity has to be brought in-house

Oversight of Critical Activities

- Board of Directors
  - Approves process for identifying critical activities
  - Reviews and approves management's plans to use third parties for critical activities
  - Approves contracts with third parties
  - Reviews results of independent reviews of third party relationship process
- Management
  - Determines which potential third party arrangements involve critical activities
  - Ensure that appropriate due diligence is performed on potential third parties
  - Ensure that independent reviews of the bank's third party relationship process are conducted, and reports results to the board of directors

Independent Review of Risk Management Process

- Periodic independent reviews of third-party risk management <u>process</u> – (especially for critical activities) that assesses adequacy of process for:
  - Ensuring that relationships align with bank strategy
  - Identifying, assessing, managing and reporting third party relationships
  - Responding to material breaches, service disruptions or other material issues
  - Identifying/managing complex third party relationships, including subcontractors
  - Involving multiple disciplines across the bank as appropriate in each phase of the life cycle
  - Ensuring appropriate staffing and expertise to perform due diligence and ongoing monitoring and management of third parties.

Independent Review of Risk Management Process

- ensuring oversight and accountability for managing third-party relationships
- ensuring that conflicts of interest or appearances of conflicts of interest do not exist when selecting or overseeing third parties.
- identifying and managing concentration risks that may arise from relying on a single third party for multiple activities, or from geographic concentration of business due to either direct contracting or subcontracting agreements to the same locations.

OCC Supervision

- Examiners will assess the bank's ability to oversee and manage the risks of its third-party relationships.
- Examiners will consider the findings when assigning the management component of CAMELS and assessing the bank's overall risk profile, and will incorporate into the Risk Assessment System.
- When circumstances warrant, the OCC may use its authority to examine the third-party service provider.

Key Takeaways

- Banks should practice effective risk management regardless of whether the bank performs the activity internally or through a third party. Management must be knowledgeable of the outsourced activity.
- Banks should:
  - Adopt risk management practices that are commensurate with the level of risk and complexity of the third-party relationship.
  - Adopt an effective risk management process that follows the third-party relationship through its lifecycle.
  - Ensure robust oversight and risk management of relationships involving critical activities.
  - Ensure periodic independent review of bank's risk management process for third-party relationships involving critical activities.

Related Guidance

- Appendix B of OCC Bulletin 2013 – 39 refers to other applicable guidance that provide specialized or expanded guidance applicable to certain types of activities and third party relationships. Examples applicable to Asset Management include:
  - Asset Management Booklets of the Comptrollers Handbook
  - Internal and External Audits Handbook
  - Retail Nondeposit Sales Handbook (updated January 2015)
  - OCC Bulletin 2011-12 – Sound Practices for Model Risk Management
  - OCC Bulletin 2011-11 – Risk Management Elements: Collective Investment Funds and Outsourcing Arrangements
  - OCC Bulletin 2004-20 – Risk Management of New, Expanded, or Modified Bank Products and Services

Related Guidance

- OCC Bulletin 2003-12 - Interagency Policy on Internal Audit and Internal Audit Outsourcing
- OCC Bulletin 2002-16 – Bank Use of Foreign-Based Third-Party Service Providers: Risk Management Guidance
- OCC Bulletin 2001-12 – Bank-Provided Aggregation Services: Guidance to banks
- OCC Bulletin 2001-8 – Guidelines Establishing Standards for Safeguarding Customer Information
- FFIEC Information Technology Examination Handbook – "Outsourcing Technology Services" and "Supervision of Technology Service Providers"

Third-Party Relationships – Asset Management Examples

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Third-Party Relationships – Asset Management

Examples of Third-Parties that play an integral part in many banks AM Activities

- Technology System and Data Providers
- Outsourcing Arrangement (general and specialized)
- Custodians/depositories
- Broker-dealers
- Automated trading platforms/trade portals
- Fiduciary Audit
- Delegated Fiduciary Activities -
  - Investment Management
  - Account Administration
- Services provided to fiduciary accounts and beneficiaries
- Retail Non-Deposit Investment Programs

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Third-Party Relationships – Asset Management

Examples - Technology System Providers - Asset Management

- Trade Order Entry Systems
- Trust Accounting Systems
- IRS Reporting/Tax Preparation
- Automated investment/administrative review systems
- Contact Management systems
- Document management systems
- Corporate action notification systems
- Data Warehousing and reporting systems
- On-line client reporting systems
- Payment systems
- Participant recordkeeping systems
- Corporate trust systems
- Reconciliation systems

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Outsourcing Arrangements - Asset Management

- Operations
- IRS Reporting/Tax preparation
- Specialized asset servicing – (Oil and Gas)
- Performance measurement/attribution analysis
- Client statement production
- Proxy Processing and Shareholder Communications
- Asset Valuation
- Tax reclamation services
- Mutual fund processing intermediaries

Custodians and depositories

- OCC regulations permit banks to hold fiduciary assets off-premises if the bank maintains adequate safeguards and controls.
- Asset Management Operations and Controls HB provides guidance for off-premises custody.
  - Third party custodians
  - Central Securities Depositories
  - Fully-disclosed brokerage custody
- Custodians and depositories also typically provide IT platforms that need to be properly controlled.

Broker Selection

- A fiduciary is required to seek "best execution" for client transactions.
- OCC regulations require that bank fiduciaries adopt and adhere to certain policies and procedures, including brokerage allocation.
- The Investment Management Services and Conflicts of Interest HBs provide extensive guidance on broker selection and oversight, the use of affiliated brokers, and on third-party research and commission-sharing ("soft dollar") arrangements.
- Banks also need to manage operational risks related to automated trading platforms.

Use of Third Parties to Perform Fiduciary Activities

- OCC regulations and guidance permit banks to use third parties (including affiliated third parties) to perform services related to the bank's exercise of fiduciary powers (12 CFR 9.4).
- Fiduciary activities, whether delegated to third parties, or performed by the bank, are the responsibility of a bank's board of directors.
- Fiduciaries are required to exercise reasonable care, skill, and caution when selecting an agent and establishing the scope and terms of the service performed by the third party. This require the fiduciary to monitor the agent's performance of the fiduciary activity and compliance with the contract.
- The use of third parties for fiduciary activities require heightened oversight to ensure that the bank is fulfilling its fiduciary obligations and that it is not engaging in impermissible conflicts of interests.

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Fiduciary Audit

- OCC regulations require, under the direction of an audit committee of the board of directors, either
  - An annual audit of all significant fiduciary activities, or
  - A continuous audit system, consisting of discreet audits of each significant activity
- Whether the fiduciary audit is performed internally or by an external audit firm, the scope and coverage of fiduciary audits is the responsibility of the board of directors. The board should base those audit decisions on an appropriate assessment of fiduciary business risk and internal control systems.
- Whether internal or external, the auditor(s) performing the fiduciary audit should have sufficient expertise in auditing fiduciary activities. The "Internal and External Audit" HB provides extensive guidance on oversight of outsourced audit arrangements.

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Delegation of Investment Management to Third Parties

- Investment Management Services HB, Appendix F
  - Decisions concerning the delegation of investment authority to a third party are matters of fiduciary judgement and discretion and require the exercise of care, skill, and caution.
  - Some requirements overlap with OCC Bulletin 2013-29, but much more targeted to fiduciary investment requirements:
    - Investment Methodology
    - Risk Management Process
    - Management Personnel
    - Investment Performance
    - Compensation and Fees
    - Reporting Capabilities

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OCC Collective Fund Guidance

OCC CIF Guidance

- One specific OCC Bulletin 2011-11 “CIFs and Outsourced Arrangements” highlighted OCC and SEC concerns with RIAs using unaffiliated banks and trust companies to serve as trustees of CIFs:
  - As required by 2011-11, national banks and FSAs ensure that unaffiliated RIAs provide clear and prominent disclosures that it is the bank and not the RIA that offers and maintains the fund.
  - Over the years it has been apparent that this guidance has not been universally adopted by the industry as examples surface of trust companies that allow RIAs to advertise CIFs to their customers without disclosing the name of the trust bank that sponsors the fund.
  - This raises questions about whether these trust companies are complying with ‘40 Act § 3(c)(11) that requires that a CIF be “maintained” by the bank sponsoring the fund. In some cases, the investment management function appears to be completely outsourced to unaffiliated RIAs.

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Third-Party Relationships – Asset Management

Delegation of Account Administration to Third Parties

- If a trust requires special skills or expertise that a trustee does not possess, the trustee may delegate certain duties and powers to a third-party vendor if the power to delegate is authorized by applicable law. In addition to complying with 2013-29, a trustee must comply with applicable law when delegating a duty or power to a third-party vendor.
- Applicable law generally requires the trustee to use reasonable care, skill, and caution in
  - selecting an agent.
  - establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust.
  - periodically reviewing the agent’s actions to monitor the agent’s performance and
  - compliance with the terms of the delegation.

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Conflicts of Interest

- When a bank delegates investment management to related parties or interests, such as an affiliate or an entity with which the bank has a business referral or other arrangement that benefits the bank or its affiliates, there is a conflict of interest.
  - Before doing so the bank should ascertain that all such conflicts are properly authorized and disclosed in accordance with applicable law.
  - Initially and on an ongoing basis the bank must be able to demonstrate that the delegation is consistent with applicable law and in the best interest of the fiduciary account.
  - a bank should apply the same standards for the selection, continued use, and oversight of investment managers to whom the bank delegates investment discretion and who are related parties or interests that it applies to the selection, continued use, and oversight of other investment managers.

Third-Parties that provide services directly to fiduciary accounts and beneficiaries

- Bank fiduciaries may need to enter into business arrangements on behalf of an account or its beneficiaries, especially in the course of estate administration.
- Examples include real estate agents, insurance agents, general contractors and care providers to a beneficiary.
- Guiding principals in such selections:
  - Duty of loyalty
  - Duty of care
- Any conflicts must be authorized by and disclosed in accordance with applicable law, and the service provider selected based on the needs of the account.

Retail Nondeposit Investment Products (RNDIP)

- Refer to "Retail Nondeposit Investment Product" HB
- Activities involving the recommendation or sale of nondeposit investment products to retail customers
- Risk associated with RNDIP sales programs include reputation; strategic; compliance; operational; credit; and market.
- Delivery channels often include use of third parties
  - Fully dedicated sales reps (licensed by an affiliated or non-affiliated 3rd party B/D, RIA, or insurance agency
  - Part-time sales reps (dual-hatted, offering bank and non-bank products)
  - Discount brokerage – customer self-directs trades; provides trade execution
  - Electronic media – online brokerage; call centers; remote banking

Retail Nondeposit Investments Products

- OCC expects banks to implement effective program management over RNDIP sales activities.
  - Most RNDIP sales activities involve an SEC registered B/D or a state licensed insurance agent.
  - Unacceptable for a bank to rely on or delegate program management responsibilities to the broker dealer.
  - Bank's responsibility is to ensure the third party is complying with applicable SEC/FNRA or state insurance regulator's rules.
- OCC's focus
  - Risks to the bank and to investors/bank customers
  - Effectiveness of the bank's risk management over these activities
  - Bank's compliance with applicable legal requirements and policy guidance

Questions ??

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