Managing the risks of vendor relationships
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Potential risks of vendor relationships*

Compliance Risk arises from violation of laws, rules or regulations, or from noncompliance with an institution’s internal policies, procedures or business standards.

Reputation Risk results from negative public opinion.

Strategic Risk comes from adverse business decisions, or the failure to implement appropriate business decisions in a manner that is consistent with the financial institution’s strategic goals.

Operational Risk stems from inadequate or failed internal processes, people, systems or external events.

Transaction Risk arises from problems with service or product delivery.

Credit Risk occurs when a third-party – or any other creditor necessary to the third-party relationship – is unable to meet the terms of the contractual arrangements with the financial institution or to otherwise financially perform as agreed.

Country Risk develops when economic, social and political conditions and events in a foreign country adversely affect the ability of the foreign-based third-party service provider (FBTSP) to meet the level of service required by the arrangement, resulting in harm to the financial institution.

“Other” Risks stem from an institution’s decision to use a third-party vendor; they cannot be fully assessed without a complete understanding of the resulting arrangement.

Benefits and risks of outsourcing

In today’s economic climate, banks frequently look to outsource certain functions, services and products to third-party vendors. This practice allows bank employees to focus on areas where they have greater expertise and can make the largest contribution. Outsourcing also may help lower administrative costs and enable banking institutions to offer additional products and services normally not provided by in-house staff.

While outsourcing is often beneficial, it may also expose your organization to significant risks. According to the FDIC Compliance Manual, published in December 2012, third-party vendors may increase a bank’s compliance risk, reputation risk, strategic risk, operational risk, transaction risk, credit risk, country risk and other risks. Regulators are intensifying their focus on vendor management within financial institutions. While much of the focus has been on data processing and IT, any vendor relationship may increase the risk of loss or damages. When assessing your institution’s exposures, it’s important to consider worst case scenarios and potential losses. This process can help you implement more effective risk management practices to reduce your risk.

Implementing risk management practices

According to the Office of the Comptroller of the Currency’s (OCC) Risk Management Guidance on Third-Party Relationships, published in October 2013: “A community bank should adopt risk management practices commensurate with the level of risk and complexity of its third-party relationships. A community bank’s board and management should identify those third-party relationships that involve critical activities and ensure the bank has risk management practices in place to assess, monitor and manage the risks.”

Implementing an effective risk management process for vendor relationships should involve the following:

1. Planning: Develop a plan to manage relationships with vendors and establish vendor requirements.

2. Due diligence and third-party selection: Review potential third-party vendors prior to selection and entering into a contract to decide if the vendors meet the requirements established in the planning process.

3. Contract negotiation: Create a contract that clearly defines expectations and responsibilities of the third-party vendor to ensure the contract’s enforceability, limit the bank’s liability and mitigate disputes concerning performance.

4. Ongoing monitoring: Perform continuous monitoring of the third-party vendor’s performance and results to help manage the risk of the third-party relationship.

5. Termination: Develop a contingency plan to ensure that the bank can transition the activities or services to another third-party vendor, bring the activities or services in-house, or discontinue the activities or services. While all of the above practices are important and need to be implemented to establish an effective risk management process with third-party vendors, many banks do not focus enough attention on the vendor contract negotiation process. Banks should put in place insurance requirements and also require hold harmless and limitation of liability provisions in the contract. These contracts should be in place with all of your third-party vendor relationships.

The importance of contract negotiation

Several years ago, a bank employee hired a family member to secure and clean out a house that the bank was foreclosing on. Unfortunately, the relative/vendor went to a nearby, vacant home with a similar address. He proceeded to break in and throw out all of the items that were stored in the house. The bank discovered what had taken place when the owner of the vacant home brought a lawsuit against the bank claiming that many valuable and precious items were thrown out by the bank’s vendor, resulting in a claim for over $600,000.

If the bank had required a contract before entering into a relationship with the vendor, it could have limited its liability by requiring the vendor to have his own insurance to protect the bank. In this case, there was no contract, and the vendor had no insurance to protect the bank. The bank ended up filing a claim against its own insurance. This result could have been prevented with a vendor contract that included certain insurance requirements, such as a certificate of insurance from the vendor’s insurance agent or broker. The contract should also require that minimum limits of insurance are provided for critical areas of coverage.

Practical tips for successful vendor management

When establishing a vendor relationship, first meet with your insurance agent or broker to determine what insurance requirements you should put in place for your vendors. This conversation should include types of coverages (i.e., general liability, umbrella, professional errors & omissions, security & privacy insurance, etc.) and adequate limits for the type of work that the vendor will be conducting for you.

Also, ensure that your contract with the vendor requires that your bank is named as an additional insured on the vendor’s insurance policy.

Before completing and signing the contract, have your attorney review and approve the contract language to make sure proper hold-harmless agreements are in place and appropriate language is included to protect you for risks that may be caused by your third-party vendor.

In a changing risk landscape, a comprehensive vendor risk management process can help your financial institution manage and reduce its risks, and potentially benefit your bottom line.

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A112005318-A (04/15) 112005318