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Continued Focus on Third-Party Risk Management Through the FDIC's "Guidance for Third-Party Lending"

by Thomas A. Simpson and John W. Sillay

In June 2008, the FDIC issued a Financial Institution Letter titled "Guidance for Managing Third-Party Risk" (the "Third-Party Guidance"). While it took a few examination cycles for the full breadth and importance of the Third-Party Guidance to be appreciated, the issue of third-party risk management has likely been at the forefront of your bank's risk management program for some time now. In light of the fact that more financial institutions have begun relying on third parties to generate loan growth, increase fee income, and/or outsource interest rate risk, the FDIC has felt it prudent to issue the Examination Guidance for Third Party Lending (the "Lending Guidance"). In large part, the Lending Guidance serves as a supplement to the Third-Party Guidance by extending many of its provisions to institutions making loans by, for or through third-parties. Like the Third-Party Guidance does for third-party relationships in general, the Lending Guidance requires bank senior management and boards of directors to carefully assess the risks inherent in third-party lending and develop a third-party lending risk management program that assesses, measures, monitors and controls the risks associated with third-party lending on an ongoing basis.

While we will not re-state the Lending Guidance in full in this article, we believe that this new regulatory publication will have significant impact on any bank that operates a third-party lending program, and we encourage bank directors, senior management and risk officers to study the Lending Guidance with care. Two items of particular importance are the emphasis that the Lending Guidance places on the agreements that evidence the relationship between a bank and its selected third-parties and the due diligence a bank should perform on perspective and current third-parties.

In our collective experience, correspondent banking agreements and other third-party lending agreements are notoriously difficult to negotiate. Using the mortgage third-party marketplace as one of the more prevalent examples, third-party originator agreements, repurchase agreements, and/or correspondent lending agreements tend to contain significant representations and warranties on the part of the originating bank and require the bank to comply with any and all terms of an ethereal "lending program" that can be modified at any time without notice. While these agreements are likely to meet the requirements of the Lending Guidance from the purchaser's perspective, the Lending Guidance indicates that a middle ground will need to be established with respect to the obligations placed on banks selling loans on the secondary market.

While the Third-Party Guidance goes into significant detail with regard to requirements of an institution's engagement of third-party vendors in general, the Lending Guidance specifically states, among other things, that a third-party lending agreement (i) should not contain indemnification, warranties, or recourse terms that pose undue risk to an institution, (ii) should provide full discretion to the institution to require implementation of specific policies and procedures and (iii) should provide for full access to all information necessary for an institution to perform its risk assessment. Furthermore, the Lending Guidance provides that legal counsel should review and analyze each of these contracts to provide an outline of potential recourse to the institution.

In addition to the emphasis on contract review and negotiation, the Lending Guidance requires that banks perform due diligence on each third party relationship to determine the suitability of the relationship. Before and during an institution's engagement in a third-party lending relationship, an institution should review certain minimum due diligence factors, including, but not limited to: (i) the credit quality of loans solicited or underwritten by the third-party, (ii) the knowledge and experience of third-party personnel, (iii) the third-party's historical repurchase volumes, (iv) the amount of consumer complaints the third-party has received and (v) the third party's vendor relationships. A full list of the minimum due diligence requirements can be found on page 7 and page 8 of the Lending Guidance, but it is important to note that these requirements represent only a minimum amount of the due diligence required. For larger relationships, and any other relationships with heightened risks, a bank will likely need to perform a deeper analysis, using any and all available information.

Finally, the Lending Guidance emphasizes that the institution itself remains responsible for all regulatory compliance matters, including credit underwriting, performance monitoring and sensitivity analysis, loss recognition, capital adequacy, consumer regulatory compliance and BSA/AML compliance. While many of these areas seem to be natural extensions of the existing regulations, it is not yet clear if and how a bank's performance monitoring and capital adequacy analysis should be modified in light of the Lending Guidance.

For bank's that sell loans on the secondary market, the Lending Guidance may prove helpful in at least one aspect. As with the Third-Party Guidance, industry standard contract provisions will eventually shift to accommodate the Lending Guidance, making it easier for banks to analyze the risks associated with these relationships and reducing the amount of negotiations needed to arrive at an acceptable agreement. Until the industry standard catches up with the terms of the Lending Guidance, banks can point to the Lending Guidance as the impetus for their requested negotiations and can feel more confident to push back against the "take it or leave it" approach to negotiations that has been the industry standard to date. After all, the FDIC is insisting that these relationships will be carefully scrutinized in upcoming exams, and when a bank chooses to enter into a third-party lending agreement from this date forward it should be certain that it is well-prepared to provide evidence that all aspects of the relationship fall within the bank's established risk tolerances.

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