	A	B	D
3	**Third Party Relationships**		
4	**INTRODUCTION AND PURPOSE**		
5	**Background**	**Yes/No**	**Comments**
6	1. Does the credit union maintain a list of the third party company(ies) or firm(s) which they use for outsourced services?		
7	2. Does the credit union maintain a description of the services provided by the third party company(ies) or firm(s)?		
8	3. Did the credit union consider more than one third party before entering into a relationship?		
9	4. Does the third party relationship(s) compliment the credit union's overall mission and philosophy?		
10	5. Has the credit union completed an appropriate risk assessment to determine the exposure related to each third party relationship?		
11	**Planning/Risk Assessment**	**Yes/No**	**Comments**
12	1. Does the credit union's planning and risk assessment address the following areas which it should based on the type and critical nature of the relationship(s):		
13	(a) Risk areas which could be affected by the third party arrangement (credit, interest rate, liquidity, transaction, compliance, strategic, and reputation);		
14	(b) Expectations of third party relationship;		
15	(c) Staff expertise;		
16	(d) Criticality of the activity to be outsourced;		
17	(e) Cost/Benefit analysis;		
18	(f) Impact on membership; and		
19	(g) Exit strategy.		
20	2. Has the credit union evaluated the costs of monitoring and providing support to the third party program (i.e., staffing, capital expenditures, communications, and technological investment)?		
21	3. Does the credit union's strategic business plan include measurable and achievable goals and clearly defined levels of authority and responsibility related to the third party arrangement?		
22	4. Has the credit union performed and documented a cost-benefit financial analysis to determine they are receiving sufficient reward for the risk associated with the proposed relationship (The financial projections should address a range of expected and possible financial outcomes)?		
23	5. Do the financial projections align with the credit union's overall strategic plan and ALM framework?		
24	**Due Diligence - Background Check**	**Yes/No**	**Comments**
25	1. Did the credit union consider the third party's experience providing the proposed service or program?		
26	2. Did the credit union request referrals from the prospective third party clients to determine their satisfaction and experience with the proposed arrangement?		
27	3. Did the credit union review and consider any lawsuits and/or legal proceedings involving the third party or its principals?		
28	4. Did the credit union ensure the third party or their agents have any required licenses or certifications and that they remain current for the duration of the arrangement?		
29	5. Did the credit union consider other sources of information such as the Better Business Bureau, Federal Trade Commission, credit reporting agencies, state consumer affairs offices, or state attorney general offices?		
30	**Due Diligence - Business Model**	**Yes/No**	**Comments**
31	1. Does the credit union understand the third party's business model?		
32	2. Does the credit union understand the vendor's sources of income and expense and have they considered any conflicts of interest that may exist between the third party and the credit union?		

	A	B	D
33	**Due Diligence - Cash Flows**	**Yes/No**	**Comments**
34	1. Is the credit union tracking and identifying the cash flows of the third party accurately?		
35	**Due Diligence - Financial and Operation Control Review**	**Yes/No**	**Comments**
36	1. Does the credit union's analysis of the financial statements of the third party and its closely related affiliates provide reasonable assurance that the third party has the ability to fulfill the contractual commitments proposed?		
37	2. Did the credit union use other available sources in evaluating the overall financial health of the prospective or existing third party (i.e., Nationally Recognized Statistical Rating Organizations, SAS 70 (Type II) reports, etc.)?		
38	**Due Diligence - Contract Issues and Legal Review**	**Yes/No**	**Comments**
39	1. Does the credit union's third party contract(s) address the following areas:		
40	(a) Scope of the arrangement, services offered, and activities authorized;		
41	(b) Responsibilities of all parties (including subcontractor oversight);		
42	(c) Service level agreements addressing performance standards and measures;		
43	(d) Performance reports and frequency of reporting;		
44	(e) Penalties for lack of performance;		
45	(f) Ownership, control, maintenance and access to financial and operating records;		
46	(g) Ownership of servicing rights;		
47	(h) Audit rights and requirements (including responsibility for payment);		
48	(i) Data security and member confidentiality (including testing and audit);		
49	(j) Business resumption or contingency planning;		
50	(k) Evidence of current insurance coverage;		
51	(l) Member complaints and member service;		
52	(m) Compliance with regulatory requirements (i.e., Gramm-Leach-Bliley Act (GLBA), Privacy, BSA, etc.);		
53	(n) Dispute resolution; and		
54	(o) Default, termination, and escape clauses.		
55	2. Did the credit union obtain an independent legal opinion about any services provided by the third party under the arrangement?		
56	3. Did the credit union ensure the third party is compliant with state and federal laws and regulations and is contractually bound to comply with applicable laws (i.e., Regulation B, Regulation Z, HMDA, etc.)?		
57	**Due Diligence - Accounting Considerations**	**Yes/No**	**Comments**
58	1. Does the credit union have an adequate accounting infrastructure to appropriately track, identify, and classify transactions in accordance with Generally Accepted Accounting Principles (GAAP)?		
59	**Risk Measurement, Monitoring and Control**	**Yes/No**	**Comments**
60	1. Are reports prepared on a monthly basis adequately reflecting the amount of activity with the third party and providing sufficient information to properly monitor the activities?		
61	2. Are informative summary reports provided to senior management or the board of directors?		
62	3. Has the credit union assigned appropriate staff to oversee the third party relationship to monitor performance and compliance with contracts?		
63	4. If the third party originates member transactions, does the credit union verify the transactions with the member?		
64	5. If the third party services member accounts, does the credit union receive periodic reports on the activity?		
65	(a) Are reports received and reviewed timely?		
66	(b) Do the reports contain sufficient information to determine how the portfolio is performing?		
67	(c) Do report balances agree with the credit union’s records?		

	A	B	D
68	6. Does the credit union control account verifications?		
69	7. Does the credit union verify the third party's reports are accurate?		
70	8. If the third party services loans, does the credit union verify that member payments are remitted to the credit union in compliance with the contract?		
71	(a) Are funds received by the servicer required to be deposited in a trust account on the credit union's behalf or does the servicer use a third party "retail lockbox"?		
72	(b) Are reports received showing returned or bounced payments are reversed, the loan re-aged, and any servicing fees reversed?		
73	9. Does the credit union have the infrastructure (staffing, equipment, technology, etc.) in place to sufficiently monitor the third party arrangement?		
74	10. Has the credit union established appropriate internal controls to ensure internal staff is following policy guidance for third party relationships?		
75	11. Does the credit union's policies appropriately address the third party relationship?		
76	12. Do policies place limits on the activity of the third parties?		
77	13. Has the credit union established lists of approved parties?		
78	**Controls Over Member Data**	**Yes/No**	**Comments**
79	1. How does the credit union communicate with the third party?		
80	2. Does the communication method ensure member data is protected?		

Cell: A4
Comment: Introduction and Purpose

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. Third party relationships provide credit unions with greater flexibility in offering products and services to members. Additionally, credit unions often contract with third parties for services such as Information Technology, Asset Liability Management, Lending, Investments, etc.

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;
• Pilot new programs for evaluation prior to implementation;
• Offer more cost-effective products and services; and
• Manage programs not feasible without external expertise.

However, inadequately managed and controlled third party relationships can result in unanticipated costs, legal disputes, and financial loss.

The purpose of this guidance is to assist an examiner in determining whether the credit union is managing its third party relationships in a sound manner. To fully evaluate an outsourced program, examiners are encouraged to complete this questionnaire in conjunction with any companion questionnaires focused on the underlying program.

Cell: A9
Comment: The credit union should provide rationale for entering a third party relationship. Reasons may include costs, inexperience, or lack of technology. However, outsourcing does not absolve the credit union from properly overseeing the duties performed by the third party.

Cell: A10
Comment: To set up an effective program, the credit union should assess third party relationship exposure. The credit union’s vendor risk assessment should consider the factors identified under the Planning/Risk Assessment Section of this questionnaire. Depending on the complexity of credit union operations, the risk assessment may be a separate written document or a discussion noted in the minutes of the board of directors. The risk assessment should be periodically reviewed and updated, particularly when new products, services, members and geographic locations are added.

Cell: A15
Comment: Is credit union staff qualified to manage and monitor the third party relationship? How much reliance on the third party will be necessary? Does the staff expertise meet the requirements set forth in regulation for certain types of activities (i.e., MBL, etc.)?

Cell: A17
Comment: The credit union should thoroughly investigate the costs it would bear to internally perform the duties outsourced. This should be compared with the expected costs and fees incurred if outsourced. Because costs can change (e.g., dependent upon the volume of activity), the analysis should consider alternative scenarios.

In its analysis, the credit union should also consider the costs and benefits from an economic standpoint, not just from an accounting standpoint. The credit union should look at the timing of actual cash flows, instead of how GAAP may permit a credit union to amortize costs or fees over time.

For example, a third-party may require fees to be paid up front for services to be performed in the future. If the credit union performed the service internally, it would pay for costs as they were incurred. By paying an up-front fee to the third party, an opportunity cost is borne by the credit union — it could have invested the funds to generate income, for example.

Also, fees may not be refundable leading to write-offs. For example, a company may charge $500 to originate and service a loan for a credit union. If the loan prepays rapidly, the credit union will have paid a $500 premium for little economic benefit.

Cell: A19
Comment: The credit union should determine an alternate course of action in case the third party is not able to satisfactorily perform its responsibilities. A third party's failure to perform could lead to the credit union taking over responsibilities that it is not

prepared or trained for. For example, managing an investment portfolio consisting of real estate backed securities requires staff with special skills and experience which a credit union may not possess. Without a reasonable exit strategy, failure of the third party servicer could result in an unreasonable reduction or delay of principal and interest income.

The credit union should also consult legal counsel to determine what action it must take to settle contractual issues such as rescinding outstanding contracts, requiring performance from the third party, settling unpaid fees or obtaining refunds from amounts already paid.

The credit union must also have the ability to execute the exit strategy.

Cell: A20
Comment: When evaluating the cost of outsourcing, the credit union should include costs that it will bear to meet its obligations or foster the relationship. This may include staffing costs associated with monitoring the third party's operations, insurance costs and other costs passed on to the credit union because they are not covered under the base fee, investments in technology, and additional fees for optional services.

Preferably, the credit union will calculate its expected return on investment in terms of economic yield (i.e., bond equivalent yield [BEY]). Some credit unions may estimate returns on investment simply by estimating accounting income. This methodology is flawed for it generally does not account for the time value of money and is based on accounting cash flows (i.e., amortizing premiums/discounts over time) instead of actual cash flows.

For example, assume a credit union pays a firm a $100 up-front fee per originated loan. This fee reflects a premium paid for the loan. From an accounting standpoint, a credit union may amortize the premium over the life of the loan. Therefore, the "cost" of the premium is mitigated by time. From an economic standpoint, the upfront fee represents a cash outlay today and incurs an opportunity cost to the credit union. This reduces the total return on the originated loan.

Cell: A22
Comment: 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.

Cell: A31
Comment: The third party's business model is simply the conceptual architecture or business logic employed to provide services to its clients. If the third party's business and marketing plans are available, officials should review them. Credit union officials should also understand and be able to explain the third party's role in the proposed arrangement and any processes for which the third party is responsible. Examiners should assess credit union officials' understanding of key third party business models.

Cell: A32
Comment: For example, if a third party's revenue stream is tied to the volume of loan originations rather than loan quality, its financial interest in underwriting as many loans as possible may conflict with the credit union's interest in originating only quality loans. Credit unions should also identify any vendor related parties (such as subsidiaries, affiliates, or subcontractors) involved with the proposed arrangement and understand the purpose and function of each. Examiners should consider the potential effects of identified conflicts of interest and ensure officials mitigate risks where reasonable.

Cell: A34
Comment: Perhaps one of the most important considerations, when analyzing a potential third party relationship, is the determination of how cash flows move between all parties in a proposed third party arrangement. In addition to third party fees, premiums, and receipts, many third party arrangements include cash flows between the credit union, the third party, and credit union members. Credit union officials should be able to explain how cash flows (both incoming and outgoing) move between the member, the third party, and the credit union. Credit unions should also be able to independently verify the source of these cash flows and match them to related individual accounts.

Cell: A36
Comment: Credit unions should carefully review the financial condition of third parties and their closely related affiliates. Credit unions should consider the financial statements with regard to outstanding commitments, capital strength, liquidity, and operating results. Additionally, credit unions should consider any potential off-balance sheet liabilities and the feasibility that the third

party or its affiliated parties can financially perform on such commitments.

Cell: A37
Comment: Audited and segmented financial statements or ratings from nationally recognized statistical rating organizations (NRSRO ratings) may be useful in periodically evaluating the overall financial health of a prospective or existing third party. If available, officials may use copies of SAS 70 (Type II) reports prepared by an independent auditor, audit results, or regulatory reports to evaluate the adequacy of the proposed vendor's internal controls. If these items are not available, credit unions should consider whether to require an independent review of the proposed vendor's internal controls. Generally, contracts establish requirements for periodic audits or access to third party records. Examiners should ensure credit unions have adequately reviewed the financial and internal control structure of the prospective third party, considering credit unions' risk profiles and the arrangement's relationship to net worth.

Cell: A50
Comment: Insurance coverage, including fidelity and errors and omission coverage, should be carried by third parties providing services to a credit union. It should also cover subcontractors, if applicable. Coverage amounts should be sufficient to mitigate risk associated with the services provided by the third party. The credit union should establish a process to confirm the continued maintenance of insurance coverage on a regular basis.

Cell: A54
Comment: Officials should be aware of each party's contractual obligations and how the credit union may terminate the contract if the performance expectations or contract obligations are not met. Credit unions should exercise their right to negotiate contract terms with third parties for mutually beneficial contracts. Credit union officials should ensure that any contract terms agreed too would not adversely affect the credit union's safety and soundness, regardless of contract performance.

Examiners should determine how costly termination of a contract may be to the credit union. If poorly structured, the credit union may not be able to terminate the contract without significant cost, or in a timely manner.

Cell: A55
Comment: As with any third party relationship, the credit union must understand its rights, responsibilities, and liability under any executed agreement. A legal review can also assist the credit union in changing language unfairly biased in the third party's favor. The legal review should be performed and documented by a party familiar with contract law prior to the credit union signing any contracts. Lack of a formally documented legal review of financially significant contracts indicates a deficiency in the credit union's due diligence review.

Cell: A60
Comment: Credit unions must be able to measure the risks of third party programs, but also the performance of third parties in terms of profitability, benefit, and service delivery. The credit union must monitor the performance of the third party relationship to determine compliance with expectations and contractual agreements. If deficiencies in performance are noted, a process to notify the third party of inadequate performance and to request corrective action should be implemented.

For example, credit unions outsourcing loan servicing functions should be able to identify individual loan characteristics, repayment histories, repayment methods, delinquency status, and any loan file maintenance relative to serviced loans. To the extent credit unions rely on the third party to provide this type of measurement information, clear controls should be contractually established and subject to periodic independent testing to ensure the accuracy of the information. Examiners should ensure credit unions are measuring the performance of third party arrangements and periodically verifying the accuracy of any information provided to them by a third party or its affiliate.

Cell: A62
Comment: Failure to monitor the third party can lead to significant risk, losses and breach of contract. Appropriate staff should be assigned to monitor performance of the service and compliance with the terms of the contract.

Designated credit union staff should be qualified and responsible for continued monitoring and oversight of third party arrangements, exhibiting familiarity with and understanding of the reports available from the third party. Responsible staff should measure the performance of third party programs in relation to credit union policy guidance, contractual commitments, and service levels. Credit unions should implement quality control procedures to review the performance of third parties periodically. Credit union officials should receive periodic reports on the performance of all material third party programs. Examiners should ensure controls are in place, and that management and officials receive periodic reports with information sufficient to assist them in evaluating the performance of the overall arrangement and the adequacy of reserves.

In many cases, credit unions outsource processes or functions due to a lack of internal infrastructure or experience. However, outsourcing processes or functions does not eliminate credit union responsibility for the safety and soundness of those processes and functions. Examiners should ensure officials demonstrate the knowledge, skills, and abilities necessary to monitor and control third party arrangements.

Cell: A64
Comment: The credit union should receive monthly reports detailing member activity. At a minimum, the content of reports should be of the same degree of detail the credit union would expect if it was performing the function in-house. Does the credit union have a list defining the codes used in the servicer's monitoring reports? It is a red flag if the credit union is unable to define any of the codes used in the reports.

Cell: A65
Comment: Reports should be received no less frequently than monthly. Controls should be in place requiring staff oversight.

Designated credit union staff should be qualified and responsible for continued monitoring and oversight of third party arrangements, exhibiting familiarity with and understanding of the reports available from the third party. Credit union officials should receive periodic reports on the performance of all material third party programs. Examiners should ensure controls are in place, and management and officials receive periodic reports with information sufficient to assist them in evaluating the performance of the overall arrangement and the adequacy of reserves.

Cell: A68
Comment: As an internal control, the credit union should control the issuance and receipt of all member account verifications. The servicer should be prohibited from this responsibility. Critical attention should be paid to confirmations returned for bad addresses, or accounts containing the servicer's address.

Cell: A69
Comment: The credit union should sample the individual transactions or member accounts to verify accuracy. Examiner should determine, for credit unions which rely on the third party to provide this type of measurement information, clear controls are contractually established and subject to periodic independent testing to ensure the accuracy of the information. Examiners should ensure the credit union is measuring the performance of third party arrangements and periodically verifying the accuracy of any information provided by a third party or its affiliate.

Cell: A70
Comment: It is imperative the credit union monitor the flow of member payments between the member, the servicer, and the credit union. Until payment is received by the credit union, the servicer is earning float, and more importantly, the credit union is exposed to credit risk—the risk of failure or fraud of the third party.

Cell: A71
Comment: The credit union must ensure member payments are not commingled with the servicer’s funds. This prevents inaccurate record keeping and loss to the credit union should the servicer fail or become subject to litigation. As a control, the credit union should require payments collected by the servicer be deposited and accounted for in a separate account held for the benefit of the credit union.

A better method for receipt of payments may be to have an agreement for a "retail lockbox." This method has the borrower send payments directly to the financial institution independent of the servicing arrangement. The financial institution opens and records the payment, and sends the records to the servicer and/or credit union. Independent third party control of funds is achieved.

Cell: A72
Comment: Payments returned or bounced must be reversed and the loan re-aged so the loan balance and interest due are correct. Some servicer's may assess servicing fees based on payments received. In this case, the credit union should ensure that the servicing fee is credited back to the credit union since a payment was not "technically" received.

Cell: A73
Comment: In many cases, credit unions outsource processes or functions due to a lack of internal infrastructure or experience. However, outsourcing processes or functions does not eliminate the credit union's responsibility for the safety and soundness of those processes and functions. Examiners should ensure officials demonstrate the knowledge, skills, and abilities necessary to monitor and control third party arrangements.

Cell: A74
Comment: Controls should include sufficient detail and address risks associated with the use of a specific third party. For example, credit

union procedures may require rotation of internal or external staff responsible for monitoring the performance of a third party relationship. The rotation of staff is one step which could reduce the risk of collusion and fraud.

Cell: A75

Comment: Credit unions which outsource products and services must continue to maintain adequate controls over those functions. Policies and procedures should outline staff responsibilities and authorities for third party processes and program oversight. Additionally, policy guidance should define the content and frequency of reporting to credit union management and officials. Finally, credit unions should establish program limitations to control the pace of program growth and allow time to develop experience with the program.

For example, credit unions participating in third party loan programs should initially limit the volume of loans granted in order to identify any problems with the third party process prior to the volume of loans becoming significant.

Cell: A76

Comment: Policy limits shape the risk tolerance of the credit union. They also alert the third party to restrictions on certain types of programs. Otherwise, the third party may be inclined to engage in the business activity that generates it the most revenue.

Policy guidance must be in place and sufficient to control the risks of the third party relationship. Policy guidance should address responsibilities, oversight, program and portfolio limitations, and content and frequency of reporting.

Cell: A77

Comment: This is particularly important in lending programs. To reduce the risk of collusion, appraisers, collection agencies, repossession agents, and collection attorneys should be rotated when possible. Policies and procedures should address these types of internal controls.

Cell: A79

Comment: Credit unions should ensure all member data transmitted between themselves and the third party are transmitted in a secure manner (encrypted email, secure fax, via encrypted tapes, VPN with secured files, etc).

Examiners can review the inbox and sent items on the email server for unsecured communications of the following nature:
- Loan officers may have unencrypted communications (email) to and from appraisers, closing companies, title insurance companies, and CUSOs (often for member business loans and real estate loans).
-Collectors may have unencrypted communications (email) to and from attorneys, collection agents, and repossession agents.
-Accounting personnel may have unencrypted communications (email) to and from their CPA firm, accounting firm, profitability analysis firms. CPA firms often complete a review of loan files, and in some instances member information has been included in the advanced or draft report emailed to credit union staff.

Credit unions should have procedures in place in order to communicate securely with third parties. PGP, encrypted Zip files, logging into a secure server using a VPN are examples of methods to communicate securely.

Cell: A80

Comment: After identifying the communication method, track a sample file from start to finish to ensure the entire method is secure.

For example, this internal control weakness can be seen when a member logs into a secure web page administered by a third party to apply for a loan. The third party's process is to create an email which is sent to a loan officer for processing and approval. If the email is created on the credit union's server, behind their firewall, this transaction is fine. However, if the email is created on the server of the third party and not encrypted, member data is not being protected because the email travels over the open internet without encryption.