

Question 1 of 3

P2.T7.811.1

According to the Guidance on Managing Outsourcing Risk (by the Board of Governors of the Federal Reserve System), with respect to a third-party service provider arrangement, the overall due diligence process by a financial institution should at least include a review of each of the following **EXCEPT** which is not essential?

- A. Ensure service provider has an appropriate background check program for its employees
- B. Financial review of service provider's most recent annual report and financial statements
- C. Evaluate the service provider's performance along with environmental, social, and governance (ESG) factors
- D. Evaluate the adequacy of standards, policies, and procedures, including adherence to applicable laws, regulations, and supervisory guidance

Explanation

C is CORRECT.

A review of ESG factors is not mentioned.

According to the Board, the three broad review areas are:

1. **Business background, reputation, and strategy:** "Financial institutions should review a prospective service provider's status in the industry and corporate history and qualifications; review the background and reputation of the service provider and its principals; and ensure that the service provider has an appropriate background check program for its employees."¹
2. **Financial performance and condition:** "Financial institutions should review the financial condition of the service provider and its closely-related affiliates. The financial review may include: The service provider's most recent financial statements and annual report with regard to outstanding commitments, capital strength, liquidity and operating results; The service provider's sustainability, including factors such as the length of time that the service provider has been in business and the service provider's growth of market share for a given service ..."¹

3. Operations and internal controls.

¹ “Guidance on Managing Outsourcing Risk,” Board of Governors of the Federal Reserve System, December 2013.

Question 2 of 3

P2.T7.811.2

Cityace Bank is a financial institution who is outsourcing a vital customer-facing function to a third-party service provider. Cityace wants to follow the Board's Guidance on Managing Outsourcing Risk, and if they do indeed follow the Board's guidance, then each of the following is true **EXCEPT**, which is not true?

- A.** Cityace should avoid outsourcing risk management activities, especially interest rate risk and model risk, because these are core competencies
- B.** If the service provider is foreign-based, Cityace should ensure the provider is in compliance with applicable U.S. laws, regulations, and regulatory guidance
- C.** Cityace should ensure an effective process is in place to review and approve any incentive compensation that may be embedded in service provider contracts
- D.** Cityace should consider especially the following risks in outsourcing: compliance risks, concentration risks, reputational risks, country risks, operational risks, and legal risks

Explanation

A is CORRECT.

According to the Guidance, risk management activities may be outsourced

In regard to (B), (C) and (D) each is TRUE.

- **In regard to TRUE (C)**, please note that the question assumes the financial institution "is outsourcing a vital customer-facing function," and therefore it is especially important that there exists a review process for incentive compensation. Many case studies have highlighted the adverse, unintended consequences of certain incentive plans that reward imprudent risk-taking.
- **In regard to false (A)**, the Guidance says (page 12): "Risk management activities: Financial institutions may outsource various risk management activities, such as aspects of interest rate risk and model risk management. Financial institutions should require service providers to provide information that demonstrates developmental evidence explaining the product components, design, and intended use, to determine whether the products and/or services are appropriate for the institution's exposures and risks. Financial institutions should also have standards and processes in place for ensuring that service providers offering model

risk management services, such as validation, do so in a way that is consistent with existing model risk management guidance."¹

¹ "Guidance on Managing Outsourcing Risk," Board of Governors of the Federal Reserve System, December 2013.

Question 3 of 3

P2.T7.811.3

Planetholding International Bank is entering a contract with its third-party service provider, Tristechnology Inc, to outsource the management of its website. Each of the following are likely contract provisions **EXCEPT**, which is unlikely to be a contract provision?

- A. Confidentiality and security of information
- B. Business resumption and contingency plan
- C. Scope of service (including reference to service level agreement and ability to subcontract)
- D. Loss waterfall allocation mechanism (including sufficient credit value adjustment for website downtime)

Explanation

D is CORRECT.

A "loss waterfall" is a mechanism typically associated with a central counterparty (CCP); a "cash flow waterfall" is typically associated with a securitization structure.

In regard to (A), (B), and (D), each are likely contract provisions. According to the Board, the following are common contractual provisions in a third-party service provider agreement (detail omitted):

- Scope: Contracts should clearly define the rights and responsibilities of each party, including: Support, maintenance, and customer service; Contract timeframes; Compliance with applicable laws, regulations, and regulatory guidance; Training of financial institution employees; The ability to subcontract services; The distribution of any required statements or disclosures to the financial institution's customers; Insurance coverage requirements; and Terms governing the use of the financial institution's property, equipment, and staff.
- Cost and compensation
- Right to audit
- Establishment and monitoring of performance standards
- Confidentiality and security of information

- Ownership and license
- Indemnification
- Default and termination
- Dispute resolution
- Limits on liability
- Insurance
- Customer complaints
- Business resumption and contingency plan of the service provider
- Foreign-based service providers
- Subcontracting