COMPLIANCE CHALLENGES

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Third-Party Oversight: What Does It Really Mean?

By Kris Kully

As credit unions become increasingly competitive in providing home financing to their members, many find it useful to bring in "outside help" to provide a broader range of products and services, or to share expenses and expertise with other credit unions.

For instance, credit unions may create or contract with a credit union service organization (CUSO) to perform certain application processing, loan underwriting, and closing activities; as well as other real estate settlement services, servicing or debt collection, or other functions.

Credit unions have for years been guided by somewhat generic regulatory principles for third-party oversight.

For example, the National Credit Union Administration (NCUA) has issued several supervisory documents over the years, calling on federal credit unions to exert the "appropriate" level of oversight in the management of the various risks those relationships may raise. While those documents certainly must be reviewed and followed, they do not give much concrete guidance on where to start or focus.

POLICIES AND PROCEDURES

First, the credit union needs policies and procedures, and to ensure that the third party has them, too.

Specifically, the credit union should

create a vendor management policy, describing how it will choose and monitor its third parties. It should consider the types of risks that may arise if the parties do not perform correctly, and how it can ensure they are performing, particularly for parties providing critical services or with access to members or their sensitive information.

The credit union should ensure that the third party has policies and procedures proving that it knows how to ensure its performance, protection of member information, and compliance with applicable laws.

The credit union also should ensure the third party has adequate insurance coverage (fidelity bond, errors and omissions, employee crime/fraud, etc.). Then, the credit union needs to assign personnel and resources to monitor that party's performance and compliance, whether through periodic reports, monitoring of any member complaints, and on-site visits.

The rights to all of these policies and procedures should be addressed through written agreement. And credit union personnel must keep management/board members apprised of any important findings.

APPROPRIATE LICENSING

Second, the credit union needs to consider whether the third party is appropriately licensed to perform its services.

While the credit union may not be directly responsible for a third party's failure to be licensed, it is responsible for ensuring they understand their licensing and other compliance obligations.

Certainly, the credit union's business and member relationships will suffer if the third party gets penalized or prevented from doing business in a particular state. States often license persons conducting loan origination, processing, underwriting, servicing, collecting, or other activities, and they define licensable activities in very different ways.

Even if the third party is a subsidiary of a credit union, states may not provide an exemption.

Similarly, the individuals who work for the third party may need to be licensed if they are performing loan origination activity, or even processing, underwriting, or loan modification activity. Then, while a state may not require licensing of the third party directly, it may require the entity to obtain a license or conduct some other filing if the entity employs individuals who must be licensed.

EXIT STRATEGY

Third, the credit union must consider its exit strategy, even (or particularly) in connection with CUSOs with which the credit union may have a deep relationship.

> *The critical piece of the GSE puzzle is: What would the actual federal backstop for housing finance look like, and how would it function?*

The credit union should ensure that its agreements contain appropriate performance benchmarks and termination clauses to be exercised if the credit union's monitoring shows that the third party is not performing, or is failing to comply with, applicable requirements.

The credit union will also need to have a backup plan, regardless of whether either it or the third party terminates the relationships, considering the critical nature of the services being provided and the availability of acceptable replacement providers.

OTHER CONSIDERATIONS

Of course, there are certain core mortgage lending functions that a credit union should never outsource.

For instance, as the NCUA has clarified, credit unions should not delegate loan approval to a CUSO or anyone else. The Federal Housing Administration similarly requires that approved mortgagees cannot contract out their loan origination or underwriting functions.

> *Bipartisan discussions are underway that utilize the Common Securitization Platform (CSP) as a starting point for any new housing finance system.*

Lastly, remember that third-party arrangements are about more than oversight of the other party.

When originating mortgage loans, credit unions must examine any type of arrangement with another person that provides settlement services through the lens of the Real Estate Settlement Procedures Act (RESPA).

Among other requirements, RESPA prohibits paying or giving anything of value in exchange for referrals of settlement services business. The credit union must generally ensure that any payments to, or from, the other person represent fair market value for distinct services, document that market-value determination, and monitor the quality and quantity of services provided.

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