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Concentration Risk

Updated Regulatory Examination Procedures & Implications

OCC Bulletin 2017-7

On January 24, 2017, the Office of the Comptroller of the Currency (OCC) published Bulletin 2017-7, which updated examination procedures for risk management of third-party relationships.

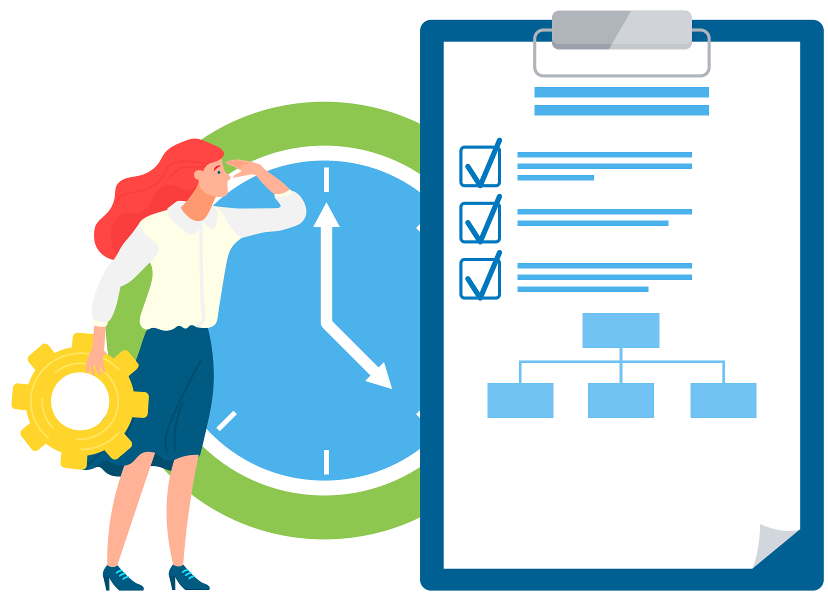
The original announcement can be found **here**.

The supplemental procedures can be found **here.**

The supplemental procedures document states:

Today, these procedures are designed to help examiners tailor the examinations of national banks and federal savings associations (collectively, banks) and determine the scope of the third-party risk management examination.

What is unsaid, is that many of the remaining regulators will follow - or formally adopt - the guidelines the OCC defines.



The OCC's guidelines reveal their new emphasis on concentration risk in the section **Quantity of Risk** beneath "Objective: To determine the quantity of operational risk associated with the use of third parties."

1. Determine whether there are any concentrations among third-party relationships.

- Review the bank's methodology for identifying concentrations among third-party relationships
- Determine whether there are concentrations due to the bank's reliance on a single third-party for multiple activities, particularly when several of the activities are critical to one or more lines of business
- Determine whether there are geographic concentrations where the bank's own operations, the operations of its third parties, or the operations of third parties' subcontractors are located in the same region or are dependent on the same critical power and telecommunications infrastructures."

Concentrations may arise when a bank relies on a single third party for multiple activities, particularly when several of the activities are critical to bank operations. Additionally, geographic concentrations can arise when a bank's own operations and that of its third parties and subcontractors are located in the same region or are dependent on the same critical power and telecommunications infrastructures."

Procedures & Implications

The new examination procedures outline a focus on the identification of major business line segments that are supported by a single vendor, such as one that supports all deposit and loan core processing, trust, digital banking, and commercial lending.

Concentration risk is not a new concept—for years now, lending organizations have been aware of the risk of concentrating their lending on a single borrower or a single industry.

However, the level of risk analysis expected in future examinations presents a new challenge to vendor management programs.

The OCC announcement ordered organizations to identify major business line segments that are being supported by a single vendor. **Connecting vendor contracts to primary business lines may need to be an expanded data factor available within your vendor management system.**

Vendor management programs will need to perform and report a vendor concentration analysis as a part of future organizational risk review and assessment forums. These analyses may be reported two ways, as illustrated below

1. By vendor, primary business line supported

Does any particular vendor hold an excessive level of risk to the organization's major lines of business if that vendor's services were disrupted? In other words, do you have too many eggs in one basket?

2. By primary business line, vendors contracted

A vendor concentration analysis reported in this format would be used to validate the distribution of key vendors utilized per business line.

Geographic Concentrations

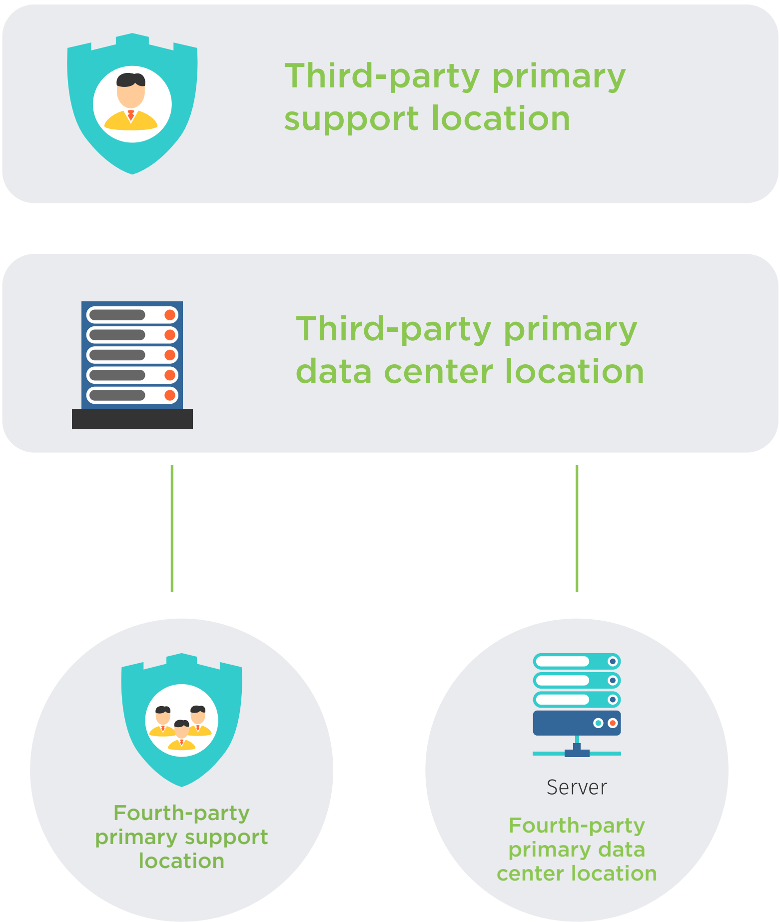
Another exam aspect announced in the bulletin is the validation of **geographic concentrations.**

Your organization's key operating and support centers must be included in this analysis—providing an overlay of your inherent locational risk and the locational risk of your key suppliers as identified within the examination procedures.

While your own locations should already be mapped, the locational data for your key supporting vendors is likely new information and must be requested and appended to your existing vendor risk management tracking efforts.

For each vendor contract outsourcing a product or service, we would expect addresses for the primary supporting location and data center. **We also recommend that you extend this policy to your key fourth-party vendors.**

We envision the inclusion of the new vendor location data reported in a tiered structure, such as:



Having this information available for your third and fourth-party vendors will be essential to validating their geographic concentration risk levels. The new SSAE 18 control audit format will help with fourth-party identification, once effective come May 1, 2017.

We infer that support and data centers located outside of the United States will attract stronger levels of scrutiny and review from regulators.

Conclusion

Initiating the depth of analysis needed in order to understand and validate concentration risk will require effort. We expect a **significant learning curve** within the financial institution community.

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In the future, **vendor negotiations might involve telling the vendor where you want to have certain applications processed across their distributed data center network** in order to mitigate concentration risk of key business lines within one vendor's offerings.
To be certain, there is no "snap of the fingers" procedure to "auto-magically" populate these new data elements into any vendor management solution.

The key is retaining the new data elements as neatly as possible while having a plan to go out and request, receive, update, report, and analyze the data for presentation to your inter- nal risk management authority and upon your next regulatory review.

Is this level of effort present in your existing vendor management plans for 2020?

VendorInsight

With VendorInsight, you have the capability to maintain data management and the analytics flexibility to allow for this new level of understanding. With this VRM solution, you can automate the requests of vendors to provide updates on the required data elements.

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