

Section 16. Vendor Risk Management and Commercial Arrangements With Third Parties

ACUA expects credit unions to practice effective risk management regardless of whether the credit union performs the activity internally or through a third party. As such, the credit union should have vendor risk management policies and procedures in place prior to engaging third parties for performance of mission critical functions of the credit union and / or those functions involving members' personally identifiable information. For clarification, services involving access to members' personally identifiable information are defined as mission critical functions for purposes of this regulation. Policies and procedures should address what due diligence is necessary to be performed prior to entering into a mission critical contract or relationship and monitoring and assessment of the vendor's performance to ensure that the activities performed are performed in a safe and sound manner and in compliance with applicable laws, regulations and the contracts.

This regulation applies to all state chartered credit unions. The credit union's board and management should identify those third-party relationships that involve mission critical activities and/or involve access to members' personally identifiable information and must ensure that the credit union has risk management practices in place to assess, monitor and manage risks.

A vendor risk management program should be tailored to each credit union's size and complexity of its vendor relationships and should include:

Risk Assessment and Planning

Risk assessments should be an on-going function to evaluate how the third party function will impact the seven risk areas of a credit union specifically, credit, interest rate, liquidity, transaction, compliance, strategic, and reputation risk of the credit union.

The risk assessment should document the following:

1. Expectations for outsourced functions;
2. Staff expertise of internal resources to monitor and manage the relationship;
3. Expertise of the third party to perform the function;
4. Assessment of the criticality of the functions being outsourced, as this will determine the level of due diligence, contract details and monitoring required.

Due Diligence

Mission critical functions outsourced to third parties will require enhanced due diligence procedures. Documentation of enhanced due diligence should include demonstrated understanding and assessment of the third party's organization, business model, financial condition and expertise to perform the activity for which it is engaged. Enhanced due diligence should also include obtaining references from the third party's clients to determine their level of satisfaction with the services provided by the third party.

Additionally, before entering into an agreement for the performance of mission critical services,

the credit union should:

1. Assess the third party's information security program when technology is necessary to support service delivery;
2. Ensure that written contracts or engagement letters address the scope of the arrangement, services offered, and activities authorized; responsibilities of all parties; service level agreements for evaluation of vendor performance; performance reports and frequency of reporting; penalties for lack of performance; ownership, control, maintenance and access to financial and operating records; business resumption or contingency planning; compliance with regulatory requirements; dispute resolution and default, termination and escape clauses; and,
3. Have its legal counsel review contracts and engagement letters prior to entering into the contract or agreement for services.

Insurance

Mission critical professional service providers such as accountants, appraisers, attorneys, technology companies must have a minimum of \$250,000 in professional liability insurance coverage to insure against losses attributable to dishonest acts, negligent acts and other acts, and hazard insurance covering fire, loss of data, and protection of documents. Additionally, for information technology providers, ensure that the provider has insurance coverage for intellectual property rights and/or the contract indemnifies the credit union from intellectual property infringement claims relating to the use of the technology service. The insurance coverage must be maintained while the professional service provider is providing services to the credit union.

Risk Measurement, Monitoring and Control

The credit union should have the staff in place with expertise to monitor the vendor relationship against agreed upon service levels. On-going monitoring is required of mission critical service providers and should include a risk assessment of the relationship, financial health of the third party and the performance against expectations.

Commercial Arrangements with Third Parties

Credit unions may enter into arrangements with third parties in order for the third party or credit union to offer the third party's products and services to the credit union's members. These arrangements are referred to in this rule as, "commercial arrangements". In connection with commercial arrangements, credit unions may:

1. Allow third parties to offer products and services to members through the credit union;
2. Endorse, directly or indirectly, products and services of a third party;
3. Enter into group purchasing arrangements with third parties;
4. Receive payment from third parties for participation in commercial arrangements; and
5. Rent, lease or sublease portions of their land and buildings to third parties to offer products and services to members. This list is not intended to be exhaustive.

As used in this rule, the term "third party" includes, but is not limited to, credit union service organizations.

Before entering into any commercial arrangements, a credit union's board must adopt a written policy regarding governing such arrangements. At a minimum, the policy should provide for:

1. An evaluation of potential risk of liability to the credit union including:
 - (a) Ensuring the arrangement is prudent and that it does not present safety and soundness risks to the credit union;
 - (b) Evaluation of the potential risk of liability and ensure that the credit union takes appropriate precautions to reduce or offset such risk, including, but not limited to, the use of such devices as disclaimers/disclosures to members and bond or insurance coverage of the third party and the credit union; and,
 - (c) Ensuring the contract evidencing the arrangement includes provision for indemnification of the credit union by the third party.
2. Guidelines for approval of each arrangement, whether by the board or management including term and dollar limits of approval authority;
3. Due diligence to be conducted before entering into or renewing each commercial arrangement; and,
4. Credit unions must comply with applicable laws in entering into and carrying out commercial arrangements, including, but not limited to, any applicable federal or state law on privacy of member information.
5. Credit Unions must be able to measure the risks of the commercial arrangements and assess the performance of third parties in terms of profitability, benefit, and service delivery.

Section 17. Mergers and Acquisitions and Charter Conversions

This section applies to mergers of credit unions when an Alabama state chartered credit union is the successor credit union, acquisitions of assets and assumption of liabilities of another financial institution by a state-chartered credit union and conversions of federally chartered or out of state credit unions to an Alabama state chartered credit union.

Fiduciary Duties of Boards in a Merger or Acquisition

The board of directors of an Alabama state chartered credit union contemplating a merger or acquisition should carefully consider all material aspects of the proposed transaction, including both the positive and negative effects that the transaction could have on the members of the credit union. Before the transaction is completed, the board should assure themselves that its credit union has done adequate due diligence on the business, assets and liabilities to be assumed in a transaction. The Alabama Credit Union Administration expects management of a state chartered credit union to contact the Administration at least five business days prior to the Board

of Directors' vote on a merger or purchase and assumption agreement as an Administration representative may attend the board meeting in which the vote will be held. Documentation of the credit union's due diligence reviews of the business, assets and liabilities to be assumed must be maintained for examination by the Administration. Documentation of due diligence should include the impact of the transaction on the surviving credit union's financial statements demonstrated in pro-forma financial statements including purchase accounting adjustments in accordance with GAAP, forecasted financial statements post transaction, pro-forma regulatory capital ratios, forecasted regulatory capital ratios, proforma interest rate risk analysis, liquidity ratios, loan portfolio composition, and credit risk analysis of loans and investments. The Board should update the credit union's strategic plan for the integration plan for the proposed transaction.

Merger and Purchase and Assumption Agreements

Credit unions should consult legal counsel before entering into a merger or purchase and assumption agreement. The written agreement should specifically detail the important agreed upon terms of the merger or purchase and assumption. The merger or purchase and assumption agreement should be signed by both the managing officer and board chair for each credit union or other financial institution, as applicable.

Credit Union Charter Conversions – Federal or Out of State Charter to Alabama State Charter

When a federally chartered or out of state credit union converts to an Alabama state chartered credit union, it becomes a new credit union. Before the new Alabama charter is issued, the credit union must obtain a commitment for member deposit insurance with either the NCUSIF or a private deposit insurance carrier.

Pre- Conversion Exam

An on-site examination may be required by the Administration particularly for credit unions with a CAMEL rating of "3" or higher. Therefore, it is recommended that the credit union allow at least 60 days after filing the conversion applications to obtain Administration approval. More time may be needed if an examination requires corrective action prior to conversion.

Notice to Members

The converting federal or out of state credit union must prepare a notice of meeting of its members, that must disclose the anticipated costs of the conversion, as well as reasons for and against the conversion. Converting credit unions must arrange for the issuance of new credit cards and check stock to members with the new name (for federals only) within a reasonable period of time after the conversion is complete. Information accompanying the merger ballot must contain a detailed description of all merger financial incentives and arrangements with merging credit union officers, officials and employees.

Conversion Application Documents Filed with the Administration

The conversion application filed with the Administration should contain the following:

1. Cover letter, including the name of the contact person at the credit union, and a brief description of the credit union's business, including any out-of-state operations;
2. Resolution of the Board of Directors authorizing the pursuit of an Alabama state charter;
3. Copy of materials filed with NCUA, if federally insured;
4. Copy of credit union's current charter and bylaws; and,
5. Proposed articles of incorporation and bylaws for the state credit union, including an opinion of counsel that the articles and bylaws are in compliance with Title 5, Chapter 17, Code of Alabama, 1975.

The Administration will request reports of examination directly from NCUA or the out of state regulator.

Membership Vote

Once the Administration, NCUA and any other regulators have approved the conversion, the conversion plan must be approved by a majority of the credit union's members voting on the proposed conversion. Voting may be at an annual or special membership meeting, by mail ballot or other election procedure permitted by the credit union's bylaws or applicable law.

Completion of the Conversion

After approval of the conversion by the Administration, NCUA, other regulators, if applicable, and the credit union's members, the credit union may take the steps necessary to complete the conversion. The conversion must be completed within 90 days after the membership vote. To complete the conversion, the following must be submitted to the Administration:

1. For federal charters, certification from the NCUA that they are satisfied with the procedures and presentation of the issues leading to the vote and its results;
2. For federal charters, NCUA Form 4505; and,
3. Three copies of the state credit union's bylaws, with a cover letter certifying that they have been duly approved by the credit union's Board of Directors
4. Certificate of insurance.

Transfer of Assets and Liabilities

Upon the conversion date, the Alabama state chartered credit union succeeds to all the assets and liabilities of the federal or out of state credit union.

Name Change

A state chartered credit union may not use the word “federal” immediately preceding the words “credit union” in its legal name as defined in the Bylaws.

Section 18. Records Preservation Program and Record Retention Guidelines: Catastrophic Act Preparedness Guidelines

This part describes the obligations of all state chartered credit unions to maintain a records preservation program to identify, store and reconstruct vital records in the event that the credit union's records are destroyed and provides recommendations for restoring vital member services. All credit unions must have a written program that includes plans for safeguarding records and reconstructing vital records. To complement these plans, it is recommended that a credit union develop a method for restoring vital member services in the event of a catastrophic act. For purposes of this part, *Vital records* refer to share, deposit, and loan balances for each member's account; a financial report; bank reconciliements; the credit union's accounts at financial institutions, insurance policies, and investments along with related contact information; and, emergency contact information for employees, officials, regulatory offices, and vendors used to support vital records.

Vital Records Preservation Program.

The board of directors of a credit union is responsible for establishing, reviewing and monitoring a vital records preservation program. The program must contain procedures for maintaining duplicate vital records; designated staff responsible for vital records preservation, a schedule for the storage and destruction of records, and a records preservation log detailing each record stored. It is recommended credit unions include in these procedures a method for using duplicate records to restore vital member services in the event of catastrophic act. Credit unions which have some or all of their member account records maintained by an off-site data processor are considered to be in compliance for the storage of those records if the service agreement specifies the data processor safeguards against the simultaneous destruction of production and back-up information.

Catastrophic Act Preparedness Guidelines

The program should be developed with oversight and approval of the board of directors. It is recommended the program address the following five elements:

1. A business impact analysis to evaluate potential threats;
2. A risk assessment to determine critical systems and necessary resources;
3. A written plan addressing:
 - (a) Persons with authority to enact the plan;
 - (b) Preservation and ability to restore vital records;
 - (c) A method for restoring vital member services through identification of alternate operating location(s) or mediums to provide services, such as telephone centers, shared service centers, agreements with other credit unions, or other appropriate methods;

- (d) Communication methods for employees and members;
 - (e) Notification to ACUA and the insurer;
 - (f) Training and documentation of training to ensure all employees and volunteer officials are aware of procedures to follow in the event of destruction of vital records or loss of vital member services; and
 - (g) Testing procedures, including a means for documenting the testing results.
4. Internal controls for reviewing the plan at least annually and for revising the plan as circumstances warrant, for example, to address changes in the credit union's operations; and,
 5. Annual testing.

Section 19. Liquidity and Contingency Funding Plans

State chartered credit unions with assets of less than \$50 million must maintain a basic written policy that provides a credit union board-approved framework for managing liquidity and a list of contingent liquidity sources that can be employed under adverse circumstances.

State chartered credit union with assets of \$50 million or more as reported on two consecutive Call Reports must establish and document a contingency funding plan (CFP) commensurate with its complexity, risk profile, and scope of operations that sets out strategies for addressing liquidity shortfalls in emergency situations. The CFP may be a separate policy or may be incorporated into an existing policy such as an asset/liability policy, a funds management policy, or a business continuity policy. The CFP must address, at a minimum, the following:

1. The sufficiency of the institution's liquidity sources to meet normal operating requirements as well as contingent events;
2. The identification of contingent liquidity sources;
3. Policies to manage a range of stress environments, identification of some possible stress events, and identification of likely liquidity responses to such events;
4. Lines of responsibility within the institution to respond to liquidity events;
5. Management processes that include clear implementation and escalation procedures for liquidity events; and
6. The frequency that the institution will test and update the plan.

In addition to the above requirements, credit unions with assets of \$250 million or more for two consecutive Call Reports must establish and document access to at least one contingent federal liquidity source for use in times of financial emergency and distressed economic circumstances. These credit unions must conduct advance planning and periodic testing to ensure that contingent funding sources are readily available when needed. A credit union subject to this paragraph may demonstrate access to a contingent federal liquidity source by:

1. Maintaining regular membership in the Central Liquidity Facility (Facility), as described in NCUA Regulation Part 725;

2. Maintaining membership in the Facility through an Agent, as described in NCUA Regulation Part 725; or,
3. Establishing borrowing access at the Federal Reserve Discount Window by filing the necessary lending agreements and corporate resolutions to obtain credit from a Federal Reserve Bank.

A state chartered credit union has 120 days from the effective date of the second Call Report to meet the requirements of this section based on the size of the credit union.

Section 20. State Chartered Corporate Credit Union

Part 704 of NCUA's Rules and Regulations, and such other rules, regulations or statutory requirements as amended from time to time, where applicable and set forth by the Administrator as regulator and / or the insurer are hereby adopted and incorporated by reference for an Alabama state chartered corporate credit union.