Third Party Diligence (TPD)

The Practical Guide to Risk-Based Bank-Fintech Partnerships

ALLOY LABS ALLIANCE

Crowe

Bank and fintech partnerships continue to be a key strategy for financial institutions of all sizes, from de novo challenger banks to community banks and those with trillions of dollars of assets. Bank/fintech partnerships are also subject to unique risks, and regulators are increasing their scrutiny. In the fall of 2021 federal banking regulators issued regulatory guidance titled, ***"Conducting Due Diligence on Financial Technology Firms: A Guide for Community Banks".*** The Guidance provides insights and overviews into the expectations of the regulators that are a part of the Federal Financial Institution Examination Council (FFIEC) when the regulated institutions partner with a fintech.

Accordingly, the Alloy Labs Alliance and participating member banks organized a Third-Party Diligence Center of Excellence, with business, operations, risk and compliance leaders from approximately a dozen banks coming together for regular, monthly working sessions. Alloy Labs Alliance member banks participate in several Centers of Excellence covering a wide array of topics. The goal of every group is to share the knowledge and workload required to develop tangible resources that can be used internally at each member bank. We are poised to develop industry-leading standards for partner due diligence and monitoring, while unlocking the value of partnerships through a prudent and adaptable risk management approach.

For this project, the group enlisted the help of the Alloy Labs' consultants at Crowe, LLP, a public accounting, consulting, and technology firm. Crowe facilitated the group through a series of working sessions to assess the ever-changing landscapes in both traditional financial services and technology focused financials. This volatility and change can create opportunities that should be embraced, while managing the risks prudently. The collective perspective of the working group is meant to capitalize on this opportunity through development of a principles-based approach to foster strategic alignment, enable execution and manage risk by leveraging the Crowe's adaptive business framework.

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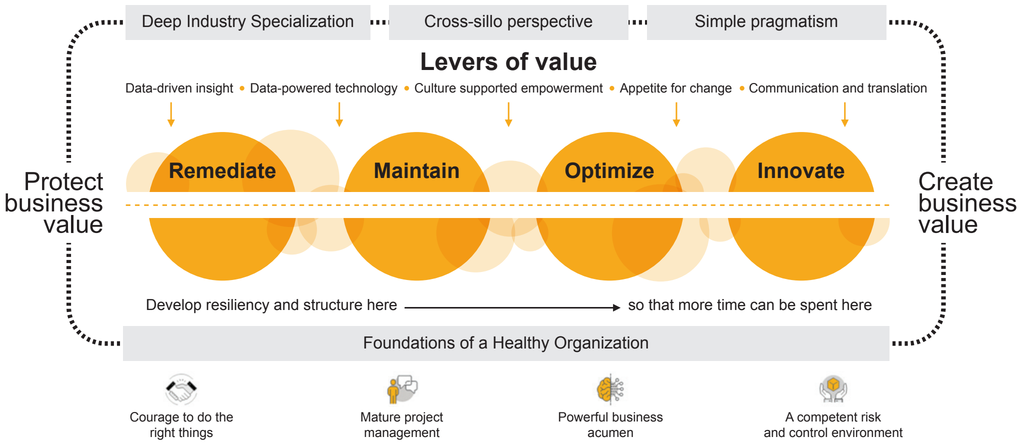


Source: Crowe LLC.

This work group focused on establishing a framework that enables financial institutions to comply with the requirements of regulatory guidance, embrace a risk-based approach and deliver practical outcomes. As part of this process, we established the following operating principles:

- Partnerships are more than a vendor relationship, where transparency, cultural alignment and outcomes should be shared, with relentless focus on customer experience and mutual value creation for both the bank and fintech.
- Investment incrementally in risk management and compliance as the partnership deepens.
- Initial due diligence is important to fully vet and understand the opportunity and risk, while ongoing monitoring to including enhanced monitoring based on triggering events, is warranted due to the nature of these relationships.

The outcomes and practical guide will be issued in two parts, the first of which will be focused on partnership enablement and the second on continued partnership management.

Keith Evans, Vice President and Vendor Management Officer of First Northern Bank, states, "being a part of this work group was a great experience. I had the opportunity to collaborate with different bankers from across the country. The team worked extremely well together and committed to a strategically focused outcome. This guide is a win-win for both the financial institution and fintechs. Banks are looking to partner with fintechs for their products, services, and expertise that is not readily available in-house. institutions yet need to understand the strict regulatory guidelines banks must abide by. This guide provides insights to assist both parties in taking the steps necessary to partner with one another."

Understanding the true risk of these partnerships and the corresponding due diligence is required in order to manage them. "As opportunities emerge for financial institutions to partner with new technology companies to improve customer experience and internal efficiencies, it is critical to have an established and trusted due diligence review process to evaluate the risks of a new partnership quickly" states Pete Boergermann, Senior Vice President and Director of Information Security of C&N bank.

The group developed initial questions to assess risk, by asking the following questions and evaluating both the likelihood and impact (risk) of these relationships:

1. How does this partner complement or enhance our strategy and align to our culture?
2. What is our overall exposure with this partnership, and does it align with our risk appetite?
3. Is this partner of a size and complexity to execute on the vision?
4. What type of customer interaction or data exposure does this partner have?
5. Are the established processes operationally resilient enough to meet the demand and expectation of our customers?
6. Is the control environment of the partner in alignment with expectations?
7. What monitoring and reporting is necessary for ongoing evaluation of the relationship?

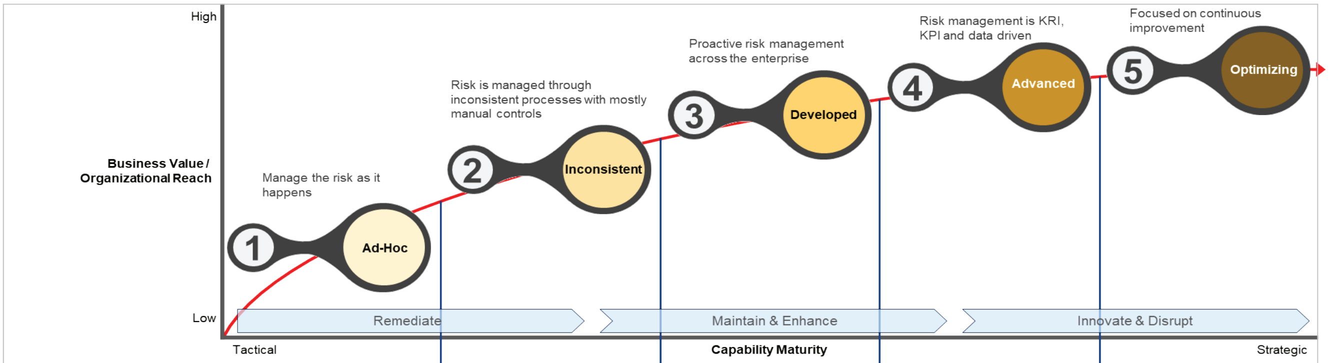
Leveraging these key questions to standardize and streamline the process, four classifications were established, as indicated in the table below. It is recognized and expected that all partnerships will not cleanly fit into these categories and should be viewed as directional or principles based to support and document the justification for the level of due diligence completed.

Leveraging the Crowe minimal acceptable maturity (MAM) model, Alloy Labs members evaluated the level of expectations for its partners based on the size and complexity of the partner, as well as the level of customer interaction and access to certain types of data, namely personally identifiable information (PII).

Minimal acceptable maturity is an organization's documented assessment level of process, systems and controls that should be in place to align to regulatory expectations and the Bank's risk appetite.

Participating bank members provided insights and developed consensus on the expected level of maturity that we expect of our fintech partners and then based on that assessed level of maturity, established due diligence expectations, requests, ongoing monitoring and triggering events for enhanced due diligence were established, which will be shared in subsequent issues of this Guide.

Minimal Acceptable Maturity Model



People	Success depends on people who put in extra effort beyond their normal responsibilities.	Defined yet overlapping roles and responsibilities leads to rework, confusion & higher resource costs.	Risk management and execution roles and responsibilities are clearly defined.	Risk management is embedded into the culture with seamless interactions across all three lines of defense.	Organization is a gold standard risk function that enables people and ideas to create value for the organization.
Process	Processes are usually reactionary and often identify risk events after they happen.	Processes and controls are inconsistently documented and maintained across the organization.	Processes, controls and effectiveness are consistently measured, tested and reported.	Processes are managed over their life-cycle and include analytics that leverage both leading and lagging indicators.	Risk management requirements are embedded in first line process execution. Second line challenge is established as an advisory and credible challenge 'firm'.
Technology	Systems are paper or Microsoft Office based with little or no consistency in how they are used.	Niche or point solutions have been implemented to address specific, high-visibility risks.	Systems designed centrally and are integrated and work together to manage risk across risk areas and departments.	Risk technology is integrated across the enterprise and used to drive decisions leveraging automation.	Continuous improvement is enabled by piloting innovative new ideas and technologies.
Data	Inconsistent data with limited controls around accuracy and completeness or clear ownership of data; no data dictionary.	Each business area has their own "data hero" that knows where to find information but has limited documentation.	Data has been prioritized and is owned & documented; teams and managers have ready access to data and reports can be easily run.	Data drives decision making and is governed, cleaned and audited. BU specific analytics are available from a shared repository.	Best in class data governance and management; advanced predictive data analytics to drive business growth.

Source: Crowe LLP

	Stages of Growth and/or Impact			
	Start-Up	**Partnering**	**Growing**	**At-Scale**
	Limited Customer Impact or PII Received	Limited roll-out or Controlled Customer Exposure	Full public offering	Multiple products and services offered
Strategy & Business Success				
Business Experience and Qualifications	3	3	4	4
Business Strategies and Plans	2	3	3	4
Financial Condition	2	3	3	4
Execution				
Operational Resilience	3	3	4	5
Business Continuity and Incident Response	2	2	3	4
Reliance on sub-contractors	2	2	3	4
Risk Management				
Risk Management and Controls	3	3	4	4
Legal, Regulatory & Compliance	3	3	4	4
Information Security	3	3	4	4

CONCLUSION

Strategy Aligned / Complementary

- Outcome alignment is important as partnerships are inherently designed for a long-term benefit of both the bank and the fintech.
- Focus on the end customer value transfer and delivery of a fair and responsible offering, with aligned or complementary strategies, are necessary to have a successful partnership.

Risk Assessment

- Setting control expectations, while maintaining a sound control environment, in line with the Bank's risk appetite, can influence the remainder of your relationship with a third-party vendor.
- Our risk assessment spectrum will enable a solid foundation with potential vendors by prioritizing the conversation of awareness around hazards, threats, and unshared risks, as well as identifying what data is allowed to be shared, how it is used, and reporting expectations prior to partnership.

Business Enablement

- As creating technology-driven processes and initiatives remains top of mind, our due diligence playbook incorporates the foundational belief that more vendors does not always mean better enablement. We emphasize the importance of prioritizing synergized business capability.
- Our risk-based approach and minimal acceptable maturity setting practice will bring insights into how to execute operational resilience, business continuity, incident reporting, and maintain a healthy reliance on sub-contractors.

Coordination and collaboration across the organization

- By collaborating cross-functionally, our third-party diligence playbook will enable time efficiency, maintain adequate communication, and provide clear priorities and direction.
- We've recognized the overlap between the strategy & planning, business experience and financial condition a fintech must secure in order to qualify them as a mature vendor. As we bring these insights into fruition, our maturity scale enables teams to assess who to cross-collaborate with, while implementing their due diligence process.

Risk Management

- Once the risk of bringing on a new partner has been assessed, the next step is managing and effectively overseeing the implementation of standards and regulations for improved operations.
- We'll provide procedure-based insights into how to best categorize and set expectations across a fintech's control environment (people, process and technology), as well as monitoring and testing, prevention tools currently in use, required safety procedures and mandatory insurance documentation.

Special thanks to the Alloy Labs member banks that participated in developing these insights:

TAB bank · Prevail Bank · Nicolet National Bank · MVB · Mercantile Bank of Michigan · Gate City Bank · C&N · California Bank of Commerce · Bremer Bank · First Northern Bank · Sunrise Banks

The **Alloy Labs Alliance** is the only consortium of its kind that brings innovation-driven banks together to partner with startups, co-create differentiated solutions, and make strategic investments. Our members take advantage of exclusive network effects to achieve exponential growth. Alloy Labs also operates The Concept Lab, a reverse accelerator that helps member banks cement relationships with fintechs, and the Alloy Alchemist Fund, which invests in early-stage partners. For more information visit www.alloylabs.com.

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