RB 21 was rescinded 1/13/95. It was incorporated into Thrift Activities 340.

Handbook: Thrift Activities
Subjects: Internal Controls

Section: 110
RB 21

November 22, 1989

RESCINDED

Servicing Contracts

Summary: To notify the District examinations staff of the need to review contracts for EDP and other vital services during safety and soundness/compliance examinations.

For Further Information Contact:
The Office of Thrift Supervision for the District in which you are located or the Division of Compliance Programs, Office of Thrift Supervision, Washington, D.C.

Regulatory Bulletin 21

Background

Recently, financial institutions (banks, thrifts, credit unions) have been entering into fixed-priced, long-term servicing contracts which could ultimately have an adverse effect on the institution. In some instances service bureaus have offered certain inducements to the institutions as an incentive to convert to the service bureau. Examples of these inducements include offers:

- To purchase the institution's existing data processing equipment at book value, which substantially exceeds its current market value;
- To purchase other assets from the institution (e.g., real estate owned) at book value, which may exceed current market value;
- To provide capital by purchasing stock from the institution;
- To provide "cash advances" to the institution once the conversion process is complete; and
- To defer expense recognition of conversion costs or processing fees under the terms of lease or licensing contracts.

Generally, these inducements represent an attempt by the institution to maintain capital by deferring losses on the disposition of assets or avoiding expense recognition for current charges. As such, the institution's treatment typically is inconsistent with generally accepted accounting principles (GAAP) and the OTS quarterly report instructions.

Until recently, EDP servicing contracts usually have been written based on a pricing structure tied to the number of accounts and items processed. Contract terms were normally one to three years in length and provided reasonable means for cancellation. Some contracts are now being written with terms of up to ten years in length which are based on a fixed price, regardless of volume. These contracts usually provide for a significant increase in costs after the first few years and contain substantial cancellation penalties, especially if the original proposal involved the purchase of equipment and/or the transfer of personnel from the institution to the service bureau. Additionally, if the institution is unable to increase volume in proportion to the increase in annual service fees, the fees may become a substantial drain on the earnings of the institution.

Examiners should pay particular attention to these contracts to insure that the institutions have not entered into agreements with severe penalties that make switching to another service bureau or back to in-house processing a non-viable alternative, even at the expiration of the contract. Examiners should also assure themselves that the service bureau is providing for a level of service that meets both the present and the long-term needs of the institution. With the rapid changes occurring in EDP technology, it would appear difficult to project the EDP needs of any institution for a ten-year period.

Examination Considerations

Examiners should review all arrangements between a provider of vital services and the institution. The review should include the servicer's proposal and contracts. A determination should be made as to the extent to which the institution obtained proposals from other servicers and the evaluation process the institution utilized in making its selection. The examiner should be aware that frequently the servicer's proposal to the institution will stress advantages that the institution will realize from the contract while not mentioning any disadvantages. In many instances, the institution is focusing on short-term benefits and does not fully weigh the long-term costs of the contracts.

Examiners are especially reminded to scrutinize any loan or other transaction involving the servicer. This includes loans to the servicer which are written at unusually favorable terms, such as non-interest bearing loans and loans which are not enforceable if the contract is terminated or the institution is closed by regulatory authorities. The examiner also should review any significant deposit accounts maintained by the servicer. Any transaction involving the transfer of assets of questionable value from the institution to the servicer at an inflated value (usually book value) also should be investigated.

While many areas that the examiner should be aware of have been indicated, these are only guidelines. The vehicle employed by the servicer and institution may vary from case-to-case. However, the one consistent factor in these transactions is that they are favorable to the servicer, but may not be in the overall best interest of the institution.

Financial Institutions Reform, Recovery, And Enforcement Act of 1989 (FIRREA) Implications

Section 225 of FIRREA amends the Federal Deposit Insurance Act (FDIA), adding Section 30 which includes the following provision:

(a) In General. An insured depository institution may not enter into a written or oral contract with any person to provide goods, products, or services to or for the benefit of such depository institution if the performance of such contract would adversely affect the safety or soundness of the institution.

Action to enforce compliance with this section may be taken under Section 8 of FDIA, and may include a requirement that the depository institution properly reflect the transaction on its books. Section 8 of FDIA provides the Federal banking agencies with the authority to issue cease-and-desist orders to ensure that depository institutions discontinue unsafe and unsound operating practices. Section 902 of FIRREA expands the authority of FDIA to include savings association affiliates and entities.

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