Thrift Bulletin

Handbook: Thrift Activities
Subject: Internal Controls

Section: 110
TB 44

February 7, 1990

Interagency Statement on EDP Service Contracts

Summary: The Office of Thrift Supervision, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and the National Credit Union Administration have jointly issued the attached interagency statement on EDP Service Contracts to all federally supervised financial institutions. The statement alerts financial institutions to potential risks in contracting for EDP services and/or failing to properly account for certain contract provisions.

For Further Information Contact: Your District office or the Division of Compliance Programs, Office of Thrift Supervision, Washington, D.C.

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See attachment.

— Jonathan L. Fiechter
Senior Deputy Director, Supervision Policy

Federal Financial Institutions Examination Council

1776 G Street, NW, Suite 701 • Washington, DC 20006

Interagency Statement on EDP Service Contracts

To: Chief Executive Officers of all Federally Supervised Financial Institutions, Senior Management of each FFIEC Agency, and all Examining Personnel

PURPOSE:

This interagency statement alerts financial institutions to potential risks in contracting for EDP services and/or failing to properly account for certain contract provisions.

ISSUE:

Some financial institutions are entering into EDP servicing contracts that contain provisions which may adversely affect the institution. Contract provisions may include extended terms (up to ten years), significant increases in costs after the first few years, and/or substantial cancellation penalties.

In addition, some service contracts improperly offer inducements that allow an institution to retain or increase capital by deferring losses on the disposition of assets or avoiding expense recognition for current charges. Institutions experiencing earnings and capital problems are particularly attracted to these inducements.

Examples of inducements include:

- The servicer purchasing assets (e.g., computer equipment or foreclosed real estate) at book value, which exceeds current market value;
- The servicer providing capital by purchasing stock from the institution;
- The servicer providing cash bonuses to the institution once the conversion process is complete; and
- The institution deferring expenses for conversion costs or processing fees under the terms of a lease or licensing contract.

These inducements offer a short-term benefit to the institution. However, the servicer usually recoups its costs by charging a premium for the data processing services it provides. These excessive data processing fees adversely affect an institution's financial condition over the long-term. Furthermore, the institution's accounting for such inducements typically is inconsistent with generally accepted accounting principles (GAAP) and regulatory reporting requirements.

Title II, Section 225 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 states:

> An (FDIC) 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.

Accordingly, when negotiating contracts, an institution must ensure that the servicer can provide a level of service that meets the needs of the institution over the life of the contract. It is also the responsibility of the institution to ensure that contracts are accounted for in accordance with GAAP.

In summary, contracting for excessive servicing fees and/or failing to properly account for such transactions is considered an unsafe and unsound practice. Servicing agreements that include contract provisions or inducements similar to those discussed above should be closely reviewed by the institution. Institutions must ensure that accounting under such agreements reflects the "substance" of the transaction, not merely the "form."

Although this statement focuses on contracting for EDP services, these same issues may exist in contracts for other vital services.

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