CONTRACTS
The Upside of Risk

A Guide to Service Level Agreements (SLAs)

Your financial institution's third-party relationships, or vendor partnerships, are critical to delivering best-in-class services and enhancing the customer experience. However, establishing clear expectations has become even more essential as reliance on third-party providers grows.

Enter service level agreements (SLAs). SLAs define each party's performance standards and responsibilities and serve as a framework for mitigating risks.

As we discuss SLAs, consider your institution's current SLAs, what steps you can take to improve your internal processes and policies, and how to better safeguard your operations and foster more trust with customers and organization stakeholders.

What are Service Level Agreements (SLAs)?

An SLA provides clear, documented performance standards so both parties (the financial institution and vendor) know what to expect in the vendor relationship.

SLAs typically include the following elements:

- Basic performance requirements
- Corrective actions for failing to meet standards
- Financial incentives for surpassing expectations

The Importance of SLAs

Third-party relationships can negatively impact a financial institution by introducing operational, reputational, and compliance risks, to name a few. For example, your institution might be affected if your vendor experiences an issue, such as a power outage or data breach.

More than two dozen financial institutions, including Capital One, learned this lesson the hard way when a fintech vendor experienced a power outage and a hardware failure that impacted their services, including payment processing and deposits. When customers can’t access or deposit funds, what may be just a one-off issue can cause consumer harm, leading to potential regulatory fines and reputation loss.

The rise of fintechs further underscores the importance of SLAs and other third-party risk documents, policies, and processes. While these technology providers can drive growth, improve efficiency, and expand your financial institution's product offerings, they lead to significant risks.

SLAs vs. KPIs

While an SLA is a performance measurement tool, not all measurement tools are the same.

KPIs are measurable metrics that help a financial institution assess business objectives and evaluate past performance, highlighting successes and increased risk areas. Regarding vendor management, KPIs help determine the value and effectiveness of the relationship. Some KPIs are focused on internal metrics, such as return on investment (ROI) and customer complaints, and others come directly from the vendors, such as system uptime and incident response time.

SLAs and KPIs work in tandem. Often, an SLA will outline specific KPIs a vendor must achieve and the penalties for noncompliance.

How to develop an effective SLA

Creating and implementing an SLA is an important step in the vendor management lifecycle. It plays a critical role in safeguarding your financial institution's operations and promoting customer trust.

Whether you're developing a new SLA or revisiting an existing document, consider these steps:

1. **Outline the service.**

Clearly outline the specific services that the vendor will provide. Establish KPIs and other measurable metrics to assess the success of each service. Examples of metrics include uptime percentages, processing times, or error rates.

To verify service levels, compare the vendor's performance or output against industry best practices.

2. **Develop SMART-R metrics.**

You may have heard of George T. Doran's framework for setting SMART goals, but when drafting an SLA, another important goal quality to consider is reportability.

When setting SMART-R SLA metrics, follow these steps:

- **Specific**: Set clearly defined, objective metrics.

- **Measurable**: Ensure that metrics are quantifiable. Include specific numbers, rates, and relevant timeframes.
- **Achievable**: Set realistic goals. Unattainable goals will set the vendor relationship up for failure and negatively affect both parties in the long run.
- **Relevant**: The defined metrics should reflect your financial institution's objectives and why you're partnering with this specific vendor.
- **Time-bound**: Establish a clear timeframe for achieving the outlined goals.
- **Reportable**: Implement a system for gathering data and reporting to capture the correct information.

3. Establish a reporting frequency

Once your SMART-R metrics have been established, it's time to determine how often the vendor will deliver performance reports, the recipients, and the reporting format.

Transparency in this process is essential for maintaining oversight and quickly addressing barriers to effectively and efficiently meeting the partnership's goals.

4. Get input from the stakeholders

Your financial institution's stakeholders, such as risk and compliance team members, should review the SLA and be aware of all essential details regarding the vendor relationship. Discuss openly with the internal team and the vendor to ensure everyone is on the same page.

5. Prepare the SLA

Once the details have been ironed out and all stakeholders are on board, it's time to implement the SLA into the vendor contract. The SLA can be incorporated as an addendum if there is an existing vendor contract.

Don't forget about the regulators

While drafting SLAs is an industry best practice, doing so can also help your financial institution meet regulatory requirements. For example, the Federal Financial Institutions Examination Council (FFIEC) advises institutions on how to develop Service Level Agreements (SLAs) in its "Outsourcing Technology Services Booklet." It emphasizes linking SLAs to contract provisions for incentives, penalties, and cancellation rights to safeguard against service provider performance failures.

Additionally, the National Credit Union Administration (NCUA) recommends that credit unions outline performance standards in their SLAs, while the FDIC, OCC, and Federal

Reserve state that banks must establish minimum SLA requirements when working with third parties.

SLAs play critical roles in fruitful vendor relationships. While drafting, approving, and implementing an SLA for specific vendors is time-involved, skipping steps or simply skipping the document altogether can lead to detrimental results for all parties involved.

The good news is that drafting an SLA is easier with the help of a vendor management solution. The right vendor management solution will help your institution understand SLAs, implement them, and keep you informed about your vendors and their activities so you can continue to mitigate risk long after the vendor agreement has been signed.