



# Regulatory

## Regulators Reinforce the Need to Develop New Products Within a Formal Risk Management Framework

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*Consumer finance companies face challenges in growing their traditional lines of business. This has resulted in increased acquisitions and consolidation in the industry as companies strive for diversification, economies of scale and improved profit margins. The alternative is innovation: the development and delivery of new products or services to customers.*

The development of new products or services is a function of both external and internal drivers. External drivers include changes in economic conditions, technology or competition, or the identification of a defined market need for a product or service. Internal drivers include the need to improve profits as well as to increase market share and customer loyalty.

For purposes of this article, new products or services are defined as traditional and non-traditional products and services, as well as modifications to existing products and services. Modifications include changes in the terms or nature of an existing product or service that significantly alter the underlying risk characteristics of the product or service (e.g., significant changes in underwriting standards, geographic or industry focus).

### Recent Regulatory Guidance on New Products

For several years, federal bank regulators have been evaluating banks' new product approval processes as part of onsite examinations. However, after the recent, highly publicized failures in the financial markets related to Enron, which involved complex structured transactions, as well as the consumer complaints related to products such as payday and title lending, the Office of the Comptroller of the Currency (OCC) has focused even more intently on banks' procedures for authorizing new products.<sup>1</sup> This resulted in targeted risk management examinations focusing on new product processes that brought about the issuance in May 2004 of formal supervisory guidance.<sup>2</sup> A unique aspect of the guidance is it requires banks to discuss their new product development plans in advance with their OCC examiner-in-charge or supervisory office if the new activity constitutes a significant deviation from the bank's existing business plan. While this guidance is specific to OCC regulated banks, its principles should be considered, and can be applied, to all companies.

<sup>1</sup> OCC News Release 2002-92, Statement of Douglas Roeder, Senior Deputy Comptroller OCC, before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the United States Senate, dated December 11, 2002.

<sup>2</sup> OCC Bulletin 2004-20, Risk Management of New, Expanded, or Modified Bank Products and Services, dated May 10, 2004.

## Risks Involved in a New Product Launch

There are a number of interconnected risks involved in a new product launch. Accordingly, it is essential for banks to identify those risks and modify or structure the product in such a way as to mitigate the risks in the best possible manner. The primary risks that arise in the development and introduction of new products or services include:

- Strategic risk: The risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions.
- Reputation risk: The risk to earnings or capital arising from negative public opinion.
- Credit risk: The risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as agreed.
- Transaction risk: The risk to earnings or capital arising from problems with service or product delivery.
- Compliance risk: The risk to earnings or capital arising from violations of laws, rules, or regulations, or from nonconformance with internal policies and procedures or ethical standards.
- Other potential risks: Increased liquidity, interest rate, price or foreign currency translation risk.

## Key Components of the Risk Management Process

Regulators recommend that banks take a proactive approach and involve all relevant bank departments in the process up front, such as risk management, compliance, audit, IT, finance and operations. This is critical because the involvement of these departments helps ensure that risks are fully understood and risk management strategies are fully vetted.

The OCC guidance highlights the process that banks should follow in order to minimize the impact of the risks outlined above. Regulators expect that all of the steps are performed prior to launch. However, the formality of the bank's risk management process should reflect the size of the bank and the complexity of the product or service offered. The key components are discussed below.

### Due Diligence

Management and the board should conduct adequate due diligence to ensure they have a realistic

understanding of the risks and rewards of the product or service being considered, as well as a clear understanding of the rationale for offering the product or service. The due diligence process should include:

- Assessing how the risks associated with the new product or service fits with the bank's current business strategy and risk profile;
- Consulting with relevant functional areas, such as credit, compliance, accounting, audit, risk management, legal, operations, information technology, and marketing, as well as the Treasury/Asset Liability Committee (ALCO), to determine risks, concerns, and necessary controls;
- Determining requirements for complying with laws, regulations and regulatory guidance;
- Determining the expertise needed to effectively manage the product or service, including the possible need to acquire additional expertise;
- Researching the background, experience, and reliability of relevant third parties that will be part of the product/service delivery;
- Developing a business and financial plan for the product or service that assesses the bank's competitive position and establishes objectives and strategies for how the product or service will be brought to market; and,
- Developing viable alternatives, including an exit strategy in the event the product or service fails to perform as expected.

Although the Board may delegate the performance of managerial duties to others, it has the ultimate responsibility for ensuring that the bank is run in a safe and sound manner. In fulfilling its responsibilities, the Board must ensure that a new, expanded, or modified bank product or service is consistent with the bank's strategic goals.

### Risk Management Controls and Processes

Once the bank decides to introduce the new/expanded/modified product or service and develops a business plan, the Board and management should develop and implement adequate risk management processes and internal controls to effectively control the risks of the activity. This should include:

- Expanding and amending bank policies and procedures, as appropriate, to ensure that they adequately address the product or service. Policies and procedures should establish accountability and provide for exception monitoring.

- Developing and implementing the information and reporting systems (MIS) necessary to monitor adherence to established objectives and to properly supervise the product or service. MIS reports should contain key indicators to allow the Board and management to effectively identify, measure, monitor, and control risk.
- Incorporating the product or service into the bank's audit and compliance processes to ensure adherence with bank policies and procedures and customer safeguards.

### **Performance Monitoring**

Management and the Board should have appropriate performance and monitoring systems in place to allow them to assess whether the product or service is meeting operational and strategic expectations. Such systems should:

- Include limits on the size of acceptable risk exposure that management and the board are willing to assume (across measurable risk categories such as credit, operations, and ALM);
- Identify specific objectives and performance criteria to evaluate success of the product or service and the timeframe for achieving success. The performance criteria should include quantitative benchmarks that will serve as a means to evaluate success of the product or service;
- Reflect a process that periodically compares actual results with projections and qualitative benchmarks, to detect and address adverse trends or concerns in a timely manner; and

- Trigger changes in the business plan, when appropriate, based on the performance of the product or service. Such changes may include exiting the activity should actual results fail to achieve projections.

### **Risk Management of Third Parties**

Unique risks are involved when a bank launches new, expanded, or modified products and services with the assistance of third-party vendors. Inferior performance or service on the part of a vendor may result in unexpected risks, including legal costs or lost business. The bank's Board and management must ensure that it understands the risks associated with the activity and conducts adequate due diligence of the vendor, including assessing the proposed vendor's reputation, products and financial condition. Management must also implement an ongoing oversight program over the vendor's activities and develop a contingency plan in the event the vendor cannot perform as expected. Management should not overly rely on the vendor's assertions, representations or warranties, but should do its own analysis to ensure the vendor and its products are a good fit for the bank.

The OCC has issued a separate guidance<sup>3</sup> in order to provide additional advice to national banks on managing the risks associated with third-party vendors.

<sup>3</sup> OCC Bulletin 2001-47, Third Party Relationships: Risk Management Principles, dated November 1, 2001.



## Illustration of the Process

The best way to demonstrate the value of an effective new product risk management process is through the description of a successful new product launch by a large division of a bank. In this case, the concept for the product was generated by market demand that was confirmed through the survey of a wide number of clients. The survey was followed by the development of a new product proposal containing a preliminary business and financial plan with projections of market size, competition, estimated revenues and expenses. This exercise demonstrated the need for the product in the marketplace and that the product would be profitable for the bank. However, in order to get approval for the launch, the division needed to ensure that all the risks associated with the product were understood and the product was structured in a way as to minimize those risks.

### Due Diligence

As part of the proposal, the sponsoring division assessed the risks inherent in the product and structured the proposed product in a way as to minimize these risks. The division worked closely with the risk management department from the beginning, as well as other departments such as operations, IT, compliance, finance and audit in order to identify risks and estimate the feasibility of the product. The product parameters and its terms and conditions were fine tuned based on their inputs. This was essentially a cross functional effort, however, the business unit/division retained the ultimate responsibility for the process.

### Risk Management Controls and Processes

The proposal grew as the terms and conditions of the product were refined and risk management controls determined. It also specified the systems changes, accounting procedures, and credit/risk limits that would be required. It also specified the MIS that would be generated (content and frequency). Once the proposal was completed, the sponsoring business unit head approved the proposal and circulated the proposal for formal sign-offs from the risk management, operations, IT and compliance departments. The product proposal was then presented to the bank's new product committee that was specifically constituted to review and approve new products. This committee was chaired by the head of risk management and contained senior management representation from business and infrastructure units. The sponsoring business unit presented the proposal, explained the business prospects and related risks, described the

risk management processes and controls designed to mitigate the risks, and the methods of monitoring and judging the performance of the product. The committee approved the product on a "pilot" basis subject to an internal audit and interim performance assessment.

### Performance Monitoring

Regular monitoring of the product was performed during the pilot period by management and risk management. As the end of the pilot period approached, internal audit performed a special review of the product's launch and performance, and reported its results to the new product committee, which then evaluated any risk and control issues as well as compared the products results to the original business plan projections.

The launch of the new product was successful, and eventually it was launched nationally by the bank. The keys to its success were:

- Strong sponsorship/accountability for ownership by the business unit;
- Thorough market due diligence;
- The early involvement of risk and operations functions in the development effort; and,
- Defined performance metrics that were well understood and monitored.

## Conclusion

There is a common belief that "process" restrains innovation. However this perception can be overcome if the process is well-managed and aligned to the strategy of the company. If a risk management process is implemented properly, the benefits from taking the time to identify and mitigate risk far outweigh the downside of significant financial and/or reputation risk caused by the introduction of a poorly conceived product or service. This is particularly relevant for the banking and consumer finance industry where reputation and compliance risks are substantial. The OCC guidance<sup>4</sup> and the concepts discussed in this article can assist companies in designing a process that meets their needs—and if handled properly—could even increase the number of innovations.

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<sup>4</sup> This is broad guidance on the process of risk management for new product/service innovation. For specific products/ services (e.g., delivery of services over the internet), other relevant regulatory guidelines should also be consulted.