New Products and Business Initiatives

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Agenda

- Succeeding in a difficult regulatory environment
- Why offer, when, and who should evaluate new products
- How to evaluate a new product, pre- and post-implementation
- Training and avoiding costly disclosure errors

A Difficult Regulatory Environment

- **Banks currently facing increased pressure**
  - Lower interest rates, decreasing spreads
  - Attrition in customer credit portfolios
  - HELOC maturity around the corner
  - Increasing competition among banks for good creditors

- **Areas regulators give particular attention in response**
  - Decreased underwriting standards
  - Strategic planning and managing risks from new products
  - Compliance and reputational risks associated with new products
    - BSA/AML compliance programs of particular concern
    - Consumer laws, regs, and guidance

A Difficult Regulatory Environment

Desire to grow earnings with new business lines combined with the pace of new regulatory requirements can lead to increased operational, reputational, and other risks if banks do not adequately invest in control processes, systems, and talent.

- **Regulators' approach in this changing environment**
  - Strong focus on risk systems
  - Continued scrutiny aimed at strategic and capital planning
  - For new products, particular focus given to
    - Adequacy of due diligence
    - Identification of inherent risks
    - Ensuring appropriate risk management infrastructure is in place <u>before a new product is rolled out</u>

- **How your bank can succeed in this new environment**
  - Have in place enterprise-wide approach to risk management
  - Banks with robust risk management systems outpace competition from both earnings and regulatory perspective
  - *Successfully rolling out new products in this environment requires understanding what may go wrong, not just what must go right*

Why Offer a New Product

- **Industry trends and trajectory**
  - Customer demands change, resulting in excess or insufficient capacity to meet new demands
  - Preexisting customers can be “recycled” without cannibalizing existing relationship
  - Industry shifts provide new funding and lending opportunities

- **Changing regulatory requirements**
  - As regulations evolve, products evolve in kind
  - A change in form does not always mean a change in function

- **Early responders earn significant profit but must be vigilant in understanding new risks**

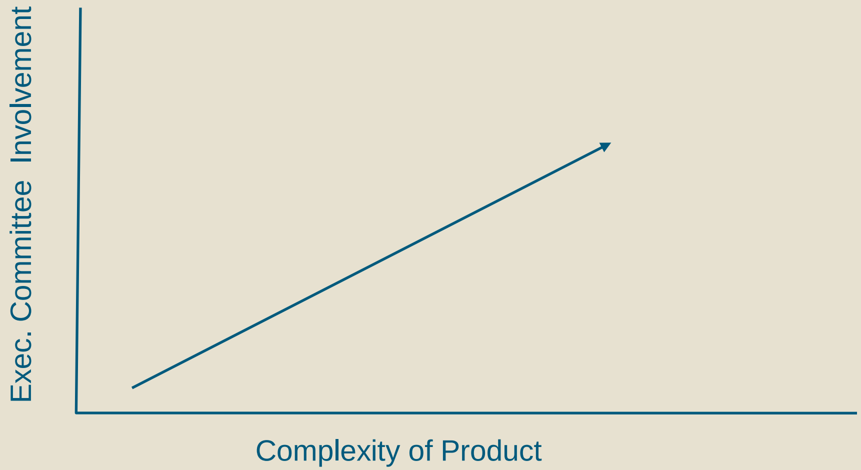
When to Evaluate a New Product

- **What is a new product?**
  - Services, depository products and non-depository products offered in new market, or to new customers, or through new channels, etc.

- **Each new product (including significant modifications to existing products) should be evaluated**
  - Degree of evaluation and risk management varies based on
    - Size of the bank
    - Complexity of product (e.g., interconnections and interrelatedness, securitizations, etc.)
    - Newness of product to the industry
    - How significant product is to overall offerings of bank
  - Must consider how product fits into organization <u>as a whole</u>

Who Should Evaluate New Products

- **Bank examiners want formalized due diligence process**
  - Outside counsel and consultants analyze capital, legal and reputational implications
  - Management should actively engage risk managers and third parties to discuss potential benefits and identifiable risks
- **Role of bank management *or* executive management committee**
  - Develop and implement risk management processes and policies to control and mitigate new risks from new products
- **Board of Directors or relevant BOD committee**
  - Receive reports from executive management on costs and benefits; remain apprised and engaged in decision making process – BOD is ultimately responsible for bank's actions
  - BOD or committee must ensure that a new, expanded, or modified bank product is consistent with bank's strategic goals
- **Significant deviations from business plan require discussion with OCC**



Process for New Product Approval

- **Three primary steps**
  - Due diligence
  - Develop risk controls and processes
  - Develop performance monitoring and review systems
- **Enterprise resource management is an effective way of accomplishing these requirements**

ERM: a Tool to Evaluate New Products

- **Enterprise Risk Management**
  - An integrated approach to identifying, assessing, managing, and monitoring risk
  - Considers risks <u>across business lines</u> and organizational objectives
  - Eliminates silo mentality; products are judged as pieces of the whole

- **Culture <u>at the top</u> is key to effective ERM; BOD sets direction of**
  - Corporate strategy and institutional risk appetite
  - Corporate culture that emphasizes the importance of compliance with laws, regulations and consumer protection

- **The more clearly articulated the product approval policy, the better**

ERM: a Tool to Evaluate New Products

- **No such thing as plain vanilla ERM**
  - ERM must fit strategy, size, products, sophistication and overall risk profile of bank

- **Individual risks <u>do not exist in a vacuum</u>**
  - Each product presents its own cross-organizational risks
  - Because a product is right for one bank does not necessarily mean it’s right for your bank

- **Effective ERM considers**
  - Strategic risk
  - Reputation / Franchise risk
  - Compliance risk
  - Operational and Model risk
  - Capital / Liquidity implications
  - Prudential requirements

ERM and Strategic Risk

- **Defined**: Risk to capital or earnings arising from adverse business decisions or improper implementation

- **Key Questions**
  - Does the product fit within the corporate vision?
  - Does management have the right expertise?
  - Is the product a one-off fad?
  - Would the product change customer perception?
  - What opportunities would new product foreclose?

- **Correct Decisions**
  - Consider risks created across bank
  - Analyze impact of increasing concentrations and interconnectedness with current products
  - Only provide new products with well-defined strategy, risk criteria and controls in place
  - Avoid negative impact on strategic direction of entity and stay within core competencies of bank

ERM and Reputation / Franchise Risk

- **Defined**: Risk created by failure to understand customers' business objectives or economic purposes of the product

- **Key Questions**
  - Does the bank fully understand costs-benefits of new product?
  - Does the product meet the bank's standards for quality?
  - Does bank have operational capacity to roll out new product (e.g., staffing, locations, expertise)?
  - To what extent will third party entities vendors be required?
  - To what extent can bank monitor and manage third party vendors to ensure <u>safe and sound</u> business practices?

- **Correct Decisions**
  - Value bank's long term reputation over short term profitability
  - Assess whether and how to engage with third party vendors; bank is ultimately responsible for third parties' actions
  - Understand <u>reputation</u> is one of a bank's <u>most valuable assets</u>

ERM and Compliance Risk

- **Defined**: Risk to earnings or capital arising from violations of laws, rules, regulations, or nonconformance with internal policies and procedures as well as ethical standards

- **Key Questions**
  - How will new product be monitored and controlled?
  - What risks to customer privacy are created?
  - What are potential conflicts of interest?
  - What is the impact on information security?
  - What is the impact on BSA/AML compliance programs?
  - Can the bank ensure that third party vendors comply with TILA, ECOA, and other regulations?

- **Correct Decisions**
  - Understand compliance problems breed reputational problems
  - Consider and quantify potential liability
  - Put in place or expand existing monitoring and compliance programs
  - Consider that new products come with new regulatory burdens

ERM and Operational / Model Risk

- **Defined**: Risk of loss due to failures of people, processes, systems, or arising due to external events

- **Key Questions**
  - How would bank validate new product inputs/outputs, assumptions and algorithms for purposes of risk models?
  - To what extent does bank need to confirm/audit operations team?
  - To what extent should the bank implement new or update existing risk models?
  - How will the bank ensure that all documentation is properly executed and accurate?
  - Does bank have sufficient staff and processes to monitor new products for BSA/AML concerns?

- **Correct Decisions**
  - Take into account potential shortcomings of current operations processes
  - Make modifications to risk models or otherwise change reliance on risk models
  - Make requisite changes to BSA/AML monitoring and reporting programs/policies

ERM and Capital / Liquidity Implications

- **Generally**: New products may have implications on the bank's regulatory capital or cause maturity mismatches

- **Key Questions**
  - How will new product change existing capital structure?
  - How would a problem in the target market impact portfolio holdings, ALLL, earnings, profit-margins, or regulatory capital?
  - Will the product cause problems for the bank in meeting obligations to creditors and counterparties (under both normal and stressed conditions)?
  - Does the bank have in place processes enabling identification and measurement of risks to asset quality, earnings and cash flows?

- **Correct Decisions**
  - Consider stress testing results of new product on pro forma financials and regulatory capital ratios
  - Assess risks, exposures, structural complexities and suitability of product for bank
  - Avoid silo mentality, consider impact on capital and liquidity of the organization as a whole
  - Ensure current policies and processes are sufficient before implementation

ERM and Prudential Requirements

- **Defined:** Prudential requirements are designed to protect the federal deposit insurance fund and avoid moral hazard

- **Key Questions**
  - What is impact on interbank inter-day credit exposure?
  - Does new product implicate any insider lending concerns?
  - Would new product result in tripping lending limits (including repo, derivatives, securities lending)?

- **Correct decisions**
  - Analyze cross-organization prudential impact
  - Do not assume counterparty banks will always be well-capitalized
  - Bear in mind that new products may overlap with existing products and increase lending concentrations

Other Potential Risks

- **Transaction Risk**
  - Risk arising from problems with service or product delivery
- **Credit Risk**
  - Risk arising from obligor's failure to meet terms of any contract or otherwise failing to perform as agreed
- **Foreign Exchange Risk**
  - Risk arising from fluctuations in the exchange rate
- **Interest Rate Risk**
  - Risk to earnings or capital arising from movement of interest rates

Post-Implementation Review

- **Product should be reviewed during period 6 months – 1 year after implementation**
  - Side-by-side comparison of expected v. actual performance
  - Consider qualitative factors (e.g., customer experience)
  - Review third party vendor performance, impact on customer perception, compliance with regulations
  - Ensure compensation arrangements and other incentives are consistent with corporate culture and institutional risk appetite

- **Post-review actions**
  - Update policies and procedures addressing shortcomings
  - Consider increasing or decreasing activity with new product
  - Update ERM processes to address unanticipated risks (e.g., operational problems or regulatory issues)
  - Assess whether training was sufficient
  - If necessary, change compensation structure

- **OCC will review significant new, expanded or modified products**

Dealing with Developers

- **Consistency in treatment is key**
  - Each new product must go through a standardized and clearly articulated process for approval
  - Process-oriented approval framework decreases confrontation
- **Discuss opportunity costs**
  - Share corporate finance requirements (e.g., WACC)
  - Not all positive ROI opportunities are good ROI opportunities
  - Industry trends versus overall trajectory of bank
- **Objective facts do not lie**
  - Use a numbers driven, ERM focused, decision and review process
  - Exceeding cost of capital hurdle only matters if bank can withstand risks created to reputation, capital, compliance and strategy

Training Programs

- **New products present new opportunities**
  - Train employees to sufficiently understand market and nuances of product to maximize reputational gains
  - Clearly define targets, goals and approval framework

- **New products present new risks**
  - Train employees on importance of avoiding high concentrations in single product lines/regions
  - Ensure employees understand discretional and objective limits
  - Adopt clear policy statements communicating BOD intentions toward compliance and communicate these policies to employees
  - Employees must understand compliance with regulations and corporate policy is not a suggestion, but a <u>requirement</u>

Adequate Disclosure

- **CFPB's UDAAP concerns risks created to consumers**
  - Targets practices that are
    - Unfair
    - Deceptive
    - Abusive

- **If new product is a retail non-depository investments product, bank should**
  - Ensure customers understand products not insured by FDIC
  - Ensure customers understand products are not deposits or obligations/guaranteed of/by bank
  - Are subject to investment risks, including possible loss of principal
  - Adopt written statement addressing risks associated with sales program

- **Learn from mistakes of your competitors**
  - Key information must be provided in a way that is <u>likely</u> to be <u>readily available</u> to customers
  - Eligibility requirements must be clearly disclosed
  - Prices, costs and penalties should not be manipulated or rapidly disclosed
  - Provide consumers with a way to request additional information
  - Closely monitor third party vendors and telemarketers

- **<u>Reputation</u> is one of a bank's <u>most valuable assets</u>**

Enforcement Actions – The Dark Side

- **Enforcement Action 1**:
  - Violations of TILA, ECOA, and unsafe and unsound banking practices resulting from third party vendor's actions in marketing, originating, and servicing payday loans; also failed to have adequate control of vendor
- **Enforcement Action 2**: The OCC required bank, before issuing new products, to provide written analysis considering
  - Risks, benefits, profitability and growth projection of the product or service
  - Product's impact on strategic plan
  - Bank's ability to identify, measure, monitor, and control risks associated with the product or service
- **Enforcement Action 3**:
  - Specifically requiring a Reg R steering committee to (1) adopt business line policies and procedures addressing Reg R in new products and services review processes; and (2) adopt risk control (compliance, risk management) systems
- **Enforcement Action 4**:
  - Specifically requiring bank to develop and implement an ERM program to, among other things, analyze and limit risks associated with new lines of business or growth

Information Resources

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Questions?

Reference Materials

- OCC 2004-20: Risk Management of New, Expanded, or Modified Bank Products
- OCC 2001-47: Third Party Relationships
- OCC 2011-12: Supervisory Guidance on Model Risk Management
- National Risk Committee, Semiannual Risk Perspective (Fall 2012)
- Interagency Statement on Retail Sales of Nondeposit Investment Products (1994)
- SR 12-17: Consolidated Supervision Framework for Large Financial Institutions
- NASD April 2005 Guidance on New Products
- OCC *A Common Sense Approach to Community Banking* (2013)
- Remarks by Thomas J. Curry, Comptroller of the Currency, before the Exchequer Club (May 16, 2012)
- Remarks by Thomas J. Curry, Comptroller of the Currency, before the Independent Community Bankers of America (March 14, 2013)
- Remarks by Carolyn G. DuChene, Deputy Comptroller of Operational Risk, at the Community Bank Enterprise Risk Management Seminar (October 22, 2012)
- Remarks by Governor Susan Schmidt Bies at the Risk Management Association and Consumer Bankers Association Retail Risk Conference (July 16, 2004)