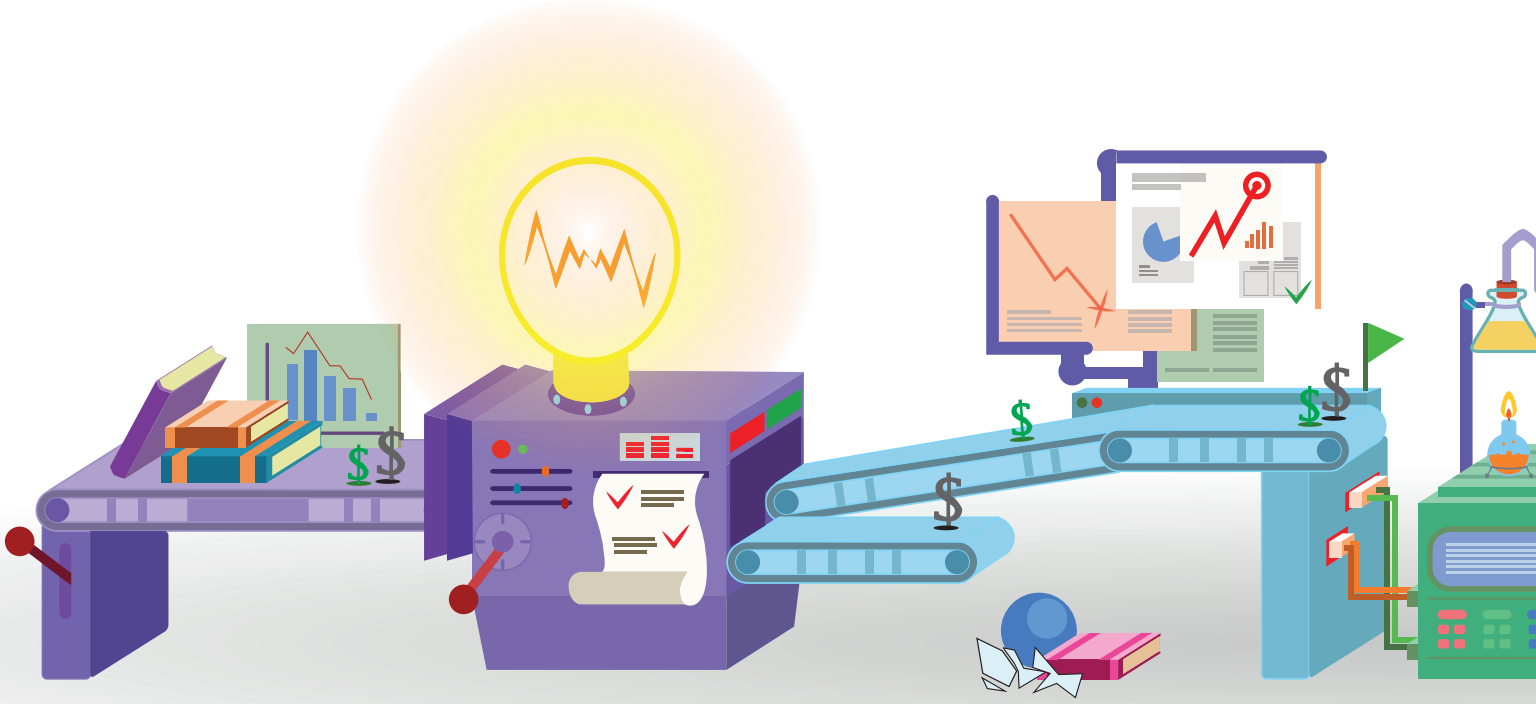
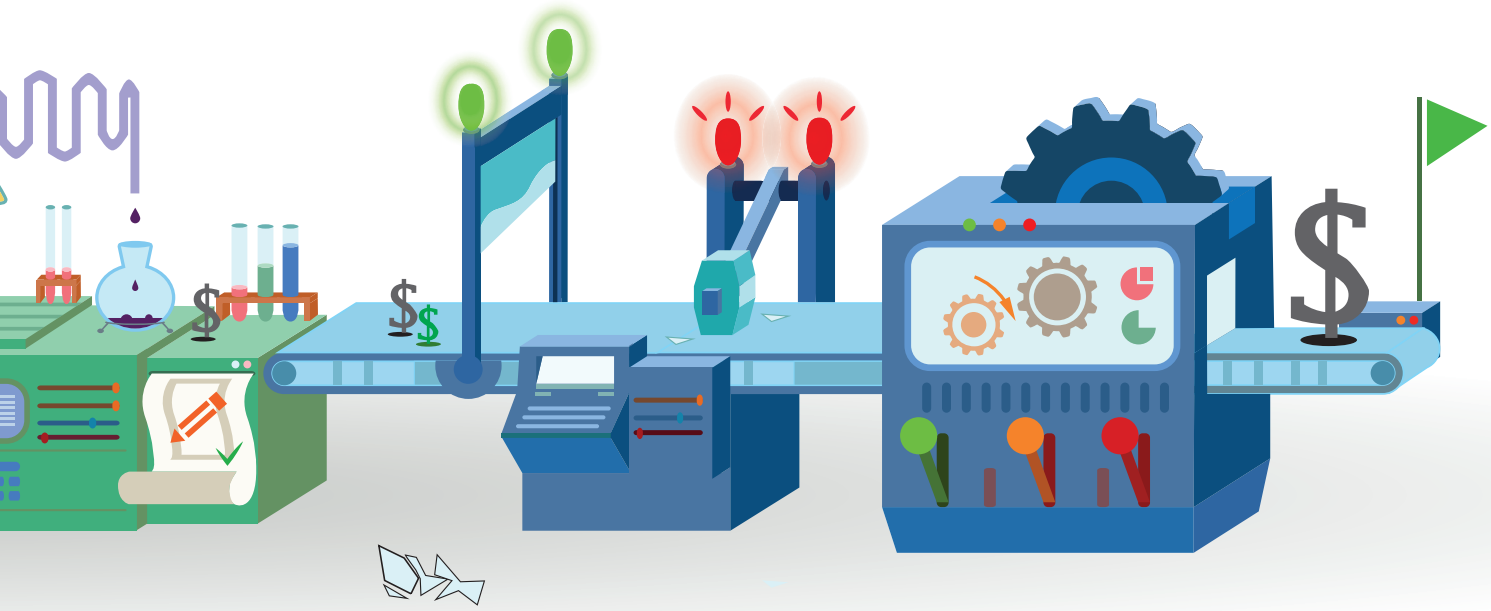


MANAGING THE NEW PRODUCT APPROVAL PROCESS

BY JEFFREY F. INGBER

EVERY REGULATED FINANCIAL institution is expected to have an ongoing, formal process for evaluating new products, services, and lines of business—something that is usually distinct from the process for approving individual complex transactions.

The new product approval process, or NPA, gained momentum in 2004 when, post-Enron, the OCC issued guidance to national banks on the process they should follow "to prudently manage the risks associated with new, expanded, or modified bank products and services."[1]



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The importance of an adequate NPA process has been ratcheted up in recent years by the introduction of myriad products—credit default swaps, payday loans, asset-backed securities, variable annuities, and structured notes—that subsequently led to supervisory sanctions, significant customer complaints and losses, the appearance of conflicts of interest, and financial harm to firms.

An example of the rising importance of a strong NPA process is the design, distribution, and governance requirements issued last July by the European Banking Authority for new retail banking products.

This article reviews six keys for ensuring that a bank's NPA process is sufficiently robust.

1

Define "new product, service, or business line."

The continuous development of new products is critical for the financial health of banks. However, few innovations are truly new in the traditional sense of the word. Accordingly, it's important to make clear that "new" in the NPA context suggests a significant modification to the features or structure of an existing product, such as a new distribution channel, a new set of targeted customers, or a new geographic market. A designation of "new" may be triggered by various other factors, such as those involving a major expenditure or greater product complexity.[2]

THE CONTINUOUS DEVELOPMENT OF NEW PRODUCTS IS CRITICAL FOR THE FINANCIAL HEALTH OF BANKS.

Conversely, not every change to an existing product needs NPA review; otherwise, the process runs the risk of becoming overwhelmed and trivial. One example is a simple rebranding. The key to determining the need for NPA review is whether there's a change that significantly alters the product's underlying characteristics or introduces one or more important new risks, whether to clients or to the bank itself (for example, from new proprietary trading activity). Such risks include a product's uncertain suitability for particular types of customers, potential reputational harm to the bank, and heightened legal liability. To determine this, a number of questions should be asked:

- Has the same or a similar product caused legal liability or other issues for other banks?
- Will the product be offered to a broader set of customers, particularly retail customers?
- Are material operational or technological changes required?

GIVEN THAT SENIOR MANAGERS HAVE SIGNIFICANT DEMANDS ON THEIR TIME, IT'S HELPFUL FOR THE COMMITTEE TO ESTABLISH ONE OR MORE ALTERNATE MECHANISMS FOR REVIEW AND APPROVAL OF MORE STRAIGHTFORWARD AND/OR LESS RISKY NEW PRODUCTS.

- Will a new regulatory scheme be activated?
- Will the introduction of the product cause an expansion of relationships in a new geographic region?
- Will the product involve a significant change in sales or distribution practices?
- Have supervisors expressed concern about the same or similar products?

If in doubt, the best practice is to err on the side of caution and subject any material modification of an existing product to NPA review.

2

Establish a formal "gatekeeper" committee.

A proper NPA framework revolves around a gatekeeper committee that has oversight of new products. In practical terms, prior to the introduction of a new product or a material modification to an existing product, there should be a detailed, independent review by a formally established NPA committee, comprised of representatives from key areas of the firm, including risk management, compliance, legal, finance, IT, marketing, and operations.

A bank's NPA committee must function with appropriate formality. For example, it should

- Operate under a charter that spells out rules for frequency of meetings, composition of the committee, quorum requirements, etc.
- Maintain minutes.
- Be run by a chairperson.
- Have a secretary who keeps track of decisions and conditions.
- Have decision-making authority to approve, disapprove, set conditions, or table a proposal.
- Have the authority to request all information that committee members may consider relevant in vetting the product.
- Have the ability to invite to its discussions representatives from all areas of the bank.

Having an NPA committee allows for a documented, consistent, and auditable process that enhances a bank's ability to administer enterprise-wide risk standards, withstand supervisory examination, and ensure accountability. In this regard, the NPA committee should have the formal authority to transmit its findings and recommendations to other senior bank committees, including committees of the board.

Given the risk-based nature of the NPA process, the committee should be driven by the control functions. For example, the committee chair ideally should be from either the independent risk or compliance areas, which, along with the legal department and apart from the NPA process, should be involved in assessing the product from an early stage. The committee should also be comprised of senior managers in order to demonstrate a commitment from the top to appropriate scrutiny of new products. This structure helps ensure the committee acts as an effective challenge mechanism that cannot be overridden by a forceful senior business manager.

Given that senior managers have significant demands on their time, it's helpful for the committee to establish one or more alternate mechanisms for review and approval of more straightforward and/or less risky new products. Examples include an abridged or "lighter" process that may involve just an exchange of e-mails or the use of a subset of the full NPA committee.

The NPA committee process should kick off only after completion of a detailed questionnaire that spells out key informational items, such as 1) the product's features, 2) how it works operationally (including highlighting any processes that are manually intensive or prone to fraud), 3) the potential risks and their mitigants throughout the product life cycle, 4) how the product is intended to perform under various market scenarios, 5) the expected financial impact, and 6) any staffing and resource requirements, including IT and operations. Other key elements of the committee's information gathering include the definition of a successful implementation of the product and the business's exit strategy in the event the product fails to perform as expected.

This questionnaire should be signed by senior business managers and each key control function. Indeed, one value of the questionnaire is to make clear which areas in the organization have a stake in the new product and are to be held responsible if problems occur. Its use also maximizes accountability by effectively requiring and providing evidence of review by every relevant business and control department.

3

Address all key applicable risks.

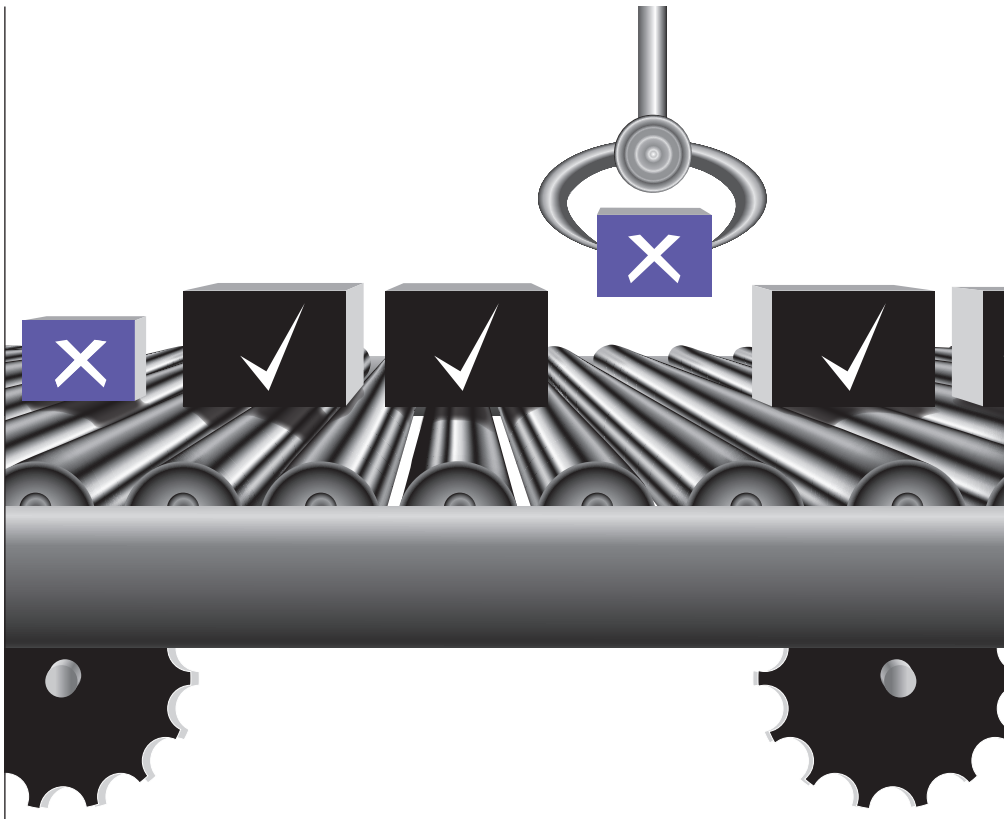
A new product may present an array of potential risks, each of which must be carefully considered. These risks include reputational, compliance, regulatory, operational, credit, liquidity, technological, financial, and legal.

That said, the NPA committee does not need to scrutinize the mitigants to each potential risk. Rather, if a risk is technical in nature and specific to a single control area, it may be sufficient for the committee to rely on control function review and sign-off.

The highest value provided by the NPA committee is the collaborative discussion it facilitates among various businesses and control functions. Thus, the committee should maximize its value added by focusing on macro concerns such as the following:

- Does the risk being introduced fit within an acceptable tolerance?
- If reputational risk is raised, can it be sufficiently mitigated?
- Are there novel concerns posed that require unique approaches?
- Does the new product have the potential to cause conflicts of interest, or the appearance thereof, between a bank and either third parties or its customers? And if so, how are they mitigated and disclosed?
- Might the new product cause significant changes to the bank's financial position, including how it calculates regulatory capital ratios?
- Are there any measures of success beyond revenue and profit (such as brand enhancement, cross-selling opportunities, a foundation for future growth in a market), and are they sufficient to offset any risk created?
- Does the bank have, or can it acquire, the staff resources and expertise needed to manage and control the added risk?
- If a significant new compliance issue is raised (such as UDAP or AML), is the product's value added worth the risk?
- Are there transactions whose primary purpose appears to be achieving a particular accounting, regulatory, or tax treatment?

One risk, which typically falls under operational risk and is critical to assess, and also one which the OCC emphasizes in its NPA guidance, is management of third-party relationships. This area deserves particular focus should the bank potentially face significant consequences if a third party fails to meet expectations, if employees of the third party interact with bank customers, or if bank operations could be affected by a failure to perform. As the OCC has cautioned, "A bank's failure to have an effective third-party risk management process that is commensurate with the level of risk, complexity of third-party relationships, and organizational structure of the bank may be *an unsafe and unsound banking practice*."



Thus, if a third party's services are critical to the new product offering, the NPA committee should require that 1) adequate due diligence of the third party has been conducted, including an assessment of its reputation and financial condition; 2) an ongoing program for overseeing the vendor's activities has been put in place; and 3) a contingency plan has been developed to kick in should the vendor fail to perform as expected.

Certain products and services, particularly ones that introduce a new business line, geographic market, or delivery channel, have the potential to alter a bank's entire business profile and significantly impact earnings and capital. For those new offerings, it's important for the NPA committee to obtain senior management buy-in to ensure consistency with strategic direction. The committee should be given assurance directly from senior managers that the product fits within the bank's risk appetite, that the bank has sufficient resources and expertise to oversee it, and that it will provide an adequate return on investment in the long term.

4

Insist that the new product be designed to create a win-win situation.

An obvious point for the NPA committee to discuss is whether the financial benefits to the bank are sufficient to warrant the new product's introduction. But a smarter starting point is for the committee to consider whether the benefits to customers and clients are clear and sufficient. In other words, a convincing demonstration of the new product's advantages should be a prerequisite to allowing the business to present its financial case. This is the best way to limit the potential for harm from reputational, legal, and regulatory risks.

THE NPA PROCESS IS A CRITICAL RISK MANAGEMENT TOOL FOR BANKS, ONE THAT SHOULD BECOME PART OF THEIR DNA.

In this regard, questions to be addressed by the business presenting the new product proposal might include the following:

- What needs of the target group will the product fill?
- Is the product suitable for all those it will be offered to? And if it may not be, how is that concern being controlled?
- If the product has a complex structure and function, will potential users truly understand it along with its costs and risks?
- Is the fee and compensation structure surrounding the product something that unbiased third parties would consider fair?
- Will the offering of the product create any conflicts of interest between customers and the bank? And if so, how will those conflicts be addressed?
- Are the disclosures made about the product's features, risks, costs, and assumed performance—through agents, in promotional and marketing materials, and other outlets—clear and transparent enough that customers can make an informed choice?
- Will customers have sufficient recourse if the product proves unsatisfactory to them?
- Are fees or penalties structured in such a way that customers could experience undue financial difficulties from using the product?
- Is this a product we would recommend to our own families and friends?

5

Train staff appropriately.

Sufficient bank-wide knowledge of the NPA process cannot be assumed. Bank staff must be sufficiently trained in the process and its requirements. In particular, those involved in developing new products need to know when and how to trigger the NPA process, how to meet the committee's informational requirements, and how to address all the issues requiring analysis.

As part of this training, it's important that the standards for determining the levels of review appropriate for any new product (for example, no review versus light touch versus standard) are clearly communicated and consistently applied throughout the bank. NPA training also supports the bank's overall risk management culture by reinforcing the importance that the board and senior management place on the NPA process.

6

Do not neglect post-approval follow-up and review.

Potential actions by the NPA committee include approving, denying, or returning the proposal for further development or for representation after various issues have been addressed. If approval of a new product is finally granted, it may come with one or more conditions attached. Examples may include 1) starting with a limited period or customer/ geographic rollout, 2) establishing limits on risk exposure, 3) first reviewing the product with supervisors and obtaining their tacit (if not formal) approval, 4) meeting initial revenue and profit targets, 5) reaching a certain level of customer satisfaction, and 6) not exceeding a specific level of technology or operational spend. Satisfaction of approval conditions needs to be tracked by the committee and reviewed at a later date with the business and control functions that presented the proposal.

Even if approval is given with no conditions attached, there should be follow-up by the committee (for a limited time—perhaps six months to a year) for it to review quantitative benchmarks and other performance criteria and evaluate matters such as 1) whether the product is meeting financial, operational, and strategic expectations; 2) whether customer or third-party complaints are being addressed; 3) whether any regulatory or competitive developments could affect the product; 4) whether market conditions have altered the risks associated with the product; and 5) ensuring there has not been "product creep." And, if the product is not implemented within a certain time period (say, one year), the committee's approval should be deemed expired, requiring a restart of the NPA process.

Conclusion

The NPA process is a critical risk management tool for banks, one that should become part of their DNA. In an environment of significant compliance, regulatory, reputational, and legal risks, the benefits of identifying and mitigating potential risks prior to the introduction of a new product far outweigh any perceived burdens from an additional business process. ®

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Notes

1. See also FINRA Regulatory Notice 12-03, "Complex Products: Heightened Supervision of Complex Products," and NASD Notice to Members 05-26, "NASD Recommends Best Practices for Reviewing New Products."
2. FINRA defines a product as potentially complex "if it would be unreasonable to expect an average retail investor to discern the existence of [its] features and to understand the basic manner in which these features interact to produce an investment return."