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INTRODUCING A NEW PRODUCT OR SERVICE

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Traditionally, new products and services have offered great opportunities for community bankers to innovate, connect with their customers, and provide value-added service. Choosing the right product or service for the institution and its customers, however, can be easier said than done. While this bulletin is not intended to set forth supervisory guidance, it discusses five factors that examiners have found are associated with successful new product development, as outlined in Chart 1. By considering these factors before introducing new products and services, management should be able to identify and mitigate risks in advance and avoid potentially costly and unintended consequences.[1]

Chart 1

- The Repeatable Process
- Strategic Fit for the Institution and Its Customers
- Risks and Mitigants
- Regulatory Compliance
- Financial Costs and Benefits

The Repeatable Process

Management teams that successfully identify and roll out new products and services typically have a documented process to guide decision making. In practice, this often means that the board of directors approves and the management team follows comprehensive new product policies and procedures, documents decisions, and ensures that all relevant functions within the organization appropriately engage with one another. Some areas for consideration in the process include the following:

People

- Management and staff from various functions – including compliance, accounting, risk, internal audit, and line management (i.e., not just the business line) – vet, review, and recommend new products and services for senior management and board approval.

Scope

- Policies cover the research, approval, and deployment stages of new products and services.
- Operating policies and procedures are updated to provide clear guidance to staff prior to product introduction.
- Processes address and mitigate risks throughout the product life cycle, including features, pricing, marketing, distribution, accounting, and ongoing service and maintenance.

Review

- Management receives timely and appropriate management information systems (MIS) reporting about the new product or service.
- Management conducts post-decision review to determine whether the new product or service met the expectations and assumptions used to support the decision.

Management and the board should also ensure that the organization's culture encourages constructive dissent and robust dialogue around all issues. This engagement could be evidenced by documenting dissenting viewpoints or considerations along with the new product recommendation.

1 For further discussion of this topic, see the First Quarter 2013 *Community Banking Connections* article, "Considerations When Introducing a New Product or Service at a Community Bank", at www.communitybankingconnections.org/articles/2013/Q1/Considerations-When-Introducing-A-New-Product.cfm.

Strategic Fit for the Institution and Its Customers

A community institution that enters a new business line, introduces a new delivery channel, expands into new markets, or offers new loan or deposit products may significantly alter its risk profile. When going beyond the boundaries of the institution's existing business model, successful management teams typically first think of new products and services in the context of the institution's strategic direction.

In addition to considering the product's strategic fit with the organization, successful management teams also consider the institution's customer base, asking, "Does the new product or service benefit the consumers and communities we serve, or does it diminish their capacity in any way?" These banks review the new product from a fairness perspective too, asking, "Does this product offer value to the consumer?" A helpful reality check is for bankers to ask "Would I recommend this product to my family?" Questions that management should consider asking are included in Chart 2.

If a potential product or service appears to be a good strategic fit with the organization and its community and customers, only then do successful management teams delve into the more tactical aspects of the decision, which are discussed below.

Chart 2

Product

- How did we learn about this product? Did a current vendor suggest the product to complement our existing products? Did a new vendor cold-call our management?
- Is this an established product or service, or is it "bleeding edge" or "leading edge"? [2]
- If it is bleeding edge or leading edge, how quickly is the product or service likely to evolve? What will be the cost of keeping pace with the evolution? What is the likelihood that our customers will value the product tomorrow?
- Will this product or service complement or cannibalize our existing products and services? Will it enable us to attract and retain new customers?

People

- Do our staff have the skills and capacity to deliver the product and service effectively?
- If we retrain our current employees and/or hire people with those skills, will we also have to change our compensation practices for consistency with other companies offering the product?

Organization

- By offering this product, will we be changing the culture of the company?
- Where do we see ourselves as an organization in 3, 5, or 10 years if we do or do not offer this product?

Customer

- Do our existing customers have a need for this product or service, or are there less-expensive products that would better serve their needs?
- If the product is intended to serve a different customer base, who are these new customers?
- Are features, risks, and terms of the product explained clearly and conspicuously, or are they buried in a lengthy document full of "legalese?"
- Are fees or penalties structured in such a way that unsuspecting, unsophisticated, or vulnerable consumers could experience financial difficulties?
- Are there financial incentives for bank employees to offer this product over other products that may also be suitable for the consumer?
- Is this a product or service we would recommend to our families?

Risks and Mitigants

It is often tempting to focus disproportionately on the benefits of a new product or service and less on the potential risks. However, successful management teams and boards of directors typically consider risks before considering and introducing new products and services. When risks are not identified and mitigated in advance, the unintended consequences can be costly to resolve.

2 A "bleeding edge" product or service is extremely new or innovative, with higher uncertainty as to consumer risk and market acceptance. A "leading edge" product or service is proven, but is still new enough that it may be difficult to implement or support and customer acceptance may still be building.

Successful management teams consider the costs and risks of a new product or service very broadly, looking at all risk dimensions across the organization. While a new product or service may appear to fit into a particular risk niche, the interconnectedness of all aspects of a community bank cannot be ignored. For example, mobile or Internet banking can not only create a variety of operational risks but also lead to increased liquidity risk (e.g., funds can move at the click of a button), compliance and legal risk (e.g., inconsistent or incomplete disclosures), and reputational risk (e.g., negative publicity from a data breach), among a host of other less obvious risks. Management may still decide to offer the new product or service, but it will do so with a clearer understanding of risks that may arise and need to be managed. Questions that management should consider asking include the following:

Risk Profile

- Will this product or service increase, decrease, or leave unchanged aggregate or specific risks?
- If it will increase risk in one or more risk dimensions, is the new level within our already established risk tolerances?

Financial Impact

- Will the new product or service cause changes to our financial position, including the calculation of regulatory capital ratios?

Risk Mitigants

- What steps can we take to mitigate risks to an acceptable level? Are there industry practices we can consider?
- Do we have or can we acquire the staff expertise to adequately manage and control the risk in the new product or service, as well as the risk in our established portfolios of products and services?

Regulatory Compliance

Community banks operate in a highly regulated industry, and successful management teams assess whether new products or services fully comply with applicable federal and state laws and regulations. The scope of permissible products and services may be limited by the institution's chartering authority and can vary depending on whether the activity is conducted in the bank, the parent holding company, or a subsidiary of one or the other. Community bankers should discuss new product or service considerations with their federal and/or state regulators to help ensure that any regulatory issues or concerns are identified early in the process. Questions that management should consider asking include the following:

General Compliance

- Has the product or service been reviewed for compliance with applicable federal and state laws?
- Does the management team have the knowledge and skills necessary to maintain the legal compliance of the new product or service?
- Will we use third-party vendors for any aspect of the new product or service? If so, do we have a sufficiently robust vendor management and oversight process to ensure that the vendor complies with all applicable laws and regulations? [3]

Consumer & Community

- Has the product been reviewed from a consumer fairness standpoint, considering laws and regulations, such as fair lending and unfair or deceptive acts or practices (UDAP)?
- Will the product or service affect our Community Reinvestment Act (CRA) profile?

BSA/AML

- Will the new product or service affect our Bank Secrecy Act/Anti-Money Laundering (BSA/AML) risk profile?

Applications

- Will an application or notice need to be filed with our federal or state regulator(s), and, if so, do we have the necessary information to submit with the application? How will that affect our lead time?

Financial Costs and Benefits

Community bankers are adept at conducting financial analysis of borrowers, and the same rigor can be applied to the financial analysis of proposed products and services. It is useful to challenge the financial assumptions underpinning the new product analysis, considering scenarios where customer adoption and sales are less than expected or certain key costs are higher than expected.

3 See Supervision and Regulation letter 13-19/Consumer Affairs letter 13-21, "Guidance on Managing Outsourcing Risk," at www.federalreserve.gov/bankinforeg/srletters/sr1319.htm.

Sometimes even seemingly minor variances in key assumptions can significantly affect profitability. It is also important to document the analysis and provide a record for back-testing. Questions that management should consider asking as it reviews the financial projections include the following:

Assumptions
- Do the assumptions underlying the financial analysis appear reasonable?

Scenarios
- Does the financial analysis adequately capture scenarios other than the best or most likely scenario? Can we live with those alternative outcomes?

Back-testing
- Have all assumptions and projections been documented and can they be back-tested?

Bringing It All Together

After the proposed product or service has passed the strategic fit test, the risks and regulatory compliance issues have been identified and evaluated, and the numbers have been crunched, management and the board are faced with two final questions:

Question #1: Do we thoroughly understand the purpose, risks, and benefits of this product or service?

Question # 2: Do the potential benefits, both financial and nonfinancial, associated with the new product or service outweigh the costs of (i) developing, providing, and servicing the proposed product or service; (ii) mitigating the identified risks; and (iii) complying with applicable laws and regulations?

If the answer to both questions is "yes," then the management team and board should feel comfortable implementing the new product or service. If the answer to either question is "no," then the management team and board can be assured that the disciplined new product review process may have saved the bank much financial and risk mitigation pain further down the road.

> *"Deciding what not to do is as important as deciding what to do. That is true for companies, and it's true for products."*
>
> Steve Jobs[4]

Final Thoughts

Community banks are most successful when they connect with their customers and communities and provide value-added products and services that are both consistent with their mission and needed by their customers. Taking a long-term strategic focus as part of a deliberative process rather than just following the pack when considering new products and services should help ensure community banks maintain a sound financial condition while innovating through new products and services to meet the changing needs of their customers.

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4 Walter Isaacson, "The Real Leadership Lessons of Steve Jobs," Harvard Business Review (April 2012), available at http://www.hbr.org/2012/04/the-real-leadership-lessons-of-steve-jobs/.