OCC BULLETIN 2004-20

Subject: Risk Management of New, Expanded, or Modified Bank Products and Services
Date: May 10, 2004

To: Chief Executive Officers, Directors, and Compliance Officers of National Banks, Department and Division Heads, Compliance Officers, and All Examining Personnel

Description: Risk Management Process

Replaced. See OCC 2017-43.

Purpose

This guidance reminds national banks of the process they should follow to prudently manage the risks associated with new, expanded, or modified bank products and services. Specifically, it outlines the expectations of the Office of the Comptroller of the Currency (OCC) for banks' management and boards to implement an effective risk management process.

The risk management principles outlined in this bulletin apply to the introduction of traditional and non-traditional bank 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).

Background

During periods of reduced net interest margins, stagnant growth in traditional business lines, and increased competition, bank management and directors face many challenges in seeking to improve the bank's financial performance. Engaging in new, expanded, or modified bank products or services is often considered a solution. However, if management and the board are overly focused on expected returns, do not have a good understanding of the inherent risks, or have poor governance practices, the bank's ability to effectively measure, monitor, and control the risks inherent in such products or services may be compromised.

Recently, the OCC has seen banks that have not performed the necessary up-front analysis to determine whether a potential new, expanded, or modified product or service offers the appropriate risk-versus-return profile and is consistent with the bank's strategic direction. Additionally, some banks have failed to implement appropriate risk management controls and processes. In some cases, these oversight failures have resulted in costly errors, unwarranted risk exposures, and deviations from the bank's business plan. Some historically well-managed banks have found themselves faced with problems because bank management underestimated its need to manage, monitor, and control the development and implementation of a product or service. Instead of boosting net income, the product or service caused systems and control problems, resulting in credit losses, compliance issues, litigation exposure, unfavorable returns, and diminished reputation in the marketplace.

Risk Management Process

The OCC expects bank management and the board to oversee all new, expanded, or modified products and services through an effective risk management process. Failure to provide an effective risk management process is an unsafe and unsound banking practice. An effective risk management process includes (1) performing adequate due diligence prior to introducing the product, (2) developing and implementing controls and processes to ensure risks are properly measured, monitored, and controlled, and (3) developing and implementing appropriate performance monitoring and review systems. 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. Depending on these factors, it may be appropriate for the bank to establish an executive management committee to oversee development and implementation of bank products and services.

Due Diligence

Before deciding to introduce a significant new, expanded, or modified product or service to bank customers, management and the board should conduct due diligence to ensure they have a realistic understanding of the risks and rewards of the product or service being considered. Management and the board should clearly understand the rationale for offering the product or service.[1]

The due diligence process should include:

- Assessing how the risks associated with the new, expanded, or modified product or service fits with the bank's 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.
- 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.
- Developing viable alternatives, including an exit strategy in the event the product or service fails to perform as expected.

Although the board may delegate 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 or its designee 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 a new, expanded, or modified product or service and develops a business plan, the board and management should develop and implement adequate risk management processes 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.

- Identify specific objectives and performance criteria to evaluate success of the product or service. 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.
- 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 obtains new, expanded, or modified products and services through third-party vendors. Inferior performance or service on the part of a vendor may result in unexpected risks, including legal costs or loss of business to the bank. Although most vendors are reputable, their products may be unproven, or the risks associated with the product or service may conflict with bank safety and soundness standards or compliance requirements. In addition, the vendor's services may not be appropriate for the bank's unique market, personnel, or operating environment. These risks can be exacerbated by so-called "turn-key" arrangements that are designed to provide the bank with only minimal involvement in the administration and oversight of the product or service.

Bank 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 adequate for the bank.

OCC Bulletin 2001-47, Third Party Relationships: Risk Management Principles, dated November 1, 2001, provides additional guidance to national banks on managing the risks associated with third-party vendors. This bulletin is available through the OCC Web site at https://www.occ.gov.

ASSOCIATED RISKS

Poor planning, oversight, or control may lead to an incomplete assessment and understanding of the risks involved with new, expanded, or modified bank products and services. This section highlights the primary risks that arise in their development and introduction.

Strategic Risk: The risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions.

Strategic risk arises when a bank offers products and services that are not compatible with the bank's strategic goals or that do not provide an adequate return on investment. This kind of risk increases when management introduces new, expanded, or modified products or services without performing adequate due diligence reviews or without implementing an appropriate risk management infrastructure to oversee the activity. Strategic risk also increases when management does not have adequate expertise and experience to properly oversee these products or services.

Reputation Risk: The risk to earnings or capital arising from negative public opinion.

Reputation risk occurs when a bank offers new, expanded, or modified products or services without fully understanding its customers' business objectives or the economic purposes of the transaction. Reputation risk also arises when a bank stretches for income by offering products or services that involve practices or techniques that differ from the bank's standards. Reputation risk increases with poor service, inappropriate sales recommendations, or violations of consumer law, any of which may result in litigation, adverse publicity, and loss of business.

Using third parties to offer products or services, or expanding the use of existing third parties, may also expose the bank to reputation risk. This risk increases when bank management fails to closely monitor the quality and appropriateness of the provider's products or services. In cases where third-party employees interact directly with bank customers, reputation risk increases if interactions are inconsistent with the bank's policies, practices, and standards.

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.

Credit risk arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet. Since credit risk is found in all activities where success depends on counter-party, issuer, or borrower performance, it is often a key risk in new, expanded, or modified bank products and services.

Transaction Risk: The risk to earnings or capital arising from problems with service or product delivery.

A bank is exposed to transaction risk when products, services, or delivery channels do not fit with the bank's operational capacity, customer demands, or strategic objectives. Transaction risk can increase with the implementation of new information technology to support a new, expanded, or modified product or service. Failed or flawed technology, either from errors, inadequate capacity, or fraud, may result in the inability to deliver products or services.

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.

Compliance risk arises when new, expanded, or modified bank products or services are not properly monitored for compliance with law, ethical standards, or the bank's policies and procedures. The potential for serious or frequent violations or noncompliance increases when a bank's oversight program does not include appropriate audit and control features. Compliance risk increases when the privacy of customer records is not protected, when conflicts of interest between a bank and affiliated third parties are not appropriately managed, and when a bank or its service providers have not implemented appropriate information security programs. Compliance risk also increases from inadequate marketing practices.

Other Potential Risks:

Depending on the product or service, a bank may be subject to increased liquidity, interest rate, price, or even foreign currency translation risk. Such risks will increase if bank management does not have a solid understanding of all risks involved and does not take all appropriate steps to control risks prior to introducing the product or service.

Supervisory Monitoring

The OCC's primary supervisory objective is to ensure that a bank does not assume more risk than it can effectively manage.

As part of ongoing supervision, OCC examiners will review significant new, expanded, or modified bank products and services, consistent with the OCC's supervision-by-risk framework. In particular, examiners will consider a product or service's impact on the bank's risk profile, and the effectiveness of a bank's product risk management program, including due diligence and oversight monitoring efforts. Examiners will be critical of banks that have not established appropriate risk management processes.

Bank management should discuss their plans with their OCC examiner-in-charge or supervisory office before developing and implementing new, expanded, or modified products or services, particularly if the new activity constitutes a significant deviation from the bank's existing business plan.[2]

Responsible Office

Questions concerning this guidance should be directed to Operational Risk at (202) 649-6550, or to Risk Evaluation at (202) 649-6360.

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RESCINDED

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[1] A topical list of regulatory guidance addressing new or expanded bank products and services is attached. These reference materials are available through the OCC Web site at https://www.occ.gov.

[2] As part of its current practice, the OCC conditions approvals of certain licensing applications (charters, conversions, and other applications, where appropriate) upon the national bank giving the OCC's supervisory office prior notice of any significant deviation to the bank's operating plan.

Subject	Issuance	Date	Description
ACH Transactions	OCC Bulletin 2002-2	January 2002	Provides guidance on ACH transactions involving the Internet
Accounts Receivable and Inventory Financing	Comptroller's Handbook	March 2000	Describes selected risks associated with accounts receivable and inventory financing
Business Continuity Planning	FFIEC IT Examination Handbook	March 2003	Includes guidance on business continuity planning
Community Reinvestment Act Examination Procedures	Comptroller's Handbook	May 1999	Provides guidance on CRA exam process and evaluation.
Commercial Real Estate and Construction Lending	Comptroller's Handbook	November 1995	Describes selected risks associated with commercial real estate and construction lending
Community Bank Supervision	Comptroller's Handbook	July 2003	Includes discussion of strategic and reputation risk in community banks
Credit Card Lending	Comptroller's Handbook	October 1996	Describes specific aspects of credit card lending
Credit Card Lending: Account Management and Loss Allowance Guidance	OCC Bulletin 2003-1	January 2003	Communicates FFIEC expectations for prudent account management, risk management, and loan loss practices in the area of credit card lending.
Custody Services	Comptroller's Handbook	January 2002	Addresses the fundamentals of securities custody and related services.
Floor Plan Loans	Comptroller's Handbook	March 1990	Describes specific aspects of floor plan loans
Information Security	FFIEC IT Examination Handbook	December 2002	Provides guidance on information security
Insurance Activities	Comptroller's Handbook	June 2002	Describes specific aspects of insurance activities
Internet Banking	Comptroller's Handbook	October 1999	Describes selected risks associated with Internet banking
Investment Management Services	Comptroller's Handbook (Asset Management)	August 2001	Includes information on investment management services

Investment Portfolio Credit Risks: Safekeeping Arrangements	OCC Bulletin 2002-39	September 2002	Alerts banks to the potentially significant credit risks they incur when safekeeping investment portfolio assets with third parties
Lease Financing	Comptroller's Handbook	January 1998	Describes specific aspects of lease financing
Merchant Processing	Comptroller’s Handbook	December 2001	Describes specific aspects of merchant processing
Mortgage Banking	Comptroller’s Handbook	March 1996	Describes specific aspects of mortgage banking
Payment Systems and Funds Transfer Activities	Comptroller’s Handbook	March 1990	Describes specific aspects of payment systems and funds transfer activities
Personal Fiduciary Services	Comptroller’s Handbook (Asset Management)	August 2002	Includes relevant information on personal fiduciary services
Predatory and Abusive Lending Practices	OCC Advisory Letter 2003-2	February 2003	Provides guidelines to guard against predatory and abusive lending practices
Predatory and Abusive Lending Practices	OCC Advisory Letter 2003-3	February 2003	Provides discussion on avoidance of predatory and abusive lending practices in brokered and purchased loans
Purchases of Loans In Whole or In Part – Participations	OCC Banking Circular 181	August 1984	Describes appropriate practices for the purchase of loans and loan participations
Retail Nondeposit Investment Sales	Comptroller’s Handbook	February 1994	Describes specific aspects of retail nondeposit investment sales
Risk Management of Outsourcing Technology	OCC Advisory Letter 2000-12	November 2000	Transmits FFIEC guidance on risk management practices when outsourcing technology services, including information and transaction processing and Internet banking activities
Subprime Lending	OCC Bulletin 1999-10	March 1999	Provides interagency guidance on risk management of higher risk retail credit products.
Subprime Lending	OCC Bulletin 1999-15	April 1999	Provides additional guidance on risk management of higher risk retail credit products.
Subprime Lending	OCC Bulletin 2001-6	January 2001	Supplements interagency guidance issued in March 1999 on subprime lending.
Third-Party Relationships: Risk Management Principles	OCC Bulletin 2001-47	November 2001	Provides detailed guidance on managing risks from business relationships with third parties
Third-Party Risk	OCC Advisory Letter 2000-9	August 2000	Alerts banks to potential credit risks arising from arrangements with third parties and emphasizes the importance of thorough due diligence and control over such risks
Third-Party Service Providers	OCC Bulletin 2002-16	May 2002	

			Provides guidance on risk management for foreign-based third-party service providers
Unfair or Deceptive Acts or Practices	OCC Advisory Letter 2002-3	March 2002	Provides guidance on unfair or deceptive acts or practices
Unsafe and Unsound Investment Portfolio Practices	OCC 2002-19	May 2002	Provides guidance on investment portfolio practices