How To Evaluate New Products

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Session Objectives

After today's session, participants should have a working knowledge to answer the following questions

1. How to properly evaluate new financial products
2. Product intervention: should regulators evaluate new financial products?

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Background

Current volatile and low-interest rate investment environment, investors are searching for alternatives to conventional investments that provide:

- higher yields and returns
- Protection from volatility

These alternative products include structured notes, distressed debt, derivatives, hedge funds, private equity and asset-backed products that have complex and unique features not fully understood by retail investors

Evaluation of new products by banks, brokers and dealers can help detect and avoid conflicts, unsuitable recommendations, and other problems before they violate various requirements which may exist in your jurisdiction.

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What is a New Product?

Firms, in their written procedures, should include clear, specific, and practical guidelines for determining what is a new product (or service.) Elements to consider:

- Is the product new to the marketplace?
- Is the product new to the firm?
- Are there changes or modifications to existing products are material enough to warrant the same level of review as a new product?
  - Existing product that has only been offered to institutional investors but will now be offered to retail investors?
- Does the product require material operational or system changes?
- Existing product being offered in new jurisdiction?
- Existing product being offered in a new currency?
- Existing product being offered to a new type of customer?
- Does the product raise conflicts that have not been previously been identified and addressed?

Written Procedures for Evaluating New Products

Firms that sell new products should have formal written procedures to ensure that no new product is introduced to the marketplace unless it has been reviewed and vetted from a regulatory as well as business perspective

- Procedures should define what is a new product or service
- Ensure participation from all relevant risk disciplines of the organization (i.e., Compliance, Legal, Operations, Business Management, Risk Management, etc.)
- Memorialize key decisions

New Products – Example

- 6-Year Retail Note with 100% Principal Protection at maturity
- First 2 years, 5% guaranteed coupon
- Years 3 through 6, variable coupon with a minimum of 0%.
- Variable coupon is tied to the individual returns of a basket of 10 global stocks
  - Returns of each stock are capped at a maximum positive return of 9% and floored at a maximum negative return of -20% per year
  - Coupon of product is average return of the 10 capped/floor stocks with a minimum coupon of 0%
  - Product will be distributed through the retail sales force of your Bank. In addition, your bank will enter into Distribution Agreement with other banks to distribute

Look for Documented Analysis that Matters

The goal of the new products vetting process is to ensure that the right questions are asked!

A. For whom is the product or service intended?
   - Retail, institutional, third-party distribution?
   - Due diligence and distribution agreements?
B. What is the product's investment objective?
C. Are there existing products already available that provide same or similar exposure?
D. Are there less costly, less complex alternatives for the issuer?
E. Are there less costly, less complex alternatives for the investor?
F. What are the costs and fees for the investor?
G. Economic projections and projected profitability of product?
H. What assumptions underlie the product? Are they sound and reasonable?

Look for Documented Analysis That Matters (continued)

I. What are the risks for the firm?
J. What are the risks for the investors?
K. How will salespeople be compensated for selling the new product? Incentives? Conflicts?
L. What are the legal or tax risks?
M. How complex is the structure?
   - Transparency
   - Suitability
   - Training?
   - Disclosures?
N. How will the product be marketed and what are the controls to ensure proper marketing?

Look for Documented Analysis That Matters (continued)

O. What are the qualifications of the people making the determinations about a new product's assumptions, performance and risk?
P. What are the qualifications of the people participating in the new products vetting process?
Q. Do the Firm's current systems and operational processes appear to support the new product? Clear, settle, and properly reflect on the firm's books and records?
R. Will introduction of the new product place stress on the organization's existing infrastructure?
S. Requires a written "new product proposal" prepared by the business group
T. Documents justifications and rationale of why the new product "fits" the organization

Stages of New Product Evaluation

1. Preliminary Evaluation or Product Forum by the Business Unit to determine whether to develop new product
2. Business Unit agrees to proceed and develop new product
3. Prepares case materials for New Product Committee Evaluation
4. Evaluation Period by key stakeholders and relevant control departments
   - Analysis by each relevant department of risks and sufficiency of compensating controls
5. New Product Committee Meeting
6. Approval, Contingent Approval or Rejection
7. Follow-up of contingent, open items
8. Product Launch
9. Post-Approval Review and Continued Product Monitoring

Sample New Product Evaluation Form

ID #	Risk	Risk Type	Risk Factors and Potential Impact	Inherent Risk Level	Controls & Mitigation	Control Applies to ABC	Control Applies to XYC	Control & Mitigation ownership	Mitigation Adequacy	Residual Risk Level	Risk Assessment by:
1	Unauthorized Trading	Operational Fraud & Theft Financial Reputational	Unauthorized trading activity could result in loss of funds	High	Segregation of duties exists between the Front (Sales/Trading) and back office (Treasury Operations). Fixed Income Sales/Trading Desk is responsible for transacting with the customer and inputting trades into the trading system. Treasury Operations is responsible for settlement, confirmation, and reconciliation. These are distinct and physically separate functions/units within the Bank with separate and distinct managers and reporting lines. The CSJ will follow the same segregation of duties	✓		Jane Doe (Treasury Operations) Jane Doe (Fixed Income)	Strong	Low	[illegible] (Treasury Operations) Teddy Bear (Compliance)
					Access to the trading systems require management authorization to add a user. Each authorized user is set-up with a unique login ID and password. The front office has a different access level from the back office. The front office is set-up with trading access only and the back office is set-up with review access only (existing process)	✓	✓	[illegible] (Treasury Operations), Jane Doe (Fixed Income)	Strong		[illegible] (Treasury Operations) Teddy Bear (Compliance)
					A licensed Principal will review end of day transaction reports for exceptions	✓	✓	Jane Doe (Fixed Income)	Adequate		Teddy Bear (Compliance)
					The trading floor is an enclosed room that is restricted to authorized personnel. Semi-annually, CBG Compliance and Treasury Departments' Project Manager receive a trading access report from Physical Security and review to ensure the appropriate personnel have access to the trading floor (existing process)	✓		Jane Doe (Treasury Operations) Jane Doe (Fixed Income)	Strong		[illegible] (Treasury Operations) Teddy Bear (Compliance)
					The cust employees will follow bank's mandatory time away policy (CP-XX-213). On an annual basis cust employees are required to take time away from their duties for at least two (2) consecutive weeks. The objective of the Policy is to create a work environment that detects attempts to perpetrate frauds or illegal transactions. CBG Compliance monitors CBG employees' completion of the time away requirement (existing process)	✓		[illegible]	Strong		Teddy Bear (Compliance)
					Trade activity reconciliation is performed by the Treasury Operations group twice a day. As part of the settlement process, by each mid-day the back office reviews the securities received from the custodial agent against the trade ticket received from the traders for any discrepancies. Each end of day the back office balances the transactions on the sub ledger system before the file is uploaded onto the general ledger. If a discrepancy is noted, the back office would bring it to the attention of the Treasury Operations manager for further handling. (existing process)	✓		Jane Doe (Treasury Operations)	Strong		[illegible] (Treasury Operations)

New Products Best Practices

Best Practices

Procedures will vary from organization to organization. However, here are my observations of best practices:

- Standing New Products Committee
- New Products Office - employees dedicated to new product approval
- Business evaluation and exploratory committees the precede a more formal New Products Committee
- Ownership of the new product by a particular business unit, product group or department
- Standardized templates that will provide consistent documented approvals
- Documented minutes
- Tracking of open and contingency items
- Post-approval follow-up and review
- Testing of approved products...integration with Internal Audit
- Participation and approval by every relevant department. At a minimum:
- Business Management, Administration, Finance, Operations (front, middle and back offices), Technology, Compliance, Legal, Risk, and Supervisory personnel
  - Each participating department is required to "sign off" and approve the proposal; Accountability.
  - Each participating department should have a template that touches upon the unique and specific issues and risks relevant to that department

Sales Practices at Banks, Brokers and Dealers

BEST PRACTICES: Sales Practices

- Approved Accounts - Consider whether purchasers of some or all new products should be limited to investors that have been pre-qualified. For instance, for accounts that have been pre-approved to trade options and/derivatives
- Distinction between "Reasonable Basis" suitability and "Customer Specific" suitability

Should Regulators Evaluate New Products?

SHOULD REGULATORS EVALUATE NEW FINANCIAL PRODUCTS?

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Should Regulators Evaluate New Products?

YES, Of course…

However, let's define what it means to evaluate new financial products by regulatory authorities

- Regulatory pre-approval of every new product is not realistic
- Products that might suggest patterns of complaints, losses, abuses
- Product failures detected during examinations: exploitive pricing, features, unfair contract terms

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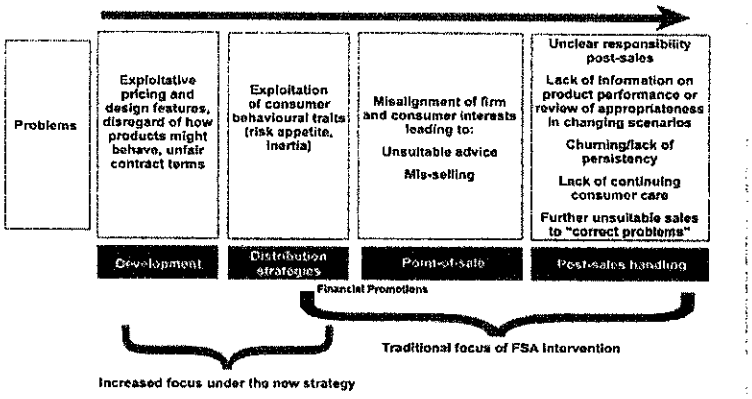
Should Regulators Evaluate New Product?

Regulatory Intervention: When and where problems can occur in the product life cycle



Source: FSA January 2011 Discussion Paper "Product Intervention"

Should Regulators Evaluate New Products?

- Product approval vs. product intervention
- In March 2010, the UK FSA began getting more involved earlier in the product life cycle
- Focus on products, including greater supervisory focus earlier in the value chain and ongoing product governance, rules targeting product features, rules limiting sales of products and setting down specific conditions of sale.
- FSA acknowledges that its form of prudential regulation over products focused on point of sale, disclosures, and sales practices. The FSA acknowledges certain shortcomings to their historic approach to product regulation. Will now become earlier involved in the product chain. More focus on issuing prescribed rules about product development and governance.
- Approach is not to dissimilar to regulation in the US. Explicit guidance about product development and roll out.

Issues to look for

- Banks, brokers and dealers should have a strong new product approval policies and procedures
- Banks, brokers and dealers must have controls to adequately review customer suitability, especially retail customers
  - Compliance Policies and Procedures
  - Controls to help ensure suitability - structures offered must coincide with the client's investment objectives, financial profile and risk tolerances
  - Supervisory Procedures
- Requiring banks, brokers, and dealers to require that, both their salespeople and the individuals responsible for supervising and monitoring SRP sales activities, participate in specialized training prior to selling SRPs
- Disclosing material facts regarding the Structured Products being offered – prospectus too voluminous? Unfortunate reality is that investors just don't read prospectuses.
- Reporting and transparency - properly reflecting structured product positions on customer statements

How to regulate – Issues to look for

- Banks, brokers and dealers having controls to independently review their Desk prices of Structured Products in the secondary market
- Having adequate procedures and controls in place to prevent and detect possible abuses in the secondary market

New Products References and Resources

US Financial Industry Regulatory Authority Notice (FINRA) 05-26 "New Products" April 2005:
http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013755.pdf

UK Financial Services Authority (FSA) Discussion Paper DP11/1"Product Intervention" January 2011:
http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf