

AL 98-03

Subject: Year 2000 Guidance on Customer Risk and Vendor Due Diligence

Date: March 17, 1998

TO: Chief Executive Officers of National Banks, Federal Branches and Data-Processing Centers, Department and Division Heads, and Examining Personnel

This advisory is to alert you to the recent release of two FFIEC interagency statements on the Year 2000 problem. "Guidance Concerning the Year 2000 Impact on Customers" and "Guidance Concerning Institution Due Diligence in Connection with Service Provider and Software Vendor Year 2000 Readiness" supplement previous FFIEC interagency statements by providing additional information on overseeing and managing Year 2000-related risk for bank customers and for vendors that provide mission-critical products and services.

"Guidance Concerning the Year 2000 Impact on Customers" describes the responsibilities of a financial institution's senior management and board of directors for assessing the risks arising from the failure of the institution's customers to address their Year 2000 vulnerabilities. A financial institution can face increased credit, liquidity, or counterparty trading risk when its customers encounter Year 2000-related problems. Year 2000 risk may result from the failure of a customer to properly remediate its own systems and from Year 2000 problems that are not addressed by the customer's suppliers and its clients. By June 30, 1998, senior management should have implemented a process which identifies, assesses and controls the Year 2000 risk posed by their customers.

"Guidance Concerning Institution Due Diligence in Connection with Service Provider and Software Vendor Year 2000 Readiness" addresses the process for determining the ability of a bank's service providers and software vendors to become Year 2000 ready.

The vendor due diligence process should enable management to:

- identify and assess the mission-critical services and products provided by service providers and software vendors;

- identify and articulate the obligations of the service provider or software vendor and the institution for achieving Year 2000 readiness;

- test the remediated services and products in the institution's own environment;

adopt contingency plans for each mission-critical service and product; and

establish monitoring procedures to verify that the service provider or software vendor is taking appropriate action to achieve Year 2000 readiness.

For further information on year 2000 issues, contact the Bank Technology unit at (202) 874-2340.

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Attachments

FFIEC Press Release

For Immediate Release
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FFIEC ISSUES GUIDANCE ON
VENDORS AND CUSTOMERS' YEAR 2000 RISK

The Federal Financial Institutions Examination Council (FFIEC) today issued additional guidance for financial institutions on risks they face due to the Year 2000 date change -- risk from service providers and software vendors and from institutions' customers. Today's guidance follows previous FFIEC Year 2000 statements on project management and business risk. "Regulators want to make sure senior management and boards of directors are fully aware of the wide range of risks that the Year 2000 date change poses for their institutions," said FFIEC Chairman Eugene A. Ludwig. "Regulators have made a major commitment to this challenge and all financial institutions are expected to do the same."

Vendor Due Diligence Guidance

Today's FFIEC guidance on Year 2000 risks from service providers and software vendors calls for financial institutions to develop a due diligence process that includes identifying mission-critical services and products provided by service providers and software vendors, monitoring procedures to verify that service providers and vendors are taking appropriate Year 2000 action, establishing contingency plans, and testing of these services and products within the environment of the financial institution to the extent possible.

The guidance encourages financial institutions to join other financial institutions through user groups to evaluate and test service providers and software vendors' Year 2000 efforts. These joint efforts may help financial institutions to solicit information and demand performance from service providers and software vendors that provide mission-critical products and services. Financial institutions should develop contingency plans for all mission critical systems and ensure that they pursue alternative means of achieving Year 2000 readiness in the event the service provider or software vendor cannot complete critical efforts by "trigger dates."

As part of the FFIEC's efforts, the FFIEC agencies are conducting examinations of service providers and will provide the results of these examinations to the federally insured financial institution clients of these servicers. The FFIEC agencies also will inspect software vendors that agree to examinations and, where software vendors consent, the agencies will release the results of those examinations to serviced institutions. The agencies, however, will not certify service providers or software vendors as Year 2000 compliant as a result of these reviews.

Customer Risk Guidance

Today's customer risk guidance outlines a due diligence process that will help financial institutions identify material customers, evaluate their Year 2000 preparedness, assess their Year 2000 customer risk, and implement controls to manage the risk. A financial institution can face increased credit, liquidity, or counterparty trading risk when its customers encounter Year 2000-related problems. By June 30, 1998, senior management should implement the due diligence process. By September 30, 1998, Year 2000 assessments, based on this due diligence process, should be substantially completed. The customer risk guidance includes sample forms and questionnaires to assist financial institutions in evaluating the Year 2000 preparedness of their customers.

The guidance recognizes that the due diligence process will vary among financial institutions, depending on the size of an institution and the size and technological sophistication of its customers. The FFIEC identifies three major types of customers: funds takers, funds providers, and capital market/asset management counterparties. For funds takers, such as borrowers and bond issuers, the guidance focuses on assessing how the Year 2000 will affect their ability to meet the terms of contracts.

The guidance notes that Year 2000 problems in the second group of customers, funds providers, can increase an institution's liquidity risk. Year 2000 due diligence plans for this group should focus particular attention to funding concentrations, including concentrations from one provider or group of providers.

Steps to limit Year 2000 risk from a third source -- counterparties and capital markets -- may include requirements for additional collateral or netting arrangements on contracts. The guidance underscores that failure by a capital market customer to meet its obligations because of the Year 2000 problem could cause liquidity problems and, in some cases, total loss on financial contracts.

The FFIEC will issue shortly two additional Year 2000 policy statements on testing and contingency planning.

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GUIDANCE CONCERNING
THE YEAR 2000 IMPACT ON CUSTOMERS

To: The Boards of Directors and Chief Executive Officers of all federally supervised financial institutions, Department and Division Heads of each FFIEC agency, and all Examining Personnel.

BACKGROUND

The Federal Financial Institutions Examination Council (FFIEC) has issued three statements providing guidance on the Year 2000 problem. Two interagency statements were issued in June 1996 and May 1997 to address the key phases of the Year 2000 project management process. The most recent guidance, published in December 1997, outlined the specific responsibilities of senior management and the board of directors to address risks associated with the Year 2000 problem.

PURPOSE

The purpose of this guidance is to assist financial institutions in developing prudent risk controls to manage the Year 2000-related risks posed by their customers. This guidance describes a variety of approaches for a financial institution's senior management and board of directors to assess the risks arising from the failure or inability of the institution's customers to address their Year 2000 vulnerabilities. This guidance outlines the due diligence process that financial institutions should adopt to manage their Year 2000-related risks arising from relationships with three broad categories of customers: funds takers, funds providers, and capital market/asset management counterparties.

SUMMARY

Key points addressed in this guidance include:

A financial institution can face increased credit, liquidity, or counterparty trading risk when its customers encounter Year 2000-related problems. These problems may result from the failure of a customer to properly remediate its own systems and from Year 2000 problems that are not addressed by the customer's suppliers and clients. By June 30, 1998, senior management should have implemented a due diligence process which identifies, assesses and establishes controls for the Year 2000 risk posed by customers. By September 30, 1998, the assessment of individual customers' Year 2000 preparedness and the impact on an institution should be substantially completed.

The due diligence process outlined in this guidance focuses on assessing and evaluating the efforts of an institution's customers to remediate their Year 2000 problems. Year 2000 issues related to the institution

exchanging data with its customers should be addressed as a part of the institution's internal Year 2000 project management program.

The guidance recognizes that each institution must tailor its risk management process to its size, its culture and risk appetite, the complexity of its customers, and its overall Year 2000 risk exposure. The FFIEC understands that these differences will affect the risk management programs developed by financial institutions. However, financial institutions must evaluate, monitor, and control Year 2000-related risks posed by funds providers, funds takers, and capital market/asset management counterparties.

The institution's due diligence process should identify all customers representing material Year 2000-related risk, evaluate their Year 2000 preparedness, assess the aggregate Year 2000 customer risk to the institution, and develop appropriate risk controls to manage and mitigate Year 2000 customer risk.

Risk management procedures will differ based on a variety of factors, including the institution's size, risk appetite and culture, the complexity of customers' information and operating systems, and the level of its own Year 2000 risk exposure. The Year 2000 due diligence processes used by smaller institutions may not be as extensive or formal as those in larger institutions where customers may be more dependent upon information technology.

The attached appendices provide examples of processes used by financial institutions to manage Year 2000-related customer risk.

An institution's management should provide quarterly reports to the board of directors that identify material customers who are not effectively addressing Year 2000 problems. The reports should summarize the action taken to manage the resulting risk.

OVERVIEW

The Year 2000 problem presents many challenges for financial institutions and their customers. The FFIEC recognizes that risk management procedures will vary depending on the institution's size, its risk appetite and culture, the complexity of customers' information and operating systems, and the level of its own Year 2000 risk exposure. For example, customers of small community financial institutions may not depend on computer-based information systems to the same extent as large business customers of large financial institutions. As a result, Year 2000 due diligence processes used by these institutions may not be as extensive or formal as those in institutions whose customers may be more dependent upon information technology. Senior management should oversee the development and implementation of a due

diligence process which is tailored to reflect the Year 2000 risk in their institution's customer base.

Three major types of customers may expose a financial institution to Year 2000-related risks. They include funds takers, funds providers, and capital market/asset management counterparties.

Funds Takers

Funds takers include borrowers and bond issuers that borrow or use bank funds. Failure of fund takers to address Year 2000 problems may increase credit risk to a financial institution through the inability of fund takers to repay their obligations.

Funds Providers

Funds providers provide deposits or other sources of funds to a financial institution. Liquidity risk may result if a funds provider experiences a Year 2000-related business disruption or operational failure and is unable to provide funds or fulfill funding commitments to an institution.

Capital Market/Asset Management Counterparties

Capital market and asset management counterparties include customers who are active in domestic and global financial markets. Market trading, treasury operations, and fiduciary activities may be adversely affected if a financial institution's capital market and asset management counterparties are unable to settle transactions due to operational problems caused by the Year 2000 date change.

GENERAL RISK CONTROL GUIDELINES

By June 30, 1998, financial institutions should establish a process to manage the Year 2000 risks posed by its customers. The process should: (1) identify material customers; (2) evaluate their Year 2000 preparedness; (3) assess their Year 2000 risk to the institution; and (4) implement appropriate controls to manage and mitigate their Year 2000-related risk to the institution. The assessment of individual customers' Year 2000 risk and their impact on an institution should be substantially completed by September 30, 1998. Year 2000 issues related to data exchanges between the institution and customers should be addressed as a part of an institution's internal Year 2000 project management program.

Identify Material Customers

Management should identify customers that represent material risk exposure to the institution, including international customers. Material risk exposure may depend on:

- Size of the overall relationship;
- Risk rating of the borrower;
- Complexity of the borrower's operating and information technology systems;

- Customer's reliance on technology for successful business operations;
- Collateral exposure for borrowers;
- Funding volume or credit sensitivity of funds providers; and
- Customer's dependence on third party providers of data processing services or products.

Assess Preparedness of Material Customers

The impact of Year 2000 issues on customers will differ widely. Smaller financial institutions may find that most of their material borrowers use either manual systems or depend on commercial software products and services. The evaluation of Year 2000 preparedness for these customers will be less involved and may not require additional risk management oversight. To ensure consistent information and a basis for comparisons among customers, management should address the following.

- Train account officers to perform a basic assessment of Year 2000 risk of customers.
- Develop a standard set of questions to assess the extent of a customer's Year 2000 efforts. Appendices A - D contain samples of forms some financial institutions use to evaluate customer Year 2000 preparedness. Financial Institutions are not required to use these forms, although they provide useful examples of methods to evaluate customer preparedness.
- Update the status of a customer's Year 2000 efforts periodically, but at least semi-annually. For customers that represent significant Year 2000 exposure to the institution, quarterly updates may be necessary.
- Document Year 2000 assessment conclusions, subsequent discussions, and status updates in the institution's customer files.

Evaluate Year 2000 Risk to the Institution

After identifying all customers representing material Year 2000 risk and evaluating the adequacy of their Year 2000 programs, management should assess the Year 2000 risk posed to the institution by these customers, individually and collectively. Management should determine whether the level of risk exposure is high, medium, or low. Management also should provide quarterly updates to the board of directors on customers that are not addressing Year 2000 problems effectively and discuss the actions taken by the institution to control the risk.

Develop Appropriate Risk Controls

Once the institution has evaluated the magnitude of Year 2000 risk from its customers, management must develop and implement appropriate controls to manage and mitigate the risk. Senior management should be active in developing risk mitigating strategies and ensure that effective

procedures are implemented on a timely basis to control risk.

SPECIFIC RISK CONTROL GUIDELINES

The specific risk controls an institution implements will vary depending on the size of the institution, its risk appetite and culture, the complexity of customers' information and operating systems, and its own level of Year 2000 risk exposure. Different risk management controls may be needed to address unique and material Year 2000 issues that arise from business dealings with different categories of customer.

Funds Takers

An institution's Year 2000 risk management controls for funds takers should focus on limiting potential credit risk by ensuring that Year 2000 problems do not prevent a borrower or bond issuer from meeting the terms of its agreements with the institution. Controls to manage an institution's exposure to its funds takers should address underwriting, documentation, credit administration, and the allowance for loan and lease losses (ALLL). These same factors also should be considered, where appropriate, when evaluating risk posed by an institution's capital market and asset management counterparties.

Underwriting

During any underwriting process, management should evaluate the extent of the borrower's Year 2000 risk. Specifically, management should:

- Ensure that underwriters are properly trained and have sufficient knowledge to perform a basic assessment of Year 2000 customer risk. There are a number of resource materials available that will assist in informing lenders of Year 2000 issues. State and national trade associations have prepared materials to assist lenders in understanding customer risk created by the Year 2000. Additional information is available on the Internet and can be located by searching on the words "Year 2000".
- Evaluate whether Year 2000 issues will materially affect the customer's cash flows, balance sheet, or supporting collateral values. As a part of the assessment and based on materiality, management should consider the complexity of the customer's operations; their dependence on service providers or software vendors; the extent of management oversight of the Year 2000 project; the resources the customer has committed to the project; and the date the customer expects to complete Year 2000 efforts.
- Control credit maturities or obtain additional collateral, as appropriate, if credit funding is

to be continued for high-risk customers.

□ Documentation

Proper loan documentation provides an effective means to monitor and manage the Year 2000 risk posed by borrowers. Loan documents should reflect the degree of risk posed by customers. Institutions should consider incorporating some or all of the following into loan agreements:

- Representations by borrowers that Year 2000 programs are in place;
- Representations that borrowers will disclose Year 2000 plans to the lender, provide periodic updates on the borrower's progress of the Year 2000 program, and provide any assessment of the borrower's Year 2000 efforts conducted by a third party;
- Audits that address Year 2000 issues;
- Warranties that the borrower will complete the plan;
- Covenants ensuring that adequate resources are committed to complete the Year 2000 plan; and
- Default provisions allowing the lender to accelerate the maturity of the debt for non-compliance with Year 2000 covenants;

□ Credit Administration

After the initial assessment, ongoing credit administration provides the best opportunity for an institution to manage Year 2000-related customer risk. Periodic credit analyses, which should include an update of the customer's Year 2000 efforts, can help to monitor a borrower's Year 2000 efforts. When performing credit analyses, loan officers should determine whether a customer's Year 2000-related risk merits an adjustment to its internal risk rating.

□ ALLL Analysis

Management's review of the adequacy of loan and lease loss allowances should include Year 2000 customer risk. When Year 2000 issues adversely impact a customer's creditworthiness, the allowance for loan and lease losses should be adjusted to reflect adequately the increased credit risk. Additionally, management's analysis of loss inherent in the entire portfolio should reflect Year 2000 risk.

Funds Providers

Management should consider the potential effect on an institution's liquidity by assessing the potential for unplanned reductions in the availability of funds from significant funding sources that have not taken appropriate measure to manage their own Year 2000 problems. Management should develop appropriate strategies and

contingency plans to deal with this potential problem.

- Risk Assessment of Funds Providers
As with funds takers, management should discuss Year 2000 issues with significant funds providers, evaluate their Year 2000 readiness to the extent possible, and assess the Year 2000-related risks posed by the providers. Management should be aware of concentrations -- including concentrations in any single currency -- from an individual provider or group of providers that may not be Year 2000 ready.

- Contingency Planning
The risk assessment of major funds providers' Year 2000 readiness should be incorporated into an institution's liquidity contingency plans. As with other contingency planning processes, management should evaluate its exposure and potential funds needs under several scenarios that incorporate different assumptions about the timing or magnitude of funds providers' Year 2000 -related problems. Institutions with significant funds flows in different currencies may need separate contingency plans for each major currency.

Although the liquidity risks from funds providers' Year 2000-related problems are similar to other "event risks" that institutions address in their liquidity contingency plans, Year 2000-related liquidity risks differ because the date of this event is known in advance. As a result, institutions may be better able to plan for and mitigate potential liquidity risks. For example, institutions may be able to reduce potential liquidity risks by extending the maturity of their advances under funding lines sufficiently past January 1, 2000, to provide time to assess and evaluate the effect of the Year 2000 on its funds providers. Maintaining close contact with funding sources throughout this potentially difficult period can provide management with timely, market sensitive information and thus allow for more effective liquidity planning.

Capital Market and Asset Management Counterparties

The focus of the controls for an institution's exposure to Year 2000-related problems in capital markets and among counterparties mirror those needed for funds takers and funds providers. Potential Year 2000-related problems with capital market participants range from a counterparty's failure to complete a securities transaction or derivatives contract settlement to, in extreme cases, the failure of the counterparty itself. A counterparty failure could lead to the total loss of the value of the payment or contract. A counterparty's failure to settle a transaction could cause the institution unexpected liquidity problems, which in turn could result in the failure of a financial

institution to deliver dollars or foreign currencies to its counterparties.

In addition, Year 2000-related problems among fiduciary counterparties could prevent a financial institution from fulfilling its fiduciary responsibilities to protect and manage assets for fiduciary beneficiaries. A counterparty's failure to remit bond payments, fund employer pension contributions or settle securities transactions could increase the institution's fiduciary risk.

□ Risk Assessment of Counterparties

As part of a sound due diligence process, management should identify and discuss Year 2000 compliance issues with those counterparties which represent large exposures to the bank itself and to fiduciary account beneficiaries. Financial institutions should evaluate counterparty exposure and develop risk reducing action plans to help manage and control that risk.

□ Risk Reduction Plans

In cases where institutions are not fully satisfied that their counterparties will be Year 2000 ready, management should establish mitigating controls such as early termination agreements, additional collateral, netting arrangements, and third-party payment arrangements or guarantees. In cases where management has a high degree of uncertainty regarding a counterparty's ability to address its Year 2000 problems, the institution should consider avoiding transactions with settlement risk after January 1, 2000. As noted earlier, the interest rate effect of material mismatches of funding, or maturity, should be evaluated as maturity and settlement risk is adjusted. The financial institution should not resume normal transaction activities until the counterparty has demonstrated that it will be prepared for the Year 2000.

CONCLUSION

Financial institutions face significant internal and external challenges from Year 2000-related risks posed by their customers. The concepts and guidance in this interagency statement are designed to assist institutions in developing appropriate risk controls. The FFIEC recognizes that risk management procedures may vary depending on the institution's size, its risk appetite and culture, the complexity of its customers' information systems, and its own Year 2000 risk exposure. While these differences will affect the risk management practices developed by management, it is essential that financial institutions identify, measure, monitor and control Year 2000-related risks posed by funds providers, funds takers, and capital market/asset management counterparties.

Appendices (4)