INTRODUCTION

Mr. Chairman and Members of the Committee, thank you for this opportunity to discuss the Office of Thrift Supervision’s (OTS) Year 2000 examination efforts.

As we draw closer to the rollover date, I am pleased to report that the thrift industry continues to make strong progress toward minimizing disruptions to its business and customer relationships that could be caused by Year 2000 problems. While this effort is by no means complete, progress to date gives us confidence that the thrift industry’s transition to the next century will be smooth and any problems that might arise will be addressed promptly. Our steady examination presence has enabled us to identify those institutions that are having difficulties, and we have, and will continue to use our supervisory and enforcement powers to get them back on track.

But we must also acknowledge the positive response by the industry to the Year 2000 challenge, and the serious approach it is taking to address potential problems. No banking issue in recent memory has gotten this much sustained attention from industry leaders. And the concerted and cooperative effort by regulators, industry leaders, trade groups, and the Congress on the Year 2000 is unmatched.

Pursuant to the Year 2000 Information and Readiness Disclosure Act (Public Law 105-271, October 19, 1998), this document is a Year 2000 Readiness Disclosure.
My testimony today focuses on our examination efforts and results, details industry progress, comments on Year 2000 liability legislation, and offers some observations about the critical issues that we must face together in the coming months. An attachment to this testimony provides detailed answers to the questions posed in your invitation letter.

OVERVIEW

Examination Efforts

The centerpiece of our Year 2000 program is examining the thrifts we regulate and the service providers they depend on. Our efforts have been steady, progressive and consistent. We began addressing Year 2000 matters in 1995 at examinations conducted by our Information Technology (IT) examiners. We greatly expanded our examination efforts in 1997 to include all thrifts regardless of their IT environment. Since then, we have completed at least three examinations of all of the thrifts we regulate. Our Year 2000 examination program has been expanded over time to address Year 2000 issues such as credit and liquidity risk in addition to matters more directly related to the renovation or replacement of computer code and equipment.

Between June 1, 1997, and March 31, 1999, we conducted over 3,700 Year 2000 examinations of thrifts, and our IT examiners led or assisted on 300 examinations of service providers and software vendors. In 1998 alone, over 300 OTS employees worked on Year 2000 examinations or provided support services for those examinations; those individuals reported spending almost 100,000 hours, excluding travel, on Year 2000 assignments.
Industry Progress

We have seen real progress in the industry’s preparations for the Year 2000 over the last two years. We were somewhat disappointed at the start of our first round of examinations, in May and June of 1997, to discover that the Federal Financial Institutions Examination Council’s (FFIEC) initial Year 2000 paper, which we had distributed the summer before, had not had the desired impact on the industry. Many of the thrifts we regulate had either not undertaken a Year 2000 project or had done superficially. Most of those thrifts were able to put an adequate plan in motion prior to the September 30, 1997, target date, but at 15 percent of the companies, plans were incomplete or unsatisfactory or other concerns emerged during our initial off-site analysis. During the first few months of our second round of examinations, a similar pattern emerged. Most thrifts had continued to properly address Year 2000 matters, but there appeared to be a small group – again about 15 percent of the industry – that was not taking the necessary steps. However, by the spring of 1998, we began to see improvement across the board.

By August 1998, the percentage of thrifts not making sufficient progress toward Year 2000 readiness to merit a “Satisfactory” Year 2000 examination rating had dropped to 6 percent. Since then, the percentage of the industry receiving “Satisfactory” Year 2000 examination ratings has not dropped below 94 percent. By March 31, 1999, we had completed Round 3 examinations at all our thrifts. At the time of these examinations, conducted between August 1998 and March 1999, most renovations and upgrades had been completed or were proceeding on schedule. Testing with primary and secondary service providers was well underway, and while much work remained to be done on contingency planning, thrifts were developing such plans. Almost all thrifts had implemented consumer awareness programs. Credit assessments appear to be effective, with Year 2000 credit risk remaining relatively low in the industry.
The high level of satisfactory ratings reflects the thrift industry’s commitment to properly prepare for Year 2000 so they can continue to provide normal services to their customers without disruption and without any deterioration in data integrity and access to funds. This commitment is found across the board, in all parts of the country, both urban and rural, in small institutions and large, and regardless of whether the institution writes its own computer programs, runs programs licensed from vendors, or relies on the data services of a provider. Examinations conducted at service providers and software vendors used by thrifts show similarly encouraging results.

**Collaboration and Cooperation**

It has been OTS’s position throughout the Year 2000 era that the financial services industry, its service providers, software vendors, and trade organizations, and the regulators should work together to make the transition into the next millennium an electronic nonevent, with minimal disruptions to the timeliness and quality of the services financial institutions provide to their customers. Accordingly, OTS has focused its energies beyond straight-forward examination and enforcement of Y2K compliance. We also work with the institutions we regulate, on an on-going basis, to increase Y2K awareness and preparation, both during on-site examinations and outside the examination process.

During examinations, examiners share insights gained from work in other institutions and encourage sharing of information among institutions regarding Y2K best practices. Outside the examination process, we host regional symposiums and small group meetings on areas of Y2K topical interest and speak about Y2K often. Our website has postings on Y2K seminar offerings, project tracking tools, review procedures and other educational materials that are available to anyone with access to the internet (www.ots.treas.gov). Included on the web page is an archive of past issues of the *MMillennium*, our Y2K newsletter (and first of its kind by a banking regulator), which
covers a wide range of topics. To enhance consistency and use resources efficiently, most of our outreach activities involve our fellow FFIEC regulators.

But the regulators are not the only participants in the process. We meet regularly, both individually and with our fellow regulators, with trade associations to promote regulatory guidance and best practices. The feedback we have received suggests that the industry sees us as firm, but also fair, in supervising its Year 2000 preparation.

Congressional Help

Congress has also helped by keeping the pressure on, responding to our needs, listening to our concerns, and assisting in our educational programs. Chairman Leach, I want to thank you and the members of this Committee for your leadership and continuing focus on the Year 2000 challenges facing the federal banking agencies and the financial institutions we regulate. You have invested considerable time and effort on this issue, and your contributions to this important matter are much appreciated. I especially appreciate your agreeing to speak at the Summit on Contingency Planning and Customer Awareness this Thursday. I would also like to thank you and your colleagues for securing passage of the Examination Parity and Year 2000 Readiness for Financial Institutions Act (Public Law 105-164), which is particularly important to our continuing efforts to prepare depository institutions and their service providers for Year 2000 readiness.

Crucial Period – Public Confidence

We are moving into yet another crucial period, with public confidence taking center stage. It is critically important not to fool the public with overly optimistic assurances; at the same time, it does no good to scare the public. The confidence that deposit insurance brings to the table cannot be underestimated. No matter what happens, the public must be reminded that its money is safe in an insured bank or thrift and that moving large sums of cash to the mattress is financially foolish and potentially physically dangerous. It is also critically important that the media not exacerbate public concern with
hyped-up negative stories that undermine public confidence and increase the possibility of panic, potentially leading many to take actions that may be unnecessary and harmful to individual customers and the financial system. When we have become aware of erroneous information regarding Y2K in press accounts, we have joined with the other regulators to correct the errors. We also have been discussing our Y2K efforts with reporters to educate them about our activities and the progress of the industry. We are continually seeking opportunities to discuss Year 2000 issues in the media in order to educate the press and the public.

While the ultimate responsibility for maintaining customer confidence rests with individual financial institutions, the federal regulatory agencies recognize we have a responsibility in this area as well and can play an important role in helping the industry we regulate maintain customer confidence. One good example of the proactive stance we are taking in this regard is the Summit on Contingency Planning and Customer Awareness that OTS and the Office of the Comptroller of the Currency will be jointly hosting two days from now for roughly 80 trade associations that are members of The Financial Sector Group of the President’s Council on the Year 2000 Conversion. At the Summit, examples of effective customer communications programs will be discussed in detail so financial industries can share best practices in this area. The agencies will also distribute a customer checklist at the Summit that will help customers of financial institutions take constructive steps to prepare themselves for the millennial rollover.

OTS, on its own as well as in concert with other banking regulators, is expanding communications about the state of readiness of the industry we regulate. Our purpose is to provide added assurance to customers and the general public that the industry is progressing toward the goal of being ready, on time, for the Year 2000 rollover. The agencies believe that we have a solid, factual story to tell -- currently built around the theme of validating the industry’s state of readiness by going into every institution to examine and rate its progress. We plan to increase our communications efforts as the year progresses.
We realize, and repeatedly remind the institutions we regulate, that neither we nor they can disclose the Y2K examination rating of any institution. But we do urge them to mount a comprehensive communications program targeted to all their customers to explain the steps they have taken, the results of their efforts, what services will be provided to address customer questions and concerns, and how customers can stay in touch with the institution.

OTS officials have been spreading the word about Year 2000 preparations at every opportunity – in speeches, interviews and other appropriate channels. We view communication about our Y2K examination efforts as crucial to building and maintaining customer confidence and key to deflating customer concerns and avoiding customer panic.

Collectively, through the continued efforts of individual institutions, the cooperative efforts of the regulatory agencies and trade associations, and with the help of the media to cover the positive progress the industry is making as well as problems that arise, we should be able to maintain the confidence the public has come to expect in our financial institutions.

**INDUSTRY PROGRESS**

**Examination Approach**

Examining the institutions we regulate to determine and evaluate their progress is the most important aspect of our Year 2000 work. We began addressing Year 2000 matters at Information Technology (IT) examinations in 1995 of thrifts with in-house computer programming and of third-party service providers. In 1996, we worked with the other federal banking agencies that are members of the Federal Financial Institutions Examination Council (FFIEC) to develop an initial Year 2000 guidance paper for banks, thrifts, credit unions, and their examiners. We greatly expanded our Year 2000
examination scope in 1997 and will continue to monitor preparations by the thrift industry and those firms that provide data services and software until critical Year 2000 issues are satisfactorily resolved and thrifts have successfully gotten past the calendar rollover.

The goal of our Year 2000 examination program is to provide a reasonable basis for us to conclude that the industry we regulate is ready for the calendar year rollover, that any disruptions to its normal business services will be minimal and addressed immediately, and that any data corruption will likewise be minimal and promptly identified and resolved. The alternative -- that institutions may not be ready to provide normal business services to their communities -- is not acceptable.

Our approach to Year 2000 examinations recognizes the huge commitment in resources and time required for financial institutions to properly prepare to transition into the next millennium. There simply is no quick fix to Year 2000. Thrifts have needed to identify all of the items\(^1\) that could be affected by Year 2000 problems, determine whether and how to renovate or replace items that would be adversely affected, prioritize their efforts, and monitor their own remediation efforts and those of their service providers and software vendors. Beyond the testing that is performed hand-in-hand with renovation, there are several other levels of testing that must be planned and orchestrated by the thrift’s Year 2000 team and evaluated by an independent party. In addition, thrifts have needed to prepare and test contingency plans to help them deal with any difficulties related to the Year 2000 transition that could arise. Concurrent with all of these tasks, thrifts have needed to address other risks that may arise due to Year 2000 matters and to communicate with their customers.

Our task has been and remains to monitor, and where needed, prod the thrift industry, and those third parties that provide electronic data services and software to it, to ensure enough momentum is maintained that they are ready for the calendar rollover well

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\(^1\)“Items” is used here to refer to systems, applications, reports, hardware, software, operating systems, networks, elevators, vault doors, and anything else used by the institution to conduct its business.
before it occurs. We require that they complete their preparations early enough to reassure their customers and thus retain their trust. We have taken action to successfully accelerate the pace of preparation by those relatively few thrifts that have fallen behind thus far.

We have performed our monitoring by periodically checking on progress. To date, we have conducted three rounds of examinations, each focusing on different phases of Year 2000 preparations. During the summer and fall of 1997, we conducted 1,211 off-site examinations of thrifts. Examiners carefully reviewed Year 2000 action plans and other materials provided by thrift management to ascertain the degree of industry awareness of potential calendar rollover problems and the adequacy of institution Year 2000 planning. This round focused on the Awareness and Assessment phases of the FFIEC’s 5-phase program guidelines for Year 2000 compliance set forth in its May 1997 policy statement. We followed the 1997 off-site examinations with a round of on-site examinations that further pursued Awareness and Assessment matters, but also addressed Renovation, the third Year 2000 project management phase. Between November 1997 and June 1998, we performed 1,181 examinations for that round. After additional training for our examiners, we started another round of on-site examinations in August 1998. That round, which we just concluded March 31, 1999, focused on Validation, the fourth and most critical Year 2000 project management phase, but also emphasized contingency planning, and corresponded to FFIEC’s Phase II. During this round, we conducted 1,132 additional on-site examinations of thrifts. Most of our Phase II examinations were preceded by an off-site review of testing plans.

At some thrifts, we also perform shorter, targeted Year 2000 examinations, commonly referred to as field visits. Most of these examinations are designed to closely

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2 We examined all of the thrifts we regulate in each round. The smaller number of examinations reported for Round 2 (vs. Round 1) represents mergers and conversions to bank charters in excess of new thrift charters.

3 Again, the fact that a smaller number of examinations is reported for this round than for previous rounds reflects the factors mentioned at Footnote 2.
follow up on the efforts of institutions to correct weaknesses or deficiencies noted at our regular Year 2000 examinations. Such follow-up examinations are required at thrifts receiving less-than-satisfactory Year 2000 ratings. In other cases, the institution’s Year 2000 plans and efforts are acceptable, but our regional offices made the determination that additional on-site examination work was appropriate due to unusual complexities in the institution’s IT environment or other factors. Through March 31, 1999, we had conducted 190 targeted Year 2000 examinations covering institutions with weaknesses identified in Phase I or Phase II examinations or otherwise selected by our regional offices.

Our approach to examinations of service providers and software vendors is similar. The main difference between these examinations and those of thrifts is the degree of coordination with other FFIEC agencies. Because many service providers and software vendors have clients regulated by two or more of the banking agencies, examinations are jointly staffed, with one agency taking the lead or serving as Agency-in-Charge.

The interagency approach is especially active at Multiregional Data Processing Servicers (MDPS) and major software vendors. MDPS data centers are large multiregional data processing servicers that would pose a systemic risk to the financial services industry should one or more of them fail. The major software vendors’ program includes firms that offer stand-alone customer software and integrated software packages that involve high risk applications for institutions, such as wire transfers, securities transfers, loans, deposits, and general ledger items. This group of companies provides a majority of the core data processing products and services used by the banking and thrift industries.

The interagency effort to examine and monitor these entities will ensure that (1) key service providers posing the greatest risks to the industry are successfully progressing toward Year 2000 readiness; (2) appropriate supervisory actions are taken to ensure Year 2000 readiness; (3) the Year 2000 efforts of these entities are consistently evaluated; (4) Year 2000 readiness information is shared among the regulatory agencies;
and, (5) examination findings of service providers are shared with their federally insured financial institution clients.

Between June and September 1997, our Information Technology (IT) examiners conducted initial off-site assessments of 16 national and regional service providers and software vendors, as then assigned by the FFIEC, plus 10 other such companies identified by our regional offices. Like the first round of our thrift Year 2000 examinations, the main focus was on Awareness and Assessment. We immediately moved on to on-site examinations and, by June 30, 1998, we had conducted Year 2000 examinations to review Renovation efforts at those national and regional companies assigned to us by the FFIEC as well as smaller regional and local companies that service only thrifts. We returned for another on-site examination, focusing on Validation but also emphasizing communications with financial institution clients. That round was completed December 31, 1998. In addition, we have and will continue to monitor progress and communications with clients through quarterly contacts with the service providers and software vendors. These contacts are conducted through brief on-site visits or by telephone. Throughout this entire period, June 1997 to March 1999, we have also assisted on examinations of service providers and software vendors where another agency is designated in-charge. Excluding the off-site or telephonic contacts, we have led or participated in 300 examinations covering Year 2000 matters.

We use both Safety and Soundness (S&S) examiners and Information Technology (IT) examiners in our Year 2000 examination program. The number of S&S examiners assigned to Year 2000 duty increased between the initial off-site examinations of 1997 and Phase II. Similarly, the training provided for all of the Year 2000 examiners was expanded with each round. For Phase II, we trained 170 S&S examiners and their supervisors and all of our IT examiners and managers. For our second and third rounds of examinations, we trained more S&S examiners than our workload projections suggested so that we would have additional resources to draw upon should problems have emerged in the industry.
In general, the IT team examines service providers, software vendors, thrifts with in-house programming, and other thrifts designated by the regions due to large operations or complex IT environments, while the S&S team examines serviced and turnkey thrifts or those thrifts that primarily rely on third parties for their electronic data processing or their software. The IT team is available for the S&S examiners to consult with, as needed.

We follow FFIEC strategy regarding the timing and focus of our Year 2000 examinations, and we use FFIEC examination work programs and training curricula as a foundation, supplementing those tools as we deem necessary. For example, to the core FFIEC training materials for Phase II, we added presentations on testing by a consultant and a trade group representative and sessions taught by our staff on accounting and enforcement matters related to Year 2000.

An important part of our examination approach is communicating with boards of directors. We expect directors to establish Year 2000 policies, provide sufficient resources, and monitor their institution’s Year 2000 efforts. By the end of April 1999, we will have issued at least three Year 2000 examination reports to the board of directors of each of the thrifts we regulate. Where deficiencies serious enough to cause a less-than-satisfactory examination rating are noted, we also meet in person with the directors.

It’s important to put this in perspective. Thrifts and banks are important to the nation’s economy and financial security. But so are utilities, telephone companies, and many other industries. No other industry has been subject to the collaborative and supervisory activity with respect to Year 2000 that thrifts and banks have. Yes, there are issues of judgment and differences of opinion, but this is a preventive effort of a scale never before attempted by a regulated industry and its regulators. We believe it will prove to have been justified and effective.
Examination Findings

Thrift Year 2000 examination results continue to be encouraging.

During our first two rounds of examinations – those conducted before June 30, 1998 – results were positive for most thrifts. By the fall of 1997, almost all thrifts had appointed a senior officer or committee to oversee their Year 2000 projects and most were performing the proper assessments of their systems and applications, were developing Action Plans, and had begun to monitor preparations by their vendors. The next round of examinations found that most thrifts were well into the Renovation phase. Thrifts with in-house systems and applications were making satisfactory renovation progress; those reliant on service providers and software vendors had significantly improved their oversight efforts and were obtaining information from those third parties that indicated satisfactory progress. Further, thrifts had begun, if not completed, assessments of credit risk arising from Year 2000 and had started customer awareness activities.

Nonetheless, during each of the first two rounds, initially approximately 15 percent had one or more deficiencies serious enough to result in less-than-satisfactory ratings or otherwise raise our concern4. Although a number of deficiencies were cited by the examiners – including incomplete Year 2000 action plans, inadequate monitoring of vendors, lack of understanding of interfaces and credit risk, and insufficient resources devoted to the Year 2000 project – the common underlying weakness at the 15 percent in question was lack of awareness and commitment by senior management and the board.

As round two progressed, the percentage of thrifts receiving less-than-satisfactory ratings declined. A combination of factors, including Congressional hearings, expanded examination and outreach activity by OTS, a series of advisories issued by the FFIEC, press coverage, and consumer awareness, all contributed to a heightened awareness of

4 We had not adopted an examination rating system for our first round of examinations. The 15 percent figure is derived from negative entries in our initial Year 2000 examination database.
Year 2000 risks. In addition, our announcement in April 1998 that thrifts receiving less-than-satisfactory Year 2000 examination ratings would be subject to supervisory follow-up, including possible formal enforcement actions, may have encouraged lagging institutions to step up their efforts.

Throughout Round 3, less-than-satisfactory Year 2000 examination ratings have never exceeded 6 percent. That 94 percent or more of the thrifts we regulate received Satisfactory ratings during their Round 3 examinations not only is a continuation of the trend noted above, but demonstrates the commitment the thrift industry has for a smooth transition into the next millennium.

By March 31, 1999, we had completed Round 3 (or Phase II) examinations at all our thrifts. At the time of these examinations, conducted between August 1998 and March 1999, most renovations and upgrades had been completed or were proceeding on schedule. Testing with primary and secondary service providers was well underway, and while much work remained to be done on contingency planning, thrifts were developing such plans. Almost all thrifts have consumer awareness programs. Credit assessments appear to be effective, with Year 2000 credit risk remaining relatively low in the industry.

As of March 31, 1999, OTS examiners had assigned Round 3 Year 2000 examination ratings to all of the thrifts we regulated; these ratings are summarized in the following table. As you can see, almost 96 percent of the number of thrifts OTS regulates, accounting for 97 percent of their total assets, were rated Satisfactory. Thrifts rated less-than-satisfactory represent less than five percent of the total number and less than three percent of total assets.

<table>
<thead>
<tr>
<th>SATISFACTORY</th>
<th>NEEDS IMPROVEMENT</th>
<th>UNSATISFACTORY</th>
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<tr>
<th>Asset Category</th>
<th>No.</th>
<th>$ Mil.</th>
<th>% to count</th>
<th>No.</th>
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<th>No.</th>
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<tr>
<td>Less than $100 Million</td>
<td>494</td>
<td>$24,921</td>
<td>95.6%</td>
<td>22</td>
<td>$ 1,076</td>
<td>4.3%</td>
<td>1</td>
<td>$    -</td>
<td>0.2%</td>
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<tr>
<td>$101 Million to $1 Billion</td>
<td>502</td>
<td>$142,334</td>
<td>96.5%</td>
<td>18</td>
<td>$ 5,395</td>
<td>3.5%</td>
<td>0</td>
<td>$    -</td>
<td>0.0%</td>
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<tr>
<td>More than $1 Billion</td>
<td>88</td>
<td>$616,001</td>
<td>92.6%</td>
<td>7</td>
<td>$16,182</td>
<td>7.4%</td>
<td>0</td>
<td>$    -</td>
<td>0.0%</td>
</tr>
<tr>
<td>Total</td>
<td>1084</td>
<td>$783,256</td>
<td>95.8%</td>
<td>47</td>
<td>$22,653</td>
<td>4.2%</td>
<td>1</td>
<td>$    -</td>
<td>0.1%</td>
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Percent by Assets

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<tr>
<td>Less than $100 Million</td>
<td>97.2%</td>
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<tr>
<td>$101 Million to $1 Billion</td>
<td>2.8%</td>
</tr>
<tr>
<td>More than $1 Billion</td>
<td>0.01%</td>
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Definitions of these interagency examination rating categories have been provided in earlier reports. In short, Satisfactory means that the institution has an acceptable Year 2000 Action Plan; is making satisfactory progress renovating, testing and implementing the items needed to attain Year 2000 readiness, as measured in part, against FFIEC milestones and guidelines; and is adequately managing other Year 2000 risks. This rating does not necessarily mean that the institution has already achieved Year 2000 readiness and should not be equated with a certification or guarantee of Year 2000 readiness.

Conversely, ratings of Needs Improvement and Unsatisfactory are not projections of likely failures. As noted elsewhere in this report, the overwhelming reaction of boards of directors and senior managers to adverse ratings is to devote sufficient additional attention and resources to promptly resolve the weaknesses noted by the examiners.

Reasons underlying the less-than-satisfactory ratings during Round 3 include the following:

- The need to expand test plan inventories and testing strategies;
- Meaningful testing not performed due to resolving problems in a recent conversion to a new service provider;
- Need to initiate or materially expand contingency plans;
- Need to initiate or expand customer awareness and related personnel training;
- Inadequate audit efforts; and
- Inadequate evaluation of credit risk.
We impose several types of informal enforcement actions on thrifts rated less than satisfactory. These include, at a minimum: (a) meetings between regional OTS staff and the boards of directors; (b) required board resolutions showing timelines for corrections of the deficiencies; (c) submission of monthly reports; and (d) follow-up examinations. They are also subject to formal enforcement actions.

**Phase II Examination Findings of Service Providers and Software Vendors**

There are 16 Multiregional Data Processing Servicers (MDPS) and 12 major software vendors supervised by FFIEC member agencies. OTS is lead agency on two national MDPS entities and two major software vendors. Overall corporate functions of these organizations are all rated Satisfactory, and Phase II examination reports are being distributed to client financial institutions. However, we are concerned that inadequate Year 2000 progress at one data center of a major service provider may cause its clients to miss Year 2000 testing deadlines as set forth in the April 10, 1998 FFIEC guidance and the October 15, 1998 Interagency Guidelines Establishing Year 2000 Standards for Safety and Soundness.

On March 30, 1999, the service provider in question entered into an agreement with OTS and other FFIEC agencies. Key provisions of that agreement are:

- All testing is to be successfully completed and implementation is to be substantially completed by June 30, 1999;
- The processing system is to be implemented into a production environment by July 11, 1999;
  - if not implemented by then, each financial institution serviced must be notified in writing; and,
  - any financial institution customers then wanting to convert to other service providers must be allowed to do so without financial penalty.
We are reasonably confident that this MDPS organization will meet the testing and implementation provisions of this agreement. We will monitor its progress closely.

OTS is also responsible for supervising 17 regional service providers. All of these entities are rated satisfactory. Follow-up reviews are conducted quarterly at all entities for which OTS has supervisory responsibility. One regional service provider rated Unsatisfactory during Phase I liquidated its assets, and all clients were successfully converted to other providers.

For the most part, the examiners’ findings reflect sound project plans, comprehensive status reports, active and effective oversight by senior management and the board of directors, timely completion of testing, proactive communications with customers, and adequate contingency planning either in the process of being developed or in place.

There are some common weaknesses identified by examiners among some service providers and software vendors. These weaknesses have varying degrees of risk depending on the organization. Examples of weaknesses include:

- the need for more frequent status reports;
- the need to develop or improve contingency planning and share such plans with client institutions;
- the need for greater involvement by the internal audit departments to ensure objectivity;
- lagging slightly behind or bumping up against internal and/or FFIEC milestones with regard to completion of testing, necessary hardware renovation at customer sites; or,
- delay in receiving upgraded software from the manufacturer.
As deficiencies are identified, examiners promptly communicate these concerns and required corrective action to senior management.

IT examiners closely monitor Year 2000 progress and management’s response to required corrective actions. At a minimum, quarterly reviews are conducted and the reports are shared with other regulators. A Year 2000 report is issued to clients when concerns are significant or a downgrade in the Year 2000 rating has occurred. Appropriate enforcement action is taken when necessary.

Supervisory Follow-up Efforts

The vast majority of thrift institutions share our view of the seriousness of the Year 2000 problem and are taking responsible steps to attain readiness. In those few instances where this is not the case, OTS will continue to promptly initiate appropriate informal and formal enforcement actions to address problems and weaknesses.

Our procedures require examiners to initiate supervisory follow-up whenever problems are detected or concerns arise. These include situations in which deficiencies or weaknesses are not material enough to cause a less-than-satisfactory rating to be assigned, but are, in the examiner’s judgment, important enough to bring to the attention of senior management and the board of directors. These matters are listed in the examination report as Matters Requiring Board Attention. Examiners follow up on them through progress reports from the institution, other contacts with management between examination rounds, or at the next examination, depending on the nature of the items.

More serious deficiencies result in examination ratings of Needs Improvement or Unsatisfactory. In March 1998, OTS adopted supervisory and enforcement guidance specifically dealing with institutions assigned Needs Improvement and Unsatisfactory Year 2000 examination ratings. Required follow-up activities for these ratings include meetings with the board of directors; board resolutions that include timelines for corrective
actions; the establishment of a board committee to oversee corrective actions; progress reports; and field visits. In August 1998, we modified this guidance to recognize the reduced time horizon remaining until the calendar date changeover by accelerating the due dates for field visits and the frequency of progress reports. We are again advancing the due dates for field visits for our next phase of Year 2000 examinations, and we will have diminishing tolerance for situations giving rise to less-than-satisfactory ratings.

These follow-up activities have been very effective. Many times, management initiates corrective action before the examiners leave the thrift.

During Round Two, 171 thrifts were initially rated less than satisfactory. Corrective action taken by management was sufficient in 161 cases for the examiner to upgrade the Year 2000 rating to Satisfactory at follow-up examinations. We have already started follow-up examinations for thrifts receiving less-than-satisfactory ratings during Round Three and these are showing similar results. That is, in most cases thrift directors and officers are promptly and effectively addressing the deficiencies noted by examiners. In some cases, the less-than-satisfactory Round 3 ratings appear to have mainly reflected a relaxation of management oversight of Year 2000 after a Satisfactory Round 2 examination. In those cases, the remedy – a refocusing of management oversight – has been relatively easy for the thrift to accomplish. However, we are concerned about the relaxation factor and will issue a reminder to the industry that management needs to sustain its efforts and oversight.

Although supervisory tools such as follow-up examinations have been effective, recognizing the shrinking time horizon before the Year 2000 changeover, we stand ready to use more formal enforcement tools for more serious deficiencies or for situations where management’s response is insufficient or untimely. If needed, we have issued and will pursue supervisory agreements, cease-and-desist orders, safety and soundness orders, and civil money penalties.
We are also using a new enforcement tool. In October 1998, OTS, the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Insurance Deposit Insurance Corporation (federal banking agencies) jointly published “Interagency Guidelines Establishing Year 2000 Safety and Soundness Standards” (Guidelines), along with the implementing interim rule, “Safety and Soundness Standards.” OTS incorporated these provisions in 12 C.F.R. Part 570. The Guidelines were issued pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act), which requires the federal banking agencies to establish operational and managerial standards for insured depository institutions relating to, among other things, information systems. Section 39 also authorizes the federal banking agencies to require institutions that fail to meet such standards to submit corrective Safety and Soundness Compliance Plans. The Guidelines were distilled from previously issued FFIEC guidance papers on important aspects of Year 2000 readiness and were effective October 15, 1998.

For two of the three most recent cases where we assigned Unsatisfactory Year 2000 examination ratings, we issued Part 570 Notices of Deficiencies. The two thrifts submitted acceptable Compliance Plans that specified the steps they were to take to correct the deficiencies noted in the Report of Examination. These institutions were upgraded to Satisfactory ratings at later follow-up examinations, but both will continue to operate under the plans until their contingency plans, which are not required to be complete under FFIEC guidelines until June 30, 1999, are deemed acceptable. If the Compliance Plans submitted by these thrifts had not been acceptable, the OTS would have issued Part 570 Safety and Soundness Orders pursuant to 12 U.S.C. § 1831p-1(e)(2) and 12 C.F.R. § 570.3(d). Similarly, if either thrift fails to develop a satisfactory Contingency Plan or had otherwise failed in any material respect to implement its Compliance Plan, the OTS would then have grounds to issue an order requiring the thrift to correct the deficiency(ies).
The third institution rated Unsatisfactory has executed a supervisory agreement and will remain under the agreement until Satisfactory Year 2000 performance is achieved and maintained.

An Unsatisfactory Year 2000 examination rating is not a prerequisite for the use of a Part 570 Notice or for the use of formal enforcement tools such as supervisory agreements. Regional offices may recommend their use at thrifts receiving Needs Improvement Year 2000 examination ratings. Similarly, a Needs Improvement or Unsatisfactory Year 2000 examination rating is not a prerequisite for a follow-up examination or other informal enforcement tools. For example, we have frequently used supervisory directives and sometimes used follow-up examinations at Satisfactory thrifts and we have issued a Part 570 Notice at one Needs Improvement thrift.

Enforcement is a tool, not a goal. It is in the mutual interest of the agency, the industry, and the general public for institutions to promptly acknowledge and address weaknesses disclosed through examinations without elevating the situation to enforcement or litigation. To date, our experience with thrifts rated less than satisfactory has been positive. Nonetheless, OTS remains poised to take quick action to address Year 2000 problems and weaknesses.

**Treasury IG Findings**

The Office of Inspector General (OIG), United States Department of the Treasury, recently issued its report of the audit it began in December 1998 of OTS’s Year 2000 examination program. The audit specifically addressed OTS’s supervisory efforts at federally insured thrift institutions under Phase II of the FFIEC’s Year 2000 supervision program. We are pleased that the OIG’s report concludes that: ‘OTS’ Y2K examinations are generally being conducted in accordance with the FFIEC guidance. OTS enforcement actions are stimulating progress toward Y2K readiness for those thrift institutions that have not made adequate prior progress. In addition, OTS staff are knowledgeable about
Y2K and are sharing their knowledge with the thrift industry. We would like to commend OTS for its efforts to date.”

The report continues “(A)s with any effort, improvements can be made as the industry moves even closer to the new millennium” and then presents four suggestions for OTS’s Year 2000 examination process. These suggestions relate to continued monitoring of our examination process, including examination scope and quality; guidance to supplement FFIEC guidelines for assigning Year 2000 ratings; consistency of supervisory enforcement actions; and timeliness of quality assurance reviews and feedback to examiners. As further noted in the OIG report, OTS has already acted on some of these suggestions and is considering the others.

OIG had projected that OTS might fall short of meeting the March 31, 1999, goal for completion of Phase II examinations. The examination shortfall projected by the OIG did not materialize, as our regional offices were able to complete all of the examinations by the FFIEC’s target date, without having to cut back on hours, scope or quality. To further assure that the late Round 3 (Phase II) examinations were not adversely affected by staffing or time pressures, the national office supplemented normal regional review processes.

OTS is consulting with the other FFIEC agencies on ratings guidance for examiners. While we expect to somewhat narrow the guidelines, we continue to believe that examiner judgment in general and the examiner’s assessment of thrift management in particular are important factors in any rating system. We will not rely solely on rigid measures. We will provide additional direction to our examiners regarding appropriate supervisory actions. As noted in the OIG report, OTS does have quality assurance coverage of Year 2000 examinations. The short duration of each examination round creates special challenges, but, going forward, we will make an extra effort to provide earlier feedback to our examiners.
Continued Industry Oversight

OTS is committed to monitoring preparations by the industry we regulate and those firms that provide data services and software to it until critical Year 2000 issues are satisfactorily resolved and thrifts have successfully gotten past the calendar rollover. Working with our regional offices, including senior management there, we have developed a risk-focused examination strategy for the remainder of this year.

Our Phase III strategy, which goes into effect April 15th, consists of on-going off-site monitoring and will involve at least one examination (off-site or on-site) and at least one other contact with the institution by year-end.

The Phase III examinations will follow up on open matters remaining from our Phase II examinations. These open matters include required corrective actions that relate to deficiencies or weaknesses noted by the examiner, as well as Year 2000 tasks that were not complete at the Phase II examination. Phase III examiners will especially focus their review on successful completion of testing, any outstanding contingency plans, cash and liquidity planning and customer awareness activities. They will issue an examination report to the board of directors.

Regional offices are to determine what Year 2000 information is needed from each institution and how best to obtain and review it. Most of these examinations will be conducted onsite or at the institution’s home office, but off-site examinations will be permitted at smaller, serviced thrifts where Year 2000 management is strong, if, as of the Phase II examination, (a) testing was complete, (b) satisfactory contingency plans had been developed, and (c) no other Year 2000 matters such as credit risk or fiduciary activities were subject to criticism.
Our approach will be risk-focused, with a streamlined report process to allow us to focus our resources and attention on the more pressing situations and on industrywide matters. More frequent and/or more in-depth examinations will be performed at thrifts with certain characteristics, particularly thrifts with in-house programming, in-house processing, or other complex IT environments.

As with our earlier Year 2000 examination phases, thrifts receiving less-than-satisfactory ratings will be subject to close supervisory monitoring. Recognizing the shrinking time horizon left until the New Year, the OTS has accelerated the time frames for follow-up examinations and status reports from those thrifts.

These examinations are to be completed by September 30, 1999, with earlier target dates for thrifts rated Needs Improvement or Unsatisfactory during Phase II; large thrifts; those with in-house programming, in-house processing, or other complex IT environments; those with other higher-than-average risk indicators such as high levels of credit risk or adverse CAMELS ratings; or as determined by regional offices.

OTS will continue to provide guidance to the industry through Chief Executive Officer (CEO) letters and articles in *MMillennium*. The last two issues of *MMillennium* included articles encouraging thrifts to increase their customer communications as set forth in the FFIEC release “Customer Communications Outline,” and discussed developing Year 2000 cash and liquidity plans. In addition, we use the agency’s website to communicate quickly with the industry and as a way for the industry to ask questions and provide us with information on its concerns.

As 1999 progresses, we will refine our strategy for Year 2000 industry oversight at the start of the new year. In general, the goal of our oversight then will be to determine that any operational disruption or data corruption is promptly and properly addressed by thrift management, with appropriate assistance of service providers and software vendors.
YEAR 2000 LEGISLATION

Congress has already helped considerably on the Year 2000 issue by passing two pieces of legislation – the Examination Parity and Year 2000 Readiness for Financial Institutions Act (Public Law 105-164) and the Year 2000 Information and Readiness Disclosure Act (Public Law 105-271). Further, these laws were passed at appropriate times. The Examination Parity Act was passed early in 1998 when the interagency Year 2000 examinations of service providers and software vendors were still in Phase I of our examination strategy. This law has now helped us directly on two occasions and may have served as a reminder or incentive for other service providers and software vendors to take timely Year 2000 actions for their benefit and that of their financial institution clients. The Disclosure Act was passed at about the time when meaningful information on renovation and testing had or was reaching a critical mass for valuable sharing of such data.

As further legislation is considered, we recommend that close attention be given to timing matters. In that vein, we believe that legislation providing relief or shelter from Year 2000 liability at this stage would be premature.

Intuitively, we all are cognizant of the likelihood of litigation arising from problems encountered at financial institutions after the Year 2000 rollover. There are too many entities gearing up for such a possibility for there not to be some litigation, whether warranted or not. There will likely be some disruptions attributable to Y2K where litigation is a legitimate means to address the problem. But we have not seen much evidence, at this time, to suggest that such litigious efforts relating to the thrifts we regulate would be significant or warranted.

The institutions we regulate are also aware of the potential cost and disruption that litigation could cause to their primary business activities. However, at only a handful of our Round 3 examinations was thrift management’s concerns about potential litigation
expressed in strong enough terms, if at all, to register in our examination database. Similarly, support for government action on this issue has not registered as a hot topic at outreach events with the industry. Thrift officers and directors recognize that litigation and liability are two-way streets; potentially they could be plaintiffs as well as defendants. Appropriately, the institutions’ directors and management teams have focused their energies and efforts on what they can control -- their internal systems -- as well as Y2K compliance of external software vendors and software providers providing mission-critical applications. This is not to say that they have ignored preparing for the adverse impact of litigation, just that they have put their strongest efforts into addressing the Y2K problem that they can control in the hope of minimizing any adverse impact from things that they cannot control.

Institutions are making their best efforts to address the problems posed by the Year 2000. These efforts are by no means complete. We do not advocate increasing liability relief at this time, as that may lead to some complacency and slackening of effort. Later in 1999, when we can better assess the likely impact of the few institutions and businesses that have not adequately addressed the challenges of Y2K, is the time to consider more comprehensive liability relief. It is important not to reward the minority of slackers at the potential expense of the majority of compliant businesses.

CONCLUSION

We are continuing to work toward a smooth transition for the calendar year rollover. This has been a multiyear effort, requiring significant financial and human resources. Success is dependent on good project management skills that address multiple tasks of various complexities at multiple interfaces over time. It not only involves financial institutions, but also service providers and software vendors. All have received multiple on-site reviews. Exam findings are encouraging, with the vast majority making satisfactory progress. Those that are not progressing as needed are under close scrutiny if not already subject to formal enforcement action.
Looking forward to Phase III, we will be focusing on all open matters, as well as testing results, contingency planning, cash/liquidity planning, customer awareness and implementation efforts.

In conclusion, from our perspective, no other industry has received more scrutiny, nor will any other be better prepared. Thank you.
INDUSTRY Y2K READINESS

1. A report on the number of institutions which met FFIEC standards for remediation and testing, including, to the maximum extent possible, preliminary findings on the number of institutions which met the December 31, 1998, and March 31, 1999, dates for “substantial” completion of testing internally and with outside service providers (note: please clarify what “substantial” means);

2. A report on the number of institutions which have failed to meet at least one of the key dates in the FFIEC’s Y2K guidelines and standards and what actions have been taken to ensure those institutions improve compliance with FFIEC standards.

Our most recent round of examinations was conducted between August 1, 1998 and March 31, 1999. In many cases, examinations preceded the key dates specified in your question. In particular, almost 90 percent of the entries in our examination database are for serviced institutions, or those thrifts that rely on one or more third parties for data processing and related services. FFIEC guidance for those thrifts indicates that testing with the service providers should be substantially complete by March 31, 1999. Field work for these examinations was concluded before March 31. Further, thrifts with in-house programming operations were examined before the December 31, 1998 milestone date for testing of internal mission-critical systems.

Scheduling Year 2000 examinations involves balancing many factors, including our need for information to fulfill our oversight responsibilities and the institution’s need to operate and proceed with Year 2000 preparations without unnecessary regulatory burden. It is neither feasible nor desirable for us to examine each thrift with the passage of each key FFIEC date, nor can we examine all thrifts at a single point in time. In developing our examination strategy, we determined that it was important to examine institutions ahead of the key FFIEC dates to provide a greater cushion of time to pursue corrective action should we discover that progress was lagging. At examinations performed prior to the milestone dates in question, Year 2000 examination ratings were assigned on the basis of
the thrift’s progress toward achieving the respective milestone. For a thrift to receive a Satisfactory, the examiner determined that as of the examination date the thrift had met, or was progressing in a manner indicating that in all probability it would meet, the FFIEC milestone for substantial completion of testing. Substantial completion is not defined by either the FFIEC or the OTS, but is a judgment by the examiner based on the volume and nature of work already completed compared to the total projected workload.

Nonetheless, our examination database enables us to measure conditions and trends within the thrift industry. The following six subsections summarize our examiners’ assessments of the Year 2000 progress being made by OTS-regulated thrifts in the areas of renovation, testing, contingency planning, customer awareness, credit risk and vendor management. While this data represents aggregate statistics, we found that the patterns presented held reasonably constant across the industry. That is, there are no significant deviations by asset size or by location.

**Renovation:** As of the dates of the examinations, Year 2000 renovations were complete at 38.2 percent of the thrifts and nearly complete at 57.3 percent. Because many of these examinations were conducted before the December 31, 1998 target date for renovation, examiners were also asked to rate renovation progress according to the thrifts’ Action Plans as well as the FFIEC target date. The results there were similar, with 95.3 percent being on schedule, ahead of schedule, or already completed. The examiners also reported that 91.2 percent of the items requiring renovation had been renovated by the thrifts or their service providers and software vendors.

Round 3 data in our database as of March 31, 1999, indicates that thrift management had identified over 13,000 mission-critical items (systems, applications, programs, pieces of equipment, etc.) that they or a third party needed to renovate (or replace), test and implement into production. As of the examinations, the status of these items was:
<table>
<thead>
<tr>
<th>Year 2000 Stage</th>
<th>No. of Mission Critical Items</th>
<th>Percentage to Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Renovation in Early Stages</td>
<td>220</td>
<td>1.6%</td>
</tr>
<tr>
<td>Renovation Well Underway</td>
<td>982</td>
<td>7.2</td>
</tr>
<tr>
<td>Testing in Early Stages</td>
<td>1,875</td>
<td>13.7</td>
</tr>
<tr>
<td>Testing Well Underway</td>
<td>3,051</td>
<td>22.3</td>
</tr>
<tr>
<td>Testing Complete (not implemented)</td>
<td>1,145</td>
<td>8.4</td>
</tr>
<tr>
<td>Implemented</td>
<td>6,397</td>
<td>46.8</td>
</tr>
<tr>
<td>Total</td>
<td>13,670</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Most of the 8.8 percent of nonrenovated items relate to examinations preceding the December 31, 1998, FFIEC target date for completion of renovation. (Over a third (35.5%) of the database entries summarized for this report relate to examinations between August and mid-December 1998.)

Our examinations did not detect any widespread concerns or adverse patterns regarding renovation progress on hardware, operating systems, applications, or other items covered by the industry’s Year 2000 Action Plans. Two items identified somewhat more frequently than average were ATMs (4.1%) and interfaces (3.7%). The identification of those two items largely reflects uncertainty or lack of knowledge and is expected to be dispelled as more external testing and testing with third parties occurs. We will continue to monitor these situations so we can alert the industry and adjust our program should the concerns not be dispelled soon.

**Testing:** FFIEC has issued a target date of June 30, 1999, for completion of testing, with earlier target dates for certain types of testing. Internal items were to have been tested by December 31, 1998, with later target dates for testing by service provider clients and testing with external parties. The examiners rated thrifts’ testing plans and
efforts to date as satisfactory at 93.6 percent of the Year 2000 examinations included in
the database.

Most thrifts are testing directly with their service providers. Approximately 40
percent of the thrifts are engaged in proxy testing with other users or clients of service
providers and software vendors. This relatively low percentage, compared to the portion
of thrifts that theoretically were eligible to participate in proxy testing, and the fact that
many of the thrifts engaged in proxy testing conduct supplemental non-proxy testing,
suggest that thrifts are approaching testing cautiously. Testing has exposed problems with
renovated code, but the examiners reported only eight cases where problems revealed by
testing were deemed significant. These problems involved equipment at some institutions
and isolated applications or interfaces at others; none were deemed severe enough to raise
doubts about the institution’s ability to attain Year 2000 readiness.

**Contingency Planning:** Almost all thrifts were developing contingency plans at the
time they were examined, but at least 23 percent of those plans were deemed to need
improvement. Recognizing the financial industry’s need for additional advice, in
December 1998, the FFIEC issued a “Questions and Answers” document on Contingency
Planning. In addition to discussions of matters such as data retention, that document
provides a target date of June 30, 1999 for completion of contingency plans. In addition,
on behalf of the Financial Sector Group of the President’s Council on Year 2000
Conversion, the OTS and the Office of Comptroller of the Currency, will host a Summit
on April 15th that addresses contingency planning (and consumer awareness).

**Credit Risk:** With the majority of their assets mortgage-related, primarily loans to
homeowners, the Year 2000 credit risk of thrifts is systemically lower than for many
commercial banks. The vast majority (93.8 %) of the thrifts we regulate are assessing and
monitoring their credit risk arising from Year 2000. The loan portfolio mix of most of the
thrifts that had not completed their initial assessments would suggest relatively low levels
of Year 2000 credit risk, but all of these thrifts are being required to make reasonable
checks of that assumption, and to manage any Year 2000 risk that is identified. Only a relatively small portion of the thrift industry – approximately 1.6 percent – appears exposed to significant levels of Year 2000 credit risk. The majority of these thrifts were in the $100 Million to $1 Billion asset range; total assets for the group represented less than 1 percent of the assets for thrifts in our database. These thrifts are expected to take steps to mitigate this risk.

**Customer Awareness:** FFIEC guidance requires thrifts to develop customer awareness programs to respond forthrightly and honestly to inquiries from customers. Most thrifts understand the importance of communicating with their customers on important topics such as Year 2000 and are taking an active role. Fewer then 4.0 percent of the thrifts have not made some kind of effort to promote public awareness. Common steps taken to date include statement stuffers and newsletter articles, but some thrifts are also providing seminars or maintaining Year 2000 information on web sites. Thrift managers indicate they will become more active in the communications area as the year progresses.

**Vendor Management:** The vast majority (96.5%) of thrifts continue to effectively monitor the renovation, testing and implementation progress of their service providers and software vendors.

**Supervisory Follow-up:** Our procedures require examiners to initiate supervisory follow-up whenever problems are detected or concerns arise. These cases include deficiencies or weaknesses that are not material enough to cause a less-than-satisfactory rating to be assigned, but which, in the examiner’s judgment, are important enough to bring to the attention of senior management and the board of directors. These matters are listed in the examination report as Matters Requiring Board Attention. Examiners follow up on them through progress reports from the institution, other contacts with management between examination rounds, or at the next examination, depending on the nature of the
items. Our five regional offices have processes in place to monitor timely and proper completion of corrective actions by thrifts.

For deficiencies considered material enough to warrant a less-than-satisfactory rating, more intense regulatory oversight is required. OTS policy requires that the regional office meet with the boards of directors of all thrifts rated Needs Improvement or Unsatisfactory shortly after the examination. To demonstrate how seriously OTS views situations giving rise to less-than-satisfactory ratings, these meetings have typically involved the examiner-in-charge, the regional IT manager and other senior regional managers. At a minimum, the directors are required to establish a committee to oversee Year 2000 efforts and to adopt a board resolution committing to correct the noted deficiencies by a date that is acceptable to the OTS. They are then required to submit periodic progress reports to OTS and are re-examined at regular intervals until sufficient progress is noted to justify a rating of Satisfactory. In most cases, sufficient progress was, in fact, evident at the first follow-up examination following a less-than-satisfactory rating; in many cases, the corrective action was initiated before the examiners completed the examination giving rise to the less-than-satisfactory rating.

Many of the institutions assigned less-than-satisfactory ratings to date have missed a milestone. In other cases, the rating was more a reflection of the quality, or lack thereof, in an activity that was otherwise completed before a key date. Missing a milestone is not, in and of itself, sufficient to warrant a less-than-satisfactory examination rating. The FFIEC milestones are not absolute deadlines. When establishing the milestones, the agencies attempted to set a schedule that was ambitious, but realistic, and that provided some cushion of time after the milestone date to maintain customer confidence and to allow us to confirm that institutions were reasonably well poised to transition into the 21st century.

When milestones are missed, or it appears likely that an upcoming milestone will be missed, the examiner must evaluate its cause and significance. If the lapse is not
material and involves just a short period of time or a small portion of work, absent other adverse findings, a rating of Satisfactory would be acceptable. In most such cases, the institution would be required to confirm with us when the overdue work was completed. Should the confirmation not be forthcoming, the regional office would consider whether an off-site rating change or a field visit was needed.

The examiner must especially evaluate management’s ability and commitment related to Year 2000 preparations. When the industry has had to deal with other problems, we have found a close relationship between the quality of management and the likelihood that the institution will be able to satisfactorily resolve the issues. A similar pattern has emerged in the Year 2000 era.

We believe an examiner must consider not only an institution’s status at the time of the examination and but also other factors set forth in the FFIEC Year 2000 Rating Definitions, including, in particular, the examiner’s critical assessment of management’s ability to take corrective action. For example, under the FFIEC definitions, a rating of Satisfactory is not precluded where there are minor weaknesses that can be readily corrected within the existing project management framework, or where the institution is making reasonable, material progress toward satisfying the requirements of an upcoming milestone date. A Satisfactory rating is not precluded even when a milestone date was missed for legitimate, supportable, sensible, and practical reasons.

This is not an issue of blind trust. An examiner cannot simply assume management will correct deficiencies. Rather, the examiner must consider future expectations based on the nature and materiality of any deficiencies, management’s track record for correcting problems, and management’s resources and ability to effect corrective actions. The report of examination makes any deficiency known to the Board of Directors, and OTS vigilantly monitors the Board’s and management’s efforts to correct deficiencies. If the corrections are in fact not made in accordance with expectations, the rating will be downgraded.
3. The OTS’s methodology for ensuring that “satisfactory” ratings and the exam data on which they are based are accurate and consistent with FFIEC standards.

The OTS has considered the accuracy and consistency of ratings important since we started our Year 2000 examination process. We have taken several steps, including training and review processes, both regional and national, to advance that end. In addition, we developed and implemented a special form for examiners to complete at the end of each examination. This form leads the examiner in the direction of correct and consistent ratings.

Training provides the foundation for accurate and consistent ratings. Our 1997 Year 2000 training program was conducted separately by our regions, but used shared training materials so that each examiner was provided similar training. For Phase II examinations, we centralized training with examiners from all five regions mixed into the two training sessions. The training program utilized FFIEC training manuals and materials supplemented by agency specific materials and was conducted by OTS S&S and IT examiners who had attended interagency train-the-trainer courses. This centralized training approach was undertaken in large part to enhance consistency in our ratings. Presentations by the National Year 2000 Coordination Team stressed the need for accurate ratings, for early recognition of problems should those surface, and for responsible reporting to the Congress and the public.

Another contribution to consistency is that Year 2000 examinations are conducted by a cadre of examiners dedicated to this area. These examiners work full-time on Year 2000 matters, typically conducting several examinations per round. This allows them to develop a solid experience base on which to make the necessary judgment calls in assigning ratings.
Each OTS region has a Year 2000 examination review process to ensure consistency and quality. Examination work papers, reports and ratings are reviewed by the examiner-in-charge’s supervisor, who also received Year 2000 training, with an additional review by the regional office staff. This allows examinations and proposed ratings to be compared to other evaluations arising from similar examination results.

As part of the regional review process, a special OTS form completed by OTS examiners after each examination is reviewed in tandem with the examination report and rating. OTS developed and implemented a Year 2000 database questionnaire, entitled Internal Assessment Survey, to gather information from examinations and to provide supplemental guidance for examiners in assigning ratings. The survey data entry form covers the stage of completion for each phase of the Year 2000 process, target dates for completion of mission critical applications, the status of implementation, contingency planning, customer awareness, vendor due diligence, credit risk and foreign exposure.

The color-coded entry form was designed in July 1998 and presented to our examiners at Round 3 (Phase II) training sessions with instructions that red responses were the equivalents of red flags suggesting weaknesses that should be considered in assigning Year 2000 examination ratings. The color coding, along with the wording of the questions and responses in the database form, was designed to lead the examiner toward an appropriate rating. OTS used a similar approach in the database entry form for our Round 2 (Phase I) Year 2000 examinations. In simplest terms, it would not take many red responses to suggest that a less-than-satisfactory rating be strongly considered. In some cases, such as critically behind schedule for renovation, even one red flag would be enough for an Unsatisfactory rating. Over time, we update the red flags by migrating some positive or neutral answers to negative. We are, in addition, updating the database questions for on-going monitoring after March 31, 1999.
As mentioned above, the draft Year 2000 examination reports and ratings are reviewed in tandem with the data entry form, so that any apparent inconsistencies can be considered before the report is issued to the board of directors. The regional offices specifically review cases where database responses suggest a different rating than the examiner proposes. The National Year 2000 Coordination Team also generates exception or outlier reports from the database. Regional offices are required to check into the exceptions and report back to the team. Overview reports with highlights of positive trends and items of concern are shared regularly with the regions. The packages are also provided to regional staff and senior management.

The National Year 2000 Coordination Team provides additional oversight of the ratings process by occasional exercises to supplement the regional review process. Early in our second round of examinations, the national team worked with regional Quality Assurance staff to conduct an interregional review of work papers and reports, wherein each region looked at examinations from all five regions. Recommendations were provided to the examiners for consideration at the remaining examinations in that round and were then repeated in procedures for the following round. We provided each region with an examination review checklist covering each of the Year 2000 phases and other subjects to use in the examination review process. The national team also undertook a review of Satisfactory and Needs Improvement examination reports early in Phase II (Round 3). Findings were presented to the regional Year 2000 coordinators, who provided assistance to the examiners in preparing examination reports and assigning ratings on a consistent basis. Late in Round 3, the national team sampled additional reports and ratings to ensure that neither scope nor quality was adversely affected as the regions approached the March 31, 1999 target date for completion of Phase II.

We will continue to closely monitor the process of assigning Year 2000 examination ratings.
4. Any rebuttal OTS wishes to make to recent media reports on a Weiss Ratings, Inc., survey suggesting that about a third of banks and thrifts responding had missed a Y2K deadline.

We stand by our examination findings that show that the thrift industry is satisfactorily progressing towards Year 2000 readiness. We have included aggregate data supporting the examiners’ findings in our response to Questions No. 1 and 2. The data was collected at on-site examinations, by specially trained examiners who spend several days reviewing plans, progress reports, and testing results, and discussing renovation, testing and a wide range of other Year 2000 matters with the individuals who are actually doing or overseeing that work.

As discussed in detail in our testimony and in our answers to Questions 1 and 2, the key dates and milestones established by the FFIEC agencies are not hard deadlines. The milestones help the institution and the examiner gauge progress, but are not absolute. A missed target date might not be material provided it did not significantly impact other tasks and target dates, and either was or will be met at a reasonable and appropriate time. These other conditions include sensible reasons why the milestone was missed and strong management with demonstrated ability to control its Year 2000 program.

There are several FFIEC target dates or milestones, especially in the area of testing. Some of these, particularly the December 31, 1998 target date, have sometimes been misunderstood.

The depth and breadth of regulatory examinations and on-going monitoring between examinations of each and every institution cannot be duplicated by off-site non-random samples or self-selected surveys.
5. OTS policy on whether financial institutions which do not meet the upcoming June 30, 1999, FFIEC regulatory deadline for completing all mission-critical testing will be rated by examiners as “satisfactory,” and whether all institutions should be prepared, as part of their public communications plan, to assure bank customers in writing that they are in compliance with the FFIEC June 30 deadline.

There will be a presumption that missing the upcoming June 30, 1999 milestone for completion of testing will result in a less-than-satisfactory rating, but this will not be an absolute rule. We will again expect our examiners to evaluate the cause and significance of that situation. We will also expect them to apply thresholds for materiality that recognize the diminishing time cushion and to more closely scrutinize the institution’s contingency planning since more comprehensive contingency plans are obviously more critical for applications and other electronic items that have not successfully been tested. For lapses not deemed material, absent other adverse findings, and assuming that the institution had legitimate, practical reasons for missing the target date, strong Year 2000 management, and strong contingency plans, a rating of Satisfactory would be acceptable. Should any of these conditions not be met, a less-than-satisfactory rating would be assigned.

However, regardless of the rating assigned, the situation would be closely monitored.

Thrifts are encouraged to actively communicate with their customers on their Year 2000 preparations and status. Certainly, those who meet the June 30, 1999 testing milestone may cite that in their communications with customers. However, we are reluctant to prescribe communications points or messages and we doubt that the
announcing of meeting FFIEC milestones would have more than modest value and that the value would be fleeting at best. While some customers would be reassured by such a message, we believe most customers are much more interested in hearing about the products and services they count on most. That is, thrift customers want to know about the testing performed on items such as checking accounts and ATMs and how the institution will deal with any problems that might otherwise jeopardize access to their funds or accuracy of their bank’s records of their funds. We encourage thrifts to actively and openly communicate on that level.

6. **An update on Y2K contingency planning at financial institutions, including examples of “best practices” being used by financial institutions to meet - or effectively mitigate - increased customer demand for cash in December 1999 and January 2000, and to communicate Y2K contingency plans to bank customers.**

   Round 4 of OTS’s Year 2000 examination process will include a continued focus on contingency planning, cash planning and customer communications.

   To continue to heighten the awareness of the thrift industry in the area of cash planning and customer awareness, and in preparation for this examination process, OTS along with the other FFIEC agencies published the Customer Communications Outline on February 17, 1999. This outline includes the suggestion that the institution should inform customers of the contingency plans it will have in place to ensure customers have access to their money and accurate account information in the event any problems occur.

   In recent months, OTS has devoted significant portions of its Y2K Newsletter, *MMillennium*, to customer awareness and cash / liquidity issues. Examples of articles include:

   - **December 1998:** How Do You Build Public Confidence
   - **January 1999:** Study Finds Tellers May Help Build Customer Confidence
   - **February 1999:** Liquidity Needs at 1/1/2000: Are you Ready? Customer Communications Ever More Timely
   - **March 1999:** Developing Year 2000 Cash Plan Demands Attention
Contingency planning and consumer awareness or communications with customers are also the themes for the upcoming April 15th Summit the OTS and the Office of Comptroller of the Currency are hosting for the Financial Sector Group of the President’s Council on Year 2000 Conversion. Invitees representing financial institutions include America’s Community Bankers, American Bankers Association, American Financial Servicers Association, American League of Financial Institutions, Association of Financial Services Holding Companies, Bank Administration Institute, Consumer Bankers Association, Independent Bankers Association of America and Mortgage Bankers Association. Other invitees include representatives of trade organizations connected with other aspects of the broader financial industry and members of the press. Trade organization attendees will be encouraged to take the messages presented back to their membership.

7. **An assessment of the effectiveness of financial institution procedures for evaluating Y2K-related credit risk from material borrowers and the OTS’s exam procedures for assessing the level of that risk for individual institutions.**

The thrift industry is primarily a residential mortgage lender and is in general not exposed to substantial direct credit risk arising from Year 2000. However, we do require each thrift to make an assessment of its situation and not just assume that it is immune from this risk. Those that are or may be exposed to Year 2000 credit risk are then expected to follow the FFIEC guidance regarding monitoring and managing that risk. OTS utilizes the FFIEC Phase II Examination Workprogram in assessing the procedures employed by institutions in evaluating their level of credit risk. The work program instructs the examiner to determine if management has implemented a due diligence process covering credit risk. Deficiencies in this area are set forth as exceptions and matters requiring board attention in examination reports. The status of credit risk is also addressed in the agency’s Internal Assessment Survey.
As explained in our response to Questions 1 and 2, the vast majority (93.8%) of the thrifts we regulate are adequately assessing and monitoring their credit risk arising from Year 2000. Of those thrifts that were not adequately monitoring credit risk at the time of their examinations, in only three cases would it appear that the thrift might have a significant level of exposure. We have required those thrifts’ boards of directors to establish due diligence procedures to assess and manage their risk and monitor their actions. The others have loan portfolios that suggest a relatively low level of Year 2000 credit risk. However, as noted above, we are requiring all thrifts to make a proper assessment.

**PENDING Y2K-RELATED LEGISLATION**

1. **Comment on legislation pending in Congress (H.J. Res. 14) which would move the federal holiday observance of New Years Day 2000 (which falls on a Saturday), from Friday, December 31, 1999, to Monday, January 3, 2000.**

OTS participated in interagency discussions on this issue and believes that the potential drawbacks of a government-mandated holiday on January 3rd outweigh the potential benefits. A government-mandated Year 2000 holiday might increase the risk of Year 2000 disruptions because business entities would divert scarce resources from other Year 2000 activities to modify and retest systems to accommodate the holiday. Organizations would need to change the holidays in their systems or make other programming changes to treat the Year 2000 holiday as a nonbusiness day. Because these changes are date-related, each system that was modified would need to undergo additional Year 2000 testing to ensure that the change did not inadvertently create a Y2K or other date-related processing problem. Movement of New Years Day in 2000 could also affect contractual and other obligations that require payment on that date.

In the financial sector, a Year 2000 holiday (if one were established in addition to the normal New Years holiday) would further increase transaction volume on the last and first business days of the year, when volume is traditionally higher than average, and
exacerbate work loads potentially complicating the transition and resolution of any problems. Finally, the declaration of a Year 2000 holiday may send a signal to the public that the government has serious concerns regarding Year 2000 readiness of the financial market participants and that significant problems may occur.

2. Comment on the potential impact of pending Year 2000 liability legislation (e.g., H.R.775) on financial institution, federal Y2K supervision of such institutions, or on the ability of such institutions to determine the Y2K compliance of borrowers or other critical external parties, such as providers of telecommunications and power services; please submit, if appropriate, any recommended amendments language to H.R. 775.

As a general matter, we believe that legislation to limit Y2K liability is premature. H.R. 775, like some Year 2000 liability bills in the Senate (e.g., S. 461 and S. 96) would insulate thrifts, among other potential defendants, in civil actions in which a claim is made that the plaintiff suffered harm or loss (other than personal injury), directly or indirectly, as a result of an actual or potential Year 2000 failure. Insulating institutions at this time from potential future liability may be counterproductive by providing a disincentive for institutions to continue working hard now to fix Y2K problems, so that Y2K problems do not occur. The desire of boards to limit their institutions’ exposure to Y2K litigation creates an added incentive to take preventative steps that will also minimize the risk to the public of Y2K problems. Moreover, as stated in our testimony, it is important not to reward the minority of slackers at the potential expense of the majority of compliant businesses.

OTS needs to be able to use all of the enforcement tools currently at its disposal to address Year 2000 problems. Some of the pending Year 2000 liability bills (e.g., H.R. 1319, H.R. 192, S. 738, and S. 461) specifically except from the restrictions on litigation
federal agency actions brought in a regulatory, supervisory, or enforcement capacity. H.R. 775 does not contain such an exception and thus, could adversely impact OTS enforcement actions. If Congress ultimately decides that Year 2000 liability legislation is needed, it is critical that the legislation not interfere with federal agency enforcement actions.

3. **OTS comment on whether references to bona fide error in current banking consumer law should be clarified to include, in the definition of computer error, explicit reference to Y2K-related errors and, if so, please provide suggested legislative language.**

OTS has taken steps to ensure that the institutions we regulate take reasonable measures to address Year 2000 issues. OTS and the other federal banking agencies have issued guidance encouraging institutions to detect and correct potential Year 2000 problems in their systems. Even so, we recognize that some institutions may experience difficulties flowing from the century date change. This type of computer malfunction and programming error appears to be covered by the statutory provisions found in several consumer protection laws dealing with bona fide errors. Presumably, institutions might assert this defense if a Year 2000 problem occurs. Because these exculpatory provisions relate to a defense against civil liability to third parties (not the federal banking agencies), the courts would determine how these provisions apply in specific cases.

We recognize there is a risk that financial institutions with Year 2000 problems may be subject to frivolous lawsuits. At the same time, we are concerned that legislation to provide institutions with additional liability protections could reduce incentives to correct Year 2000 problems. On balance, we would not suggest amending current laws for this one time event unless a clear case has been made that the statutory standard cannot fairly be applied in the Year 2000 context. We are not convinced that case has been made at this time.
4. Any other issues which should be brought to the attention of the Committee, including any recommendation for legislation to facilitate industry readiness and contingency planning for the Year 2000.

The Committee may wish to consider suspending the specific liquid asset requirements in section 6 of the Home Owners’ Loan Act for the six month period from October 1, 1999 through March 31, 2000. Unusual cash demands that may arise in connection with the transition to Year 2000 could result in technical violations of the requirement; thus, it could prove useful to relieve savings associations temporarily from having to comply with this provision. Of course, liquidity will remain an important component of the CAMELS rating system, as it is for banks, and contingency plans of savings associations can be expected to result in their initially holding higher levels of liquid assets than usual as Year 2000 approaches.

We will keep the Committee apprised of any other legislation that may be needed to help us address issues arising from our continuing supervision of the thrift industry and its service providers. For example, we appreciate the Committee’s assistance last year in helping us obtain the examination authority we needed to supervise service providers. At this time, we have not identified any further issues that require legislative redress.