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OTS 98-09 - Testimony on the Examination Parity and Year 2000 Readiness for Financial Institutions Act Before the Committee on Banking and Financial Services United States House of Representatives

Office of Thrift Supervision

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**TESTIMONY ON THE EXAMINATION PARITY AND
YEAR 2000 READINESS FOR FINANCIAL INSTITUTIONS ACT
before the
COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES**

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**Ellen Seidman, Director
Office of Thrift Supervision**

I. Introduction

Mr. Chairman and Members of the Committee, thank you for the opportunity to present the Office of Thrift Supervision's (OTS) views on H.R. 3116, the Examination Parity and Year 2000 Readiness for Financial Institutions Act.

The legislation would grant the OTS statutory authority to examine entities that provide a host of services critical to the core business operations of savings associations. These services include data processing, information system management, and the maintenance of computer systems that are used to track everything from day-to-day deposit and loan activity to portfolio management at an institution. Unlike the other Federal banking agencies, the OTS does not currently have explicit statutory authority to examine these third party service providers.

As I will describe later in my testimony, the lack of the proposed statutory examination authority has, at times, posed problems for the OTS in carrying out its primary mission of protecting the safety and soundness of insured savings associations. So far, the obstacles have not been insurmountable. However, the types and length of delays that have arisen in the past when examining a service provider may prove costly in addressing a time-sensitive Year 2000 problem. Thus, while we believe this legislation is highly desirable as a continuing matter, it is even more critical as we face the Year 2000.

Mr. Chairman, your continued leadership on this issue is greatly appreciated. The November 4, 1997, hearing before this Committee on Year 2000 computer compliance helped focus attention on the problem. The proposed legislation will support the OTS's ongoing efforts to educate the industry about the Year 2000 problem and assist us in better understanding the Year 2000 risks that savings associations may be exposed to from their service providers. In addition, the legislation will help thrifts make sure that those that provide them with services will be able to continue to do so without disruption, both with respect to the Year 2000 and in connection with all the other functions performed for thrifts by service providers. In this respect, it will be of particular benefit to smaller regulated institutions, which rely heavily on outside service providers.

The OTS takes the Year 2000 problem very seriously and looks forward to working with the Congress as our efforts proceed. We know that no matter how well we are prepared, there will be glitches and problems. With your help, we intend to do our best to minimize the disruptions that may arise.

The proposed legislation contains two key features that I will address today. First, it calls upon the OTS and the other Federal banking agencies, as well as the National Credit Union Administration (NCUA), to continue developing guidance on the Year 2000 computer problem. Second, it grants the OTS and the NCUA statutory parity with the other Federal banking agencies in the oversight of service providers, including those providing Year 2000-sensitive services.

II. Providing Seminars and Model Approaches to Year 2000 Computer Problems

The legislation calls upon the Federal banking agencies and the NCUA to conduct seminars and provide guidance for regulated institutions on the implications of the Year 2000 computer problem. It provides that the agencies may perform these activities on an interagency basis and in cooperation and coordination with the FFIEC and appropriate organizations. The legislative objective is to protect the safety and soundness of depository institution operations and to promote the integrity of depository institution transactions with other financial institutions, including the Federal Reserve Banks and Federal Home Loan Banks. In particular, it requires the agencies to explore and identify appropriate approaches to common Year 2000 computer problems with regard to project management, servicer contracts, testing regimes, and business continuity planning.

We welcome these responsibilities, but we do not view them as new. We are already doing much of what the proposed legislation would require of us -- education is critical to helping our institutions successfully meet the Year 2000 challenge.

Clearly, the primary responsibility and liability for Year 2000 compliance rests with the regulated institutions themselves, including those that rely on service providers. Thrifts use the service providers day in and day out. Their knowledge of how their systems are supposed to work puts them in the best position to assess whether the systems are Year 2000 compliant, if they are given access to information and testing by the service providers. We urge service providers to cooperate fully in allowing thrifts to test and see for themselves whether their systems are Year 2000 compliant.

The proposed legislation will enhance awareness of Year 2000 issues and promote a better understanding of steps needed to properly identify and correct potential computer problems. It also buttresses the aggressive efforts of the OTS and other regulators to inform financial institutions and service providers about Year 2000 issues through seminars and conferences and, where possible, to recommend guidelines for management to follow.

I am pleased to report on the progress of the FFIEC interagency working group to leverage our collective resources to reach the broadest possible audience with a uniform message. To date, the interagency efforts include development of policy statements issued to the financial institutions industry; advisory letters to depository institutions' boards of directors and senior management; formal presentations to financial institution management, industry trade groups, and service providers; and direct contact with and counseling of regulated institutions through the examination process.

These efforts began in June 1996 when the OTS, along with the other FFIEC agencies, alerted institutions to computer system risks posed by the forthcoming calendar rollover to the next millennium. The FFIEC statement stressed the need for early, careful planning by management to develop an action plan. It also provided guidelines for financial institutions to follow in their efforts to ensure that computer systems will function properly and without disruption when the calendar rolls over. In May 1997, the FFIEC agencies sent a follow-up industry advisory highlighting the need for institutions to make all information processing systems Year 2000 compliant and specifically identified concerns institutions should consider in managing any necessary system conversions.

In December 1997, the OTS and the other FFIEC agencies sent out safety and soundness guidelines concerning Year 2000 business risks. This guidance emphasized that the preparation for Year 2000 is more than a computer system issue. It is an enterprise-wide challenge that must be addressed at the highest levels of management. The advisory established specific expectations for senior management and the board of directors of financial institutions for addressing the business risks associated with the Year 2000 problem.

We believe this guidance, a copy of which is attached to this testimony, is consistent with the type of guidance expected of the regulatory agencies under the proposed legislation. The OTS, together with the other FFIEC agencies, has drafted additional advisories on service provider management, credit risks, and testing. We expect to release these advisories sequentially through the FFIEC over the upcoming weeks and months.

In addition, last month, the OTS published its first Year 2000 newsletter to thrift executives. A copy is attached to my statement. We hope to publish the newsletter on a monthly basis until the Year 2000, and thereafter if necessary. The purpose of the newsletter is to advise and maintain a regular dialog with the thrift industry on particular aspects of the Year 2000 problem as we become aware of these issues. It is also intended to provide the industry with

insight into what we are doing to address the problem, as well as to encourage institutions to contact us if we could be doing something more or better.

We will also continue to offer on our website a special Year 2000 page. Among other information, including a hot link to the FFIEC's Year 2000 web page, the OTS page contains an electronic checklist that helps institution management, service providers and examiners monitor progress toward completing a Year 2000 renovation project. The checklist sets forth a quantitative approach with five stages and 59 steps. The FFIEC Year 2000 web page contains relevant policy releases and examination procedures, as well as "hot links" to other sites of interest that offer useful Year 2000 materials.

The OTS, both in conjunction with the other FFIEC agencies and on its own, has taken every opportunity to speak directly with the industry and service providers about the Year 2000 issue. For example, in May 1997, our Northeast Region held a Year 2000 symposium that attracted over 100 thrift institution representatives and 29 service providers. On November 10, 1997, the FFIEC sponsored a conference, in which about 40 service providers participated, to establish an ongoing dialogue on Year 2000 related issues and to communicate agency expectations to data processing and software providers. On January 13, 1998, the FFIEC agencies sponsored their third meeting with about a dozen financial institution trade associations and one service provider trade association. All of these efforts have addressed the needs of financial institutions in their efforts to become Year 2000 compliant.

We are also working closely with industry trade associations who are coordinating conferences on Year 2000 issues and facilitating communication within the banking industry as a whole. We are presently working with the FDIC in cooperation with America's Community Bankers to present a series of Year 2000 conferences for that group's member institutions in three sessions in February and March at sites around the country. The conferences are entitled "Countdown 2000: Is Your Bank Ready?". They will include presentations by OTS officials on business risk, examination issues, testing, and contingency planning. Also in March, the OTS will discuss how the regulators are preparing for the Year 2000 at a conference sponsored by the Association for Financial Technology.

Finally, in a coordinated FFIEC interagency effort, our Information Systems examiners are currently conducting Year 2000 examinations of the Multiregional Data Processing Servicers (MDPS) and Shared Application Software Review (SASR) bank software providers. MDPS data centers are large multiregional data processing servicers that pose a systemic risk to the financial industry should one or more fail. The SASR program covers turnkey systems, stand-alone customer software, and integrated packages. Criteria for selection include purchased software that involves high risk applications such as wire transfer, securities transfer, loans, deposits, and general ledger.

To complete the interagency examinations of the MDPS and SASR entities effectively, we established a task force of seasoned examiners from each of the FFIEC agencies. The task force developed a process to examine the MDPS and SASR entities by June 1998. The targeted companies provide over half of the core data processing products and services used by the banking industry. This project has three objectives:

- (1) to conduct timely reviews of the Year 2000 efforts of the key providers posing the greatest risk to the industry;
- (2) to promote consistency in reporting; and
- (3) to ensure that we have an efficient means to distribute results among the regulatory agencies.

The task force will also provide recommendations to improve the consistency of subsequent quarterly monitoring of Year 2000 progress of these entities.

The proposed legislation will clearly support our ongoing Year 2000 efforts and will encourage us to continue them. At the same time, it will give us the flexibility to address specific circumstances we encounter without a one-size-fits-all solution to every problem. And it leaves the responsibility on each financial institution to address its individual needs.

III. Granting the OTS Statutory Parity with Other Federal Banking Agencies to Regulate and Examine the Provision of Services through Service Corporations and Others Under Contract or Otherwise

The proposed legislation would also grant the OTS, as well as the NCUA, statutory parity with the other Federal banking agencies in the oversight of service providers. As I mentioned at the onset, this is a statutory anomaly that impacts all services critical to a thrifts' operations, but is particularly troubling in the Year 2000 context. Although the ultimate responsibility for Year 2000 compliance rests with the thrift institutions themselves, many of them rely heavily on the services of outside service providers for the processing of critical business applications such as the general ledger, deposits, investments, and loans. This is particularly true of smaller thrifts.

Consequently, it is incumbent on us to conduct detailed reviews of the progress of servicers to help thrifts ensure that systems will function properly - now and in the Year 2000. Although the OTS has been aggressive in its examination efforts, the proposed legislation will remove some of the obstacles that have complicated and delayed our efforts in reviewing the performance of thrifts' outside service providers. The proposed legislation will provide the OTS with the same statutory authority as the other Federal banking agencies have under the Bank Service Company Act to examine the operations of third-party contractors that perform various data processing and electronic network services for savings associations.

The OTS currently addresses this statutory shortcoming by requiring savings associations to obtain a service provider's consent to OTS examination as part of the association's contract with a service provider. Some service providers, however, have been resistant to these contractual provisions and, as a result, thrifts have been hindered in their ability to contract for services. This is particularly true for smaller institutions that may lack the bargaining power to get service providers to agree to the OTS examinations. The safety and soundness risks with this limited authority are problematic.

For example, we know that some thrifts have not obtained this authorization, despite the regulatory requirement. On several occasions, the OTS examination staff has had to spend considerable time negotiating access to service provider premises and records, significantly delaying our examination of the savings association. In some instances, the process has resulted in delays of several months, which could be particularly problematic in addressing a Year 2000 issue.

As an example of the problems we have encountered, one situation involved a grocery chain that owns one of the largest Electronic Funds Transfer (EFT)/ATM networks in the country. In September 1995, the OTS attempted to schedule an examination of this network but encountered significant resistance from store executives and board members. Three months of written correspondence, telephone conference calls and meetings with the ATM network's legal counsel were required before it agreed to permit an examination of the network by the OTS and representatives of the Federal Reserve, the FDIC, and the OCC.

Another example involved a software development company that sold an integrated banking software package providing core banking functions to thrifts and a few small banks. The company wanted to find new sources of revenue so it decided to expand by contracting with a few customers to manage their facilities and then contracting with other banks and thrifts to

provide services at those sites. The company did not understand that what it viewed as a small change in its business strategy - moving from providing software to providing services - would have such a significant effect on its supervisory requirements. When OTS examiners found a number of weaknesses, one of the hurdles to correcting those weaknesses was establishing that the OTS had jurisdiction to conduct the examination.

The proposed legislation would have been of great assistance to the OTS in both of these circumstances. With the statutory authority in the proposed legislation, the OTS will continue to perform the same types of examinations of the same types of entities and in the same types of circumstances, but will no longer have to rely primarily on contract provisions negotiated by the institutions we regulate. The proposed legislation supports our efforts to examine service providers whose activities could directly impact the safety and soundness of thrifts. This authority will be especially useful in our examination of service providers delivering Year 2000-sensitive services, but will also be valuable in many other circumstances. This reform will improve our ability to conduct timely reviews of entities posing significant systemic risk to the financial industry and help institutions that use service providers meet the Year 2000 challenge with confidence.

IV. Conclusion

The proposed legislation will aid us in our efforts to protect institutions, their customers and the insurance fund. It will help the computer operations of thrift institutions and their service providers work as smoothly as possible when the calendar rollover occurs 695 days from now. It supports our efforts to educate the thrift industry to make sure thrifts and their service providers are ready for the Year 2000. Most significantly, the legislation will aid us in the examination of service providers whose activities could directly impact the safety and soundness of thrifts by providing us parity with the other Federal banking agencies.

The proposed legislation is well designed to achieve its purposes and we are pleased to support it. Again, we thank the Committee for its timely leadership on this issue.

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The Office of Thrift Supervision (OTS), a bureau of the U.S. Treasury, regulates and supervises the nation's thrift industry. OTS' mission is to ensure the safety and soundness of thrift institutions and to support their role as home mortgage lenders and providers of other community credit and financial services. For copies of news releases or other documents call PubliFax at 202/906-5660, or visit the OTS web page at www.ots.treas.gov.