

SUMMARY OF YEAR 2000 TESTIMONY

- The Department of Banking, in conjunction with federal banking regulators, is actively evaluating the readiness of state-chartered banks to convert to the Year 2000. Each institution will receive an onsite examination before June 30, 1998, with efforts thereafter aimed at monitoring the progress of necessary conversions. Recent examinations indicate the industry is responding to regulatory mandates for preparedness, and no major or systemic concerns have been identified. However, should we identify that an institution may be exposing itself to Year 2000 risk, the Department is prepared to issue an enforcement action to require whatever remedial action is necessary to protect the public's funds.
- State-chartered trust companies and foreign bank agencies are also receiving onsite Year 2000 examinations. The Department is reviewing the Year 2000 preparedness efforts of sale of check licensees, currency exchange operators, prepaid funeral contract sellers, and perpetual care cemeteries during normal examinations, but risk among this sector of regulated entities is considered low.
- As a part of the Department's strategy for raising awareness of Year 2000 risks, the following supervisory issuances have been distributed to regulated entities. These documents are available upon request or can be found on our web site at www.banking.state.tx.us.
 - ▶ Issuances from the Federal Financial Institution Examination Council (FFIEC) to all insured banks regarding Year 2000 risks and regulatory initiatives, dated June 1996, May 1997, and December 1997
 - ▶ August 28, 1997, letter from the Department of Banking to every state bank regarding special Year 2000 examinations
 - ▶ September 24, 1997, memorandum from the Department to all sale of checks and currency exchange licensees regarding Year 2000 compliance
 - ▶ October 30, 1997, Regulatory Advisory from the Department to every state-chartered trust company regarding Year 2000 compliance
 - ▶ Articles in the February and November 1997 issues of *The Texas Bank Report* highlighting the potential Year 2000 risk
 - ▶ Article regarding the Year 2000 in the Department's October 1997 newsletter issued to all perpetual care cemeteries and prepaid funeral licensees

**TESTIMONY PRESENTED TO
TEXAS HOUSE OF REPRESENTATIVES
COMMITTEE ON APPROPRIATIONS'
SUBCOMMITTEE ON MAJOR INFORMATION SYSTEMS**

YEAR 2000 ISSUES

By

**Catherine A. Ghiglieri
Texas Department of Banking
Banking Commissioner**

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Overview of the Year 2000 Issue for Banks

As the regulator of the state-chartered banks and other financial service providers in Texas, the primary concern of the Department of Banking regarding the Year 2000 is the safety and accessibility of the public's funds in regulated institutions. The Department, in conjunction with federal regulatory authorities, is engaged in a program of encouraging and assessing Year 2000 readiness among regulated entities and monitoring their individual efforts to ensure that the advent of the new century poses no hazard to the public.

The potential that computer programs will not properly recognize the Year 2000 holds risks for every sector of the Texas economy. The banking sector is especially at risk due to the heavy reliance on computers for processing financial records. Banks have been relying on computers since the 1960s and 1970s when computer programs were designed to use only two digits to represent each year. When the Year 2000 occurs, financial calculations may be performed incorrectly and records may become inaccessible. The biggest Year 2000 risks to banking operations are: paying customers the wrong amount of interest owed on deposits; collecting the wrong amount of interest on loans; and inhibiting customer access to deposits due to inaccurate account balances or inoperative computer systems. Correction of errors would likely be an extremely labor intensive process, and too many errors could seriously damage an institution's reputation and affect its ability to retain customers even after problems were fixed. Ultimately, some banks might fail.

While institutions may take every precaution to avoid Year 2000 risk internally, certain external threats exist which require attention. Although the largest payment systems providers have made necessary changes or provided assurances that their systems will be Year 2000 compliant, the interdependency among financial institutions worldwide makes it impossible to isolate any bank from the risk of disruption in payments due to problems at a sending or receiving institution. Similarly, banks are susceptible to risk in the form of customers who are not prepared for the Year 2000. If a borrowing customer cannot accurately determine the amount and status of its accounts receivable, or if a customer is subject to possible litigation risk for failing to service its own clientele in a Year 2000 environment, a bank may be faced with questionable repayment sources on loans to otherwise creditworthy borrowers.

The Year 2000 could subject both banks and their borrowers to potentially serious business disruptions due to aspects of their physical site. Systems which may be susceptible include date-sensitive devices such as alarms and time locks on vaults. Also, equipment with embedded microchips may refuse operation after a perceived 50+ years without maintenance (such as elevators, escalators, telephone systems, automated teller machines, heating, ventilation, air-conditioning systems, and fax machines). Because public confidence is an integral component of safe banking operations, it is essential that depository institutions insulate themselves from even minor Year 2000 risks. While a

non-functioning elevator is more of a inconvenience than a risk, the failure of any obvious system may unduly contribute to public concerns.

Overview of the Year 2000 Issue for Other Entities Supervised by the Department

In addition to state-chartered banks, the Department regulates nonbank financial service providers including trust companies, foreign bank agencies, prepaid funeral contract sellers, perpetual care cemeteries, money exchangers and transmitters, and companies licensed to sell checks (money orders.) Much like the banks, trust companies, foreign bank agencies, and sale of check providers are considered to have some Year 2000 exposure due to their relative dependence on technology. However, because of a continued reliance on nonautomated systems and a lack of date-sensitive transactions and equipment, Year 2000 risk is considered very low for most prepaid funeral contract sellers, perpetual care cemeteries, and money exchangers and transmitters. Nonetheless, as outlined below, the Department is acquainting these entities with Year 2000 issues and risks, and offering guidance and oversight to ensure that appropriate action is taken prior to the century date change.

Overview of the Department's Efforts to Address the Year 2000 with Regulated Entities

The Department's plan for addressing the transition to the Year 2000 for regulated entities includes educating them on the risk, performing onsite examinations of banks, trust companies, and data processors, and monitoring efforts to correct identified problems.

The majority of regulated entities have concluded a thorough self-assessment of their Year 2000 risks, and have begun initiatives to correct, or track vendor/servicer correction of, noncompliant systems. To date, no critical problems have been identified which would impede a smooth transition. However, the Department will continue to monitor the situation and, to the extent we have the authority to do so, be prepared to address any problem situation. If an institution is experiencing a lack of vendor support on any critical software or hardware, the entity will be encouraged to seek backup providers before such alternatives cease to be viable. If management inaction is identified as an impediment to the smooth transition to the Year 2000 for any bank, trust company, foreign bank agency, or currency exchange operator, the Department will use supervisory enforcement procedures to ensure that appropriate steps are taken by that entity to protect consumers' funds. However, it should be noted that we lack the statutory authority to undertake any form of Year 2000 enforcement action against a sale of check operator, a prepaid funeral contract seller or a perpetual care cemetery operator.

Through guidance issued by the Department and other regulators (outlined below), banks have been

advised of the need to complete an internal assessment of the Year 2000 risk of their systems by September 30, 1997. The assessment should include both computer and physical site systems, and should result in a prioritized list of target corrective measures and dates. We have recommended that each bank establish a committee, to include representation from each major department as well as senior management, to supervise Year 2000 compliance efforts and report to the board of directors at least quarterly. Rather than merely rely on the assurances of service providers or manufacturers that systems and programs either are compliant or being made compliant, we have required that banks ask detailed questions and perform their own testing of systems which are reported to be Year 2000 compliant. The industry has been advised that all systems should be brought into Year 2000 compliance by year-end 1998, leaving 1999 for extensive testing.

Specific Actions Taken by the Department to Address Year 2000 Risk at Regulated Entities

The Department has been actively addressing the Year 2000 risk among its regulated entities since early 1997. The largest measure of time to date has been spent notifying the industries of the potential risks posed by the Year 2000. We believe this effort has been effective in that recent examinations of banks and servicers indicate that meaningful action is being taken. The challenge going forward will be to monitor efforts and avoid complacency among serviced institutions.

The following is a broad outline of initiatives adopted by the Department to address the Year 2000 in regulated entities:

- **Assessing Industry Status**

During the first half of 1997, the federal banking agencies conducted a survey of banks to obtain an indication of their preparedness for the Year 2000. Information shared with the Department during this period indicated that, especially among smaller institutions, the banking industry had not yet initiated substantial Year 2000 efforts. Notwithstanding, it was found that the data processing centers that service the majority of the state's community banks were generally already working to make necessary programming changes to convert to the Year 2000. Since each serviced bank uses a different combination of hardware and software to interface with their servicer's product, it remains essential that bank management not be complacent regarding the additional efforts needed to ensure a

seamless conversion. Therefore, we have proceeded with raising industry awareness and closely assessing individual banks' efforts.

■ **Raising Awareness**

The Year 2000 has been the subject of numerous communications issued by the Department and the federal banking regulators. Each successive issuance (listed below in chronological order) has contained more intense detail and guidance:

- ▶ A June 1996 letter was sent by the Federal Financial Institution Examination Council (FFIEC) to all insured banks notifying entities of the risks associated with the Year 2000. Also, at that time, a recommended plan of action was provided.
- ▶ In February 1997, the Texas Department of Banking featured an article in its newsletter, *The Texas Bank Report*, highlighting the potential Year 2000 risk.
- ▶ In May 1997, the FFIEC sent a second letter to the banking industry which more specifically outlined a process for managing the transition to the Year 2000. It also included the procedures that are used by the Department and the federal agencies in their onsite Year 2000 examinations.
- ▶ An August 1997 letter was sent by the Department of Banking to the CEO of every state bank notifying regulated entities that the Department would be conducting special examinations to assess readiness for the Year 2000.
- ▶ In September 1997, a memorandum was sent by the Department to all sale of check and currency exchange licensees alerting them to the need to adopt specific strategies to convert any necessary applications and validate them well in advance of January 1, 2000.
- ▶ The 1997 fall newsletter issued by the Department to all perpetual care cemeteries and prepaid funeral licensees contained an article on the Year 2000, and offered regulated entities a video entitled "Year 2000 - Executive Awareness."
- ▶ In October 1997, the Department sent a letter to the CEO of every state-chartered trust company encouraging these entities to comply with the guidelines contained in the May 1997 FFIEC Year 2000 issuance, and alerting companies to the Department's plan to conduct special examinations to assess readiness for the Year 2000.
- ▶ The November 1997 issue of the Department's *Texas Banking Report* ran an article that provided more detail on the Year 2000 preparation efforts expected of all banks.

- ▶ In December 1997, a third issuance was provided by the FFIEC to all insured banks, which emphasized the business-wide nature of Year 2000 risk and the need for senior management attention to, and oversight of, internal bank assessments.

The Department's Internet web site (www.banking.state.tx.us) contains the foregoing issuances in searchable format, as well as links to other web sites that specialize in Year 2000 issues.

■ **Performing Individual Examinations**

All state-chartered banks, trust companies, and foreign bank agencies will receive an onsite examination of Year 2000 preparedness during 1998. Normally scheduled examinations of other entities regulated by the Department will include discussion of the Year 2000.

- ▶ In conjunction with the FDIC and Federal Reserve, the Department is conducting onsite examinations of each state-chartered banks' Year 2000 readiness, using the procedures attached (exhibit 1). Banks which rely on an external data processor for servicing and those performing in-house data processing with a turnkey system will be evaluated using Tier 1 procedures, which are a more general overview of Year 2000 preparatory efforts. A more intense examination incorporating Tier 2 procedures, will occur in banks that: have more than \$1 billion in total assets; perform in-house programming; provide data processing service to other banks; or, have extensive network configurations. All state-chartered banks will be examined by June 30, 1998. Thereafter, follow-up will occur during the normal examination process. Any institution identified as requiring special attention during the initial assessment phase will receive more active monitoring.
- ▶ The Department will conduct readiness examinations of all state-chartered trust companies by August 31, 1998.
- ▶ Evaluations of the Year 2000 readiness of foreign bank agencies will be conducted by the Federal Reserve Bank at each agency's home office by March 31, 1998.
- ▶ Regular examinations of prepaid funeral licensees, prepaid cemeteries, sale of check operators, and currency exchange operators will include an inquiry regarding their respective plan for the Year 2000.

■ **Examining Data Centers and Major Software Vendors**

Bank data processing servicers and major software providers are receiving an interagency assessment of their efforts to ensure Year 2000 compliant programs for institutions using their services and products. Federal and state regulators will remain in close contact with these entities over the next two years to ensure that proper actions are carried forward.

■ **Evaluating Corporate Applications**

Entities applying to the Banking Commissioner for approval of certain actions (new charters, new branches, changes in ownership, etc.) are evaluated by corporate analysts for Year 2000 readiness as part of the application review process.

Overview of the Department's Efforts to Address the Year 2000 Internally

Like all other businesses, the Texas Department of Banking has Year 2000 risks. Although an IBM Year 2000 review regarded the Department's risk as minor (attached, exhibit 2), we are committed to identifying and resolving any problem which could disrupt the delivery of service or performance of our duties.

The following are the actions being taken to assess and correct the Department's Year 2000 risk:

■ **Replacing Noncompliant Systems**

The Department is upgrading its main management information system from a state available VAX system to an in-house PC client server, Oracle system. Programming and conversion efforts will be completed during 1998, with testing to occur in 1999. Necessary upgrades in noncompliant operating systems have been completed.

■ **Contracting for Bonuses for Year 2000 Critical Programmers**

The Department has identified three programming personnel who are critical to ensure that systems conversions are completed within the target time frames. As allowed by Section 18 of the General Appropriations Act passed by the 75th Legislature, bonus contracts have been signed with these employees as a means of retaining them through the transition.

■ **Upgrading and Replacing Noncompliant Software**

Because our automated examination program is not Year 2000 compliant, the Department has decided to move to the FDIC's GENESYS program, which should be ready by mid-1998. We plan to upgrade noncompliant commercial software used by the Department (i.e. Novell, WinFrame) by the first quarter of 1999.

■ **Assessing Equipment and Physical Plant**

Because the Department recently replaced the oldest computers with new models, all computer hardware is Year 2000 compliant. The Deputy Banking Commissioner is overseeing efforts of Staff Services personnel to assess the readiness of other equipment which may have Year 2000 risk, including fax machines, elevators, alarm systems, copiers, etc. If a potential Year 2000 problem is identified, the Department will obtain a commitment from the vendor or servicer of that equipment that necessary corrections will be implemented by December 31, 1998.

Summary

Thank you for this opportunity to testify regarding the Year 2000. The Department is making every effort to ensure that public funds are safe from any risk related to the advent of the new century. We hope that this type of public testimony outlining our efforts will provide public assurance that the industry is well equipped and will be ready for the date change. Please let me know if there is any additional information that I can provide you, or if you would like a paper copy of any document on our web site.