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YEAR 2000 COMPUTING CRISIS

Office of Thrift Supervision's Efforts to Ensure Thrift Systems Are Year 2000 Compliant

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to discuss the progress being made by the Office of Thrift Supervision (OTS) in ensuring that the more than 1,200 thrifts it oversees are ready for the upcoming century date change. If Year 2000 issues are not adequately addressed, key automated thrift systems—affecting hundreds of billions of dollars in assets, transactions, and insured deposits—are subject to serious consequences ranging from malfunction to failure. Such consequences would at the very least cause significant inconveniences to both thrifts and their customers. More significantly, system failure could lead to thrift closings and serious disruptions to both the thrift community and customers. We will also be discussing the progress OTS is making in addressing Year 2000 concerns for its own internal systems.

This testimony is the third in a series of reports you requested on the status of efforts by federal financial regulatory agencies to ensure that the institutions they oversee are ready to handle the Year 2000 computer conversion challenge.[1] We previously reported on the status of the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration[2] (NCUA) and plan to report on the Office of the Comptroller of the Currency and the Federal Reserve System.

To prepare for this testimony, we evaluated OTS' efforts to date to ensure that the thrifts it oversees have adequately mitigated the risks associated with the Year 2000 date change and compared these efforts to criteria

[1]The Year 2000 problem is rooted in the way dates are recorded and computed in automated information systems. For the past several decades, systems have typically used two digits to represent the year, such as "97" representing 1997, in order to conserve on electronic data storage and reduce operating costs. With this two-digit format, however, the year 2000 is indistinguishable from 1900, or 2001 from 1901, etc. As a result of this ambiguity, system or application programs that use dates to perform calculations, comparisons, or sorting may generate incorrect results or, worse, not function at all.

[2]Year 2000 Computing Crisis: National Credit Union Administration's Efforts to Ensure Credit Union Systems Are Year 2000 Compliant (GAO/T-AIMD-98-20, October 22, 1997), Year 2000 Computing Crisis: Actions Needed to Address Credit Union Systems' Year 2000 Problem (GAO/AIMD-98-48, January 7, 1998), and Year 2000 Computing Crisis: Federal Deposit Insurance Corporation's Efforts to Ensure Bank Systems Are Year 2000 Compliant (GAO/T-AIMD-98-73, February 10, 1998).

detailed in our Year 2000 Assessment Guide[3] and Year 2000 examination guidance and procedures set forth by the Federal Financial Institutions Examination Council (FFIEC).[4] We reviewed OTS' Year 2000 procedures and guidance used to perform the initial industry assessment and the follow-on on-site examinations. We reviewed relevant correspondence to its examiners and the institutions it supervises and interviewed OTS officials responsible for overseeing the safety and soundness of thrift management practices and procedures. We also interviewed officials from America's Community Bankers, a trade association representing thrifts, to obtain its views on the adequacy of OTS' efforts and determine what the industry was doing to ensure Year 2000 readiness.

In addition, we compared OTS' efforts to prepare its own systems for the century date change with our assessment guide. To accomplish this, we reviewed OTS' project plan, monthly status reports, and other Year 2000 documentation. We interviewed officials responsible for planning and implementing the Year 2000 initiative. We also reviewed an October 1997 contractor assessment of OTS' internal system readiness. We performed our work at OTS headquarters in Washington, D.C., and its field offices in Jersey City, New Jersey; Atlanta, Georgia; and San Francisco, California, from December 1997 through early March 1998 in accordance with generally accepted government auditing standards.

In summary, we found that the Year 2000 problem poses a serious dilemma for thrifts due to their heavy reliance on information systems. It also poses a challenge for OTS and the other financial institution regulators who are responsible for ensuring the Year 2000 readiness of thrifts, banks, and credit unions. Regulators have a monumental task in making sure that financial institutions have adequate guidance in preparing for the Year

[3]Year 2000 Computing Crisis: An Assessment Guide (GAO/AIMD-10.1.14, September 1997). Published as an exposure draft in February 1997 and finalized in September 1997, the guide was issued to help federal agencies prepare for the Year 2000 conversion. It advocates a structured approach to planning and managing an effective Year 2000 program through five phases: (1) raising awareness of the problem, (2) assessing the extent and severity of the problem and identifying and prioritizing remediation efforts, (3) renovating, or correcting, systems, (4) validating, or testing, corrections, and (5) implementing corrected systems. The guide also stipulates that interfaces with outside organizations be identified and agreements with these organizations executed for exchanging Year 2000-related data. Contingency plans must be prepared during the assessment phase to ensure that agencies can continue to perform even if critical systems have not been corrected. GAO and the Office of Management and Budget established a schedule for completing each of the five phases, including requiring agencies to complete assessment phase activities last summer and the renovation phase by mid- to late-1998.

[4]FFIEC was established in 1979 as a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions, and to make recommendations to promote uniformity in the supervision of these institutions. The Council's membership is composed of the federal bank regulators—FDIC, the Federal Reserve System, and the Comptroller of the Currency—plus the regulators for credit unions and thrift institutions—the National Credit Union Administration and the Office of Thrift Supervision, respectively.

2000 and in providing a level of assurance that such guidance is being followed. Further, regulators will likely face some tough decisions on the readiness of individual institutions as the millennium approaches. We found that OTS is taking the problem very seriously and is devoting considerable effort and resources to ensure the thrifts it oversees mitigate Year 2000 risks. It has been very emphatic in alerting thrifts to the Year 2000 problem, conducted a high-level assessment of the industry's Year 2000 readiness, and is in the process of making more detailed assessments.

Despite aggressive efforts, OTS—like the other regulators—still faces significant challenges in providing a high level of assurance that individual thrifts will be ready. In fact, the problems we found at OTS are generally the same as those found at the other regulators we reviewed. First, OTS was late in addressing the problem and, consequently, is behind the Year 2000 schedule recommended by both GAO and the Office of Management and Budget (OMB). In addition, key guidance—being developed under the auspices of FFIEC—needed by thrifts and other financial institutions to complete their own preparations is also late, which in turn could potentially hurt individual institutions' abilities to address Year 2000 issues. Finally, OTS needs to better assess whether it has an adequate level of technical resources (staff) to evaluate the industry's Year 2000 efforts. These problems hinder the regulators' ability to develop more positive assurance that institutions will be ready for the century date change. However, the regulators cannot turn the clock back and start again. Consequently, the challenge for them at this point is how can they use their resources from here to the millennium to ensure that thrifts, banks, and credit unions mitigate Year 2000 risks.

OTS has done much to mitigate the risk to its mission-critical internal systems. In fact, it has already renovated, tested, and implemented 13 of its 15 mission-critical systems. However, it has not yet completed contingency plans—which should have been completed by mid-1997 as part of the assessment phase—necessary to ensure business continuity in case system renovations or replacements are not completed in time or do not work as intended. Such plans are expected within the next 3 months. Compounding this problem is the fact that OTS has not developed a comprehensive Year 2000 conversion program plan providing a clear understanding of the interrelationships and dependencies among the automated systems that support, for example, its supervisory functions, office equipment, and facilities. Such a plan provides added assurance that all systems and interrelationships are assessed and corrected, mitigating

the risk that systems will not operate as intended in the year 2000 and beyond.

We are making recommendations to strengthen both the OTS examination process and its internal mitigation processes. Further, we are making recommendations designed to sharpen OTS' strategy for focusing its limited resources over the limited time remaining.

The Year 2000 Poses a Serious Problem for Thrifts

Located organizationally within the Department of the Treasury, the Office of Thrift Supervision through its five regional offices supervises 1,210 federal and state chartered savings institutions—commonly called thrifts—to maintain the safety, soundness, and viability of the industry. Thrifts primarily emphasize residential mortgage lending and are an important source of housing credit. Most of these institutions have assets of under $500 million and are locally owned and managed. Together, they are responsible for about $770 billion in assets. As part of its goal of maintaining safety and soundness, OTS is responsible for examining and monitoring thrifts' efforts to adequately mitigate the risks associated with the century date change. To ensure consistent and uniform supervision on Year 2000 issues, OTS and the other regulators coordinate their supervisory efforts through FFIEC. For example, the regulators jointly prepared and issued an August 1996 FFIEC letter to banks, thrifts, and credit unions informing them of the Year 2000 problem and its potential adverse impacts. Together, they also developed and issued in May 1997 an FFIEC examination program and guidance on how to use it. More recently, the regulators established an FFIEC working group to develop guidance on mitigating the risks associated with using contractors that provide automated systems services and software to thrifts.

According to OTS, virtually every insured financial institution relies on computers—either their own or those of a third-party contractor—to process and update records and to perform a variety of other functions. Because computers are essential to their survival, OTS believes that all its institutions are vulnerable to the problems associated with the year 2000. Failure to address Year 2000 computer issues could lead, for example, to errors in calculating interest and amortization schedules. Moreover, automated teller machines may malfunction, performing erroneous transactions or refusing to process transactions. In addition, errors caused by Year 2000 miscalculations may expose institutions and data centers to financial liability and loss of customer confidence. Other supporting systems critical to the day-to-day business of thrifts may be affected as

well. For example, telephone systems, vaults, and security and alarm systems could malfunction.

In addressing the Year 2000 problem, thrifts must also consider the computer systems that interface with, or connect to, their own systems. These systems may belong to payment system partners, such as wire transfer systems, automated clearinghouses, check clearing providers, credit card merchant and issuing systems, automated teller machine networks, electronic data interchange systems, and electronic benefits transfer systems. Because these systems are also vulnerable to the Year 2000 problem, they can introduce errors into thrift systems.

In addition to these computer system risks, thrifts also face business risks from the year 2000, that is, exposure from its corporate borrower's inability to manage their own Year 2000 compliance efforts successfully. Consequently, in addition to correcting their computer systems, thrifts have to periodically assess the Year 2000 efforts of large corporate customers to determine whether they are sufficient to avoid significant disruptions to operations. OTS and the other regulators established an FFIEC working group to develop guidance on assessing the risk corporate borrowers pose to thrifts.

OTS Has Developed a Strategy and Has Initiated Action to Address the Year 2000 Problem

OTS has taken a number of actions to raise the awareness of the Year 2000 issue among thrifts and to assess the Year 2000 impact on the industry. To raise awareness, OTS formally alerted thrifts in August 1996 to the potential dangers of the Year 2000 problem by issuing an awareness letter to thrift chief executive officers. The letter, which included a statement from the interagency Federal Financial Institutions Examination Council, described the Year 2000 problem and highlighted concerns about the industry's Year 2000 readiness. It also called on thrifts to perform a risk assessments of how systems are affected and develop a detailed action plans to fix them.

In May 1997, OTS, along with the other regulators, issued a more detailed awareness letter that

- described the five-phase approach to planning and managing an effective Year 2000 program;
- highlighted external issues requiring management attention, such as reliance on vendors, risks posed by exchanging data with external parties, and the potential effect of Year 2000 noncompliance on corporate borrowers;

- discussed operational issues that should be considered in Year 2000 planning, such as whether to replace or repair systems;
- related its plans to facilitate Year 2000 evaluations by using uniform examination guidance and procedures; and
- directed thrifts to (1) inventory core computer functions and set priorities for Year 2000 goals by September 30, 1997, and (2) to complete programming changes and to have testing of mission-critical systems underway by December 31, 1998.

As of November 30, 1997, OTS had completed its initial assessment of all thrifts for which it has supervisory responsibility. In conducting this assessment, OTS performed off-site examinations of the thrifts that addressed whether (1) their systems were ready to handle Year 2000 processing, (2) they had established a structured process for correcting Year 2000 problems, (3) they prioritized systems for correction, (4) they had determined the Year 2000 impact on other internal systems' important to day-to-day operations, such as vaults, security and alarm systems, elevators, and telephones, (5) they had estimated Year 2000 project costs and targeted sufficient resources, (6) their milestones for renovating and testing mission-critical systems were consistent with those recommended by FFIEC, and (7) they had been closely tracking the progress of service bureau and vendor Year 2000 remediation efforts. Thrifts were also asked to submit Year 2000 assessment reports, action plans, and their most recent progress reports.

According to OTS, this assessment showed that the thrift industry was generally aware of and addressing the potential impact of Year 2000. For example, 94 percent of thrifts had assigned Year 2000 oversight duties or a senior officer or committee and 90 percent were then developing a Year 2000 action plan. However, OTS did find that about 170 thrifts were designated at high risk due to poor performance in conducting awareness and assessment phase activities.

OTS is following up on this initial assessment with on-site exams to all thrifts to be completed by the end of June 1998. To help thrifts prepare for these visits, OTS developed a detailed Year 2000 checklist. It is a self-assessment tool addressing the five phases of the Year 2000 correction process and about 10 other areas, including reliance on vendors and borrowers' credit risk that informs thrifts of key activities to be performed and allows them to quantify their progress. OTS also issued additional examination guidance and procedures to supplement those of the FFIEC. This supplemental guidance, if implemented correctly, will address the

FFIEC examination procedure shortcomings (i.e., lack of detailed questions, vague terminology) reported in our previous testimony.

To ensure OTS completes the on-site visits by June 1998, each regional office has been given the authority to establish its own plans for assessing institutions. OTS' national Year 2000 coordinator is currently reviewing regional plans to assess their reasonableness. To make sure regions stay on track, the coordinator is monitoring regional progress in completing the on-site reviews on a biweekly basis and, starting in April, on a weekly basis. More recently, on March 13, 1998, OTS issued a memorandum to the regional offices that, among other things, reiterated its supervisory goal of ensuring that the thrift industry becomes Year 2000 compliant and provided guidance on exam followup for thrifts assigned a Year 2000 rating less than satisfactory.

OTS has also been participating with other regulators to conduct on-site Year 2000 assessments of major data processing servicers and software vendors. These servicers and vendors provide support and products to a majority of financial institutions. OTS and the other regulators expect to complete their first round of servicer and vendor assessments in April 1998. OTS is providing the results of the servicer assessments to OTS-supervised thrifts that use these services. Together with the results of on-site assessments conducted at thrifts, OTS expects to have a better idea of where the industry stands, which thrifts need close attention, and thus where to focus its supervisory efforts.

OTS Efforts to Ensure Thrift Year 2000 Readiness Are Hampered by Similar Problems Identified at Other Regulators

As noted in our summary, OTS must successfully address a number of issues to provide adequate assurance that the thrift industry will meet the Year 2000 challenge. Also noted, these issues for the most part are similar to those we found at FDIC and NCUA.

First, like the other regulators, OTS is behind in assessing individual institution's readiness. As with NCUA and FDIC, OTS got off to a late start assessing the readiness of the institutions it oversees and, consequently, was late in completing assessment phase activities. For example, it did not complete its initial assessment of all thrifts until November 1997. According to OMB guidance and our Assessment Guide, these activities should have been completed by the summer of 1997. Because OTS is behind the recommended timelines, the time available for assessing institutions' progress during renovation, validation, and implementation phases and for taking needed corrective actions is compressed.

Second, OTS and the other regulators are still developing key guidance to help institutions complete their Year 2000 efforts. In their May 1997 letter to thrifts, banks, and credit unions, the financial regulators recommended that institutions begin (1) developing contingency plans to mitigate the risk that Year 2000-related problems will disrupt operations and (2) ensuring that their data processing services, software vendors, and large corporate customers are making adequate Year 2000 progress.

In recommending these measures, the regulators noted that they have found that some financial institutions were heavily relying on their service providers to solve their Year 2000 problems. They outlined an approach for dealing with vendors that included (1) evaluating and monitoring vendor plans and milestones, (2) determining whether contract terms can be revised to include Year 2000 covenants, and (3) ensuring that vendors have the capacity to complete the projects and are willing to certify Year 2000 compliance. The regulators also noted that all institutions—even those who have Year 2000-compliant systems—could still be at risk if they have significant business relations with corporate customers who, in turn, have not adequately considered Year 2000 issues. If these customers default or are late in repaying loans, then banks and thrifts could experience financial harm. The regulators recommended that institutions begin developing processes to periodically assess large corporate customer Year 2000 efforts and to consider writing Year 2000 compliance into their loan documentation.

The regulators agreed to provide guidance on contingency planning and dealing with vendors and borrowers. The guidance on vendors and borrowers is expected to be issued in mid-March 1998 and the contingency planning guidance by the end of April 1998. As noted in our last testimony, these time lags in providing guidance increase the risk that thrifts have taken little or no action on contingency planning and dealing with vendors and corporate borrowers in anticipation of pending regulator guidance. Moreover, in the absence of guidance, thrifts may have initiated action that does not effectively mitigate risk of Year 2000 failures.

Third, although OTS has been working hard to assess industrywide compliance, it has yet to determine the level of technical resources needed to adequately evaluate the Year 2000 conversion efforts of the thrifts and vendors who service them. Instead, OTS is using its existing resources to perform the evaluations. Specifically, OTS is using its 24 information systems examiners to (1) evaluate the progress of the roughly 250 institutions with in-house or complex systems, (2) work with systems

examiners from the other regulators to assess the progress of about 260 computer centers of data processing vendors that service thrifts, and (3) assist 84 OTS safety and soundness examiners with their evaluations of the remaining 1,000 institutions that rely heavily or entirely on vendors. As institutions and vendors progress in their Year 2000 efforts, we are concerned that the evaluations of the examiners will increase in length and technical complexity, and put a strain on an already small pool of technical resources. Without sufficient resources, OTS could be forced to slip its schedule for completing the current on-site exams or, worse, reduce the scope of its evaluations in order to meet its deadline. In the first case, institutions would be left with less time to remediate any deficiencies. In the second, OTS might overlook issues that could lead to failures. In either case, the risk of noncompliance by thrifts and service bureaus—and the government's exposure to losses—is significantly increased.

OTS officials told us they are in the process of adding four additional systems examiners. They also believe that it is effective to use its safety and soundness examiners to perform Year 2000 assessments at the thrifts not visited by the system examiners. Finally, these officials expressed concern that even if they could hire more technical examiners, it is very hard to find and hire staff with these skills. However, without the requisite analysis, OTS cannot know whether adding four additional examiners will meet it needs. In addition, by using safety and soundness examiners, OTS runs the risk of having examiners make incorrect judgments about the readiness of thrifts. This risk will only increase as we get closer to the millennium because the latter phases of correction—renovation, testing, and implementation—take a higher level of technical knowledge to asses whether these steps are performed correctly.

Challenge for Regulators Is How to Effectively Use Their Resources During the Time Remaining

Looking forward, the challenge for OTS—and the other regulators—is to make the best use of limited resources in the time remaining. The challenge is immense: thousands of financial institutions, numerous service providers and vendors, and a finite number of examiners and time to address the problem. By mid-1998, however, OTS and the other regulators should have available a good picture of how their industry stands. The on-site examinations will be complete as will the assessment of vendors and service providers.

This information should provide good definition as to the size and magnitude of the problem. That is, how many institutions are at high risk

of not being ready for the millennium and require immediate attention and which service providers are likely to be problematic. Further, by carefully analyzing available data, OTS should be able to identify common problems or issues that are generic to thrifts that are of similar size, use specific service providers, etc. This in turn will allow regulators to be able to develop a much better understanding of which areas require attention and where to focus limited resources. In short, regulators have an opportunity to regroup, develop specific strategies, and have a more defined sense of where the risks lie and the actions required to mitigate those risks.

Concerns With OTS' Efforts to Correct Its Internal Systems

OTS internal systems are critical to the day-to-day operation of the agency. For example, they facilitate the collection of thrift assessments, monitor the financial condition of thrifts, provide the Congress and the public with information on thrift mortgage activity, schedule and track examinations, and calculate OTS employee payroll benefits. As with the other regulators, the effects of Year 2000 failure on OTS could range from annoying to catastrophic. OTS system failures could, for example, result in inaccurate or uncollected assessments, inaccurate or unpaid accounts payable, and miscalculated payroll and benefits. Because of the systems' importance, Treasury hired a contractor to assess OTS' internal Year 2000 efforts, and the contractor reported its results in October 1997.

The contractor reported that OTS had made good progress in completing its assessment phase activities and was well underway in performing renovation and testing for selected systems. We also found that OTS was making substantial progress in remediating its systems. For example, 13 of OTS' 15 mission-critical systems have already been renovated, tested, and implemented. The remaining two—the Home Mortgage Disclosure Act system and the Interest Rate Risk system—are expected to be completed by the end of this year. OTS has also inventoried and assessed the nonmission-critical systems that were developed and maintained outside the Information Resources Management office at OTS' headquarters. In addition, it has assessed other electronic equipment important to day-to-day operations, such as telecommunications equipment, office equipment, security systems, and personal computers and made plans to modify or replace the equipment it identified as being noncompliant.

Despite OTS' good efforts to convert its internal systems, the contractor (1) found that OTS had not prepared contingency plans as part of its assessment phase activities and (2) recommended that it develop such plans. As of the time of our work, OTS had not yet implemented this

recommendation. It was still developing these plans to ensure continuity of operations in the event its remediated systems fail or the two systems being renovated are not fixed in time. Our Assessment Guide calls on agencies to initiate contingency plans during the assessment phase so that they have enough time to (1) identify the manual or other fallback procedures, (2) define the specific conditions that will cause the activation of these procedures, and (3) test the procedures. The agency expects to complete these plans by the middle of 1998.

Our final concern is that even though OTS has corrected the majority of its mission-critical systems and is making good progress toward remediating other systems and equipment, it does not have a comprehensive Year 2000 program plan. To its credit, the agency has prepared plans for correcting its systems and has been reporting its progress to Treasury on a monthly basis. However, OTS did not develop a single plan providing a clear understanding of the interrelationships and dependencies among the automated systems that support its business operations, such as thrift supervision, office equipment, payroll, and facilities. Instead, OTS officials told us they prepared separate plans for (1) systems operated and maintained by the Information Resources Management office, (2) systems operated and maintained by other offices and regions, and (3) office equipment and facilities. Without an integrated plan, OTS cannot provide assurance that all systems and interrelationships had been assessed and corrected. This increases the risk that systems will not operate as intended in the year 2000 and beyond.

In conclusion, Mr. Chairman, we believe that OTS has a good appreciation for the Year 2000 problem and has made significant progress, especially with regard to its effort in correcting its own systems. However, OTS and the other regulators are facing a finite deadline that offers no flexibility. OTS needs to take several actions to improve its ability to enhance the ability of thrifts to meet the century deadline with minimal problems and to enhance the agency's ability to monitor the industry's efforts and to take appropriate and swift measures against thrifts that are neglecting their Year 2000 responsibilities. We, therefore, recommend that OTS

- work with the other FFIEC members to complete their guidance to institutions on mitigating the risks associated with corporate customers and reliance on vendors. Further, OTS should work with the other FFIEC members to complete the contingency planning guidance by its April 1998 deadline.

Additionally, a combination of factors—including starting the thrift assessment process late and issuing more specific guidance to thrifts at a relatively late date—are hindering OTS' and the other regulators' ability to develop more positive assurance that their institutions will be ready for the year 2000. Accordingly, we recommend that OTS work with the other FFIEC members to

- develop, in an expeditious manner, more explicit instructions to thrifts for carrying out the latter stages of the Year 2000 process—renovation, validation, and implementation—which are the critical steps to ensuring Year 2000 compliance.

Because OTS and the other regulators will have more complete information on the status of institutions, servicers, and vendors by mid-1998, we recommend that OTS work with the other FFIEC members to

- develop a tactical plan that details the results of its assessments and provides a more explicit road map of the actions it intends to take based on those results. This should include an assessment of the adequacy of OTS' technical resources to evaluate the Year 2000 efforts of the thrifts and the servicers and vendors that service them.

Finally, with regard to OTS' internal systems, we recommend that the Director instruct the agency to develop (1) contingency plans for each of OTS' mission-critical systems and core business processes and (2) a comprehensive Year 2000 program plan.

Mr. Chairman, that concludes my statement. We welcome any questions that you or Members of the Subcommittee may have.

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