

AMERICAN BANKER STRATEGIC INSTITUTE CONFERENCE

Chicago, Illinois  
July 20, 1998



**Year 2000 Personal and Corporate Liability  
Compliance for Financial Institutions**

**I. Introduction**

- A. Thank you, George. [George P. Rapp, Executive Vice President and Chief Financial Officer, First Republic Bank of Philadelphia and chair of conference] Pleased to be here. This is a very important conference.
- B. In looking over the agenda, I think the conference planners did an excellent job. The program touches many of the challenging Year 2000 issues and shows a good balance between prevention of the problem and legal remedy.
- C. Let me clarify my position at the beginning.
  - 1. The Federal Reserve’s intent is to work with financial institutions so that they’re ready for the new millenium well before January 1, 2000.
  - 2. We’re doing all we can now to avoid any systemic problems later.
  - 3. I don’t want to alienate any of lawyers in the room, but we’re focused on fixing the problem up front so that there won’t be as much need to resort to legal remedy after the fact.
  - 4. From our perspective, an ounce of prevention—or maybe I should say a pound of prevention in this case—is worth a ton of cure.

- D. The excellent turnout today reinforces that the Year 2000 message is getting through – people are aware the issue is real, and the stakes are high.
1. All of us here today share the same goal. We all want a safe and sound financial system operating in an orderly manner in the new millenium.
  2. This is an important goal. It's worth striving for. And it's attainable.
- E. We're closer to our goal than many other industries. People in the banking industry appear to understand the importance of the problem and realize that it can't be negotiated away or compromised away. January 1, 2000 is coming in 530 days, whether we're ready or not.
- F. Not everyone would be upset if the problem were not resolved, however. I heard that one man was going to spend New Year's Eve in 1999 setting his VCR to tape the Rose Bowl parade the next morning . . . he's hoping to see the 1900 parade.
- G. Well, as far as his banking services go, the Federal Reserve is committed to seeing that nothing rains on his parade. It is our goal to ensure that the banking industry and the payments system avoid serious problems as they move into the 21st century. This is no small task, as you know. The Year 2000 problem affects every one of us, and every one of us must do something to fix it.
- H. The Year 2000 problem is affecting the Fed in each of its three main responsibilities.
1. First, it's a factor we have to monitor in carrying out monetary policy.
  2. Second, it significantly affects the financial services we provide to our customers.
  3. And third, it's a major concern of our supervision and regulation function.
- I. Just how much will preparations for the Year 2000 affect our economy?
1. You've heard some of the doomsday predictions—computer meltdowns, economic recession, worldwide chaos.
  2. Well, we don't see any of this happening.
- J. That's not to say Year 2000 preparations won't involve significant costs. The costs will be high.
1. The rough rule of thumb for banks is \$1 million of remedy for every \$1 billion of assets.
  2. Federal Reserve Governor Kelley recently testified before Congress that the U.S. private sector has already spent an estimated \$50 billion on the Year 2000 problem.
  3. On a worldwide basis, the eventual costs could total a staggering \$300 to \$600 billion, according to the Gartner Group, a consulting firm specializing in Year 2000 issues.
- K. That's a lot of money. You may have seen a recent projection that the Year 2000 remedy will be the

second most costly endeavor that man has undertaken in modern times – second only to World War II, and more than the Vietnam conflict, and the Kobe and Los Angeles earthquakes combined.

1. Economic activity of this magnitude is something the Federal Reserve is monitoring as part of our monetary policy responsibilities. We'll obviously see a temporary boost in certain sectors, primarily the computer hardware and software industries, as some firms replace their aging computer systems.
  2. But this temporary boost will probably not be enough to offset other factors. So we project that the net effect will probably be negative. Why? Most Year 2000 expenditures are aimed at maintaining existing systems.
  3. These expenditures are additional costs with few benefits coming back to the firm. Productivity will suffer as a result of the extra hours devoted to reprogramming and testing.
  4. Conservative estimates indicate that Year 2000 could reduce the growth of labor productivity by a tenth of a percent or two.
  5. The effect on real GDP growth could be as much as a tenth of a percentage point a year over the next two years. That's not insignificant, but it's clearly not the disaster scenario some are predicting.
- L. What I'd like to do today is discuss what the Fed is doing to help make sure that there isn't a disaster. There are three areas I'd like to cover.
1. First, I'll touch on the Fed's preparations of its own operations, especially its financial services.
  2. Then, I'll describe our efforts to guide the preparations of the banking industry.
  3. Finally, I'll discuss the importance of contingency planning.

## II. The Fed's financial services

- A. Let me begin with the financial services the Fed provides.
1. As you know, the Fed operates the infrastructure for the nation's payments system—the plumbing that allows trillions of dollars to be transferred electronically each day.
  2. The Fed's operations include Fedwire, ACH, the National Book-Entry System, and a nationwide check processing system.
  3. We also operate a wide array of applications, supporting business functions ranging from currency distribution to economic research.
- B. We're giving the highest priority to preparing all our computer systems. Will they be ready on time? The answer is Yes! We're committed to it.

- C. What have we done so far? A lot.
1. We set an aggressive deadline of this past June 30th to have our mission-critical systems renovated and tested.
    - a. I'm happy to say, we met it. This is important. Our systems are ready, and our customers and vendors have begun testing with us.
    - b. All banking institutions that have electronic data interchanges with us are expected to test their ability to send, receive, and process data between their automated systems and ours.
    - c. Windows for these tests are available up to 19 hours a day for the next 18 months.
    - d. While it's still very early in the process, and only a small proportion of institutions have tested, the process is working very well. Those institutions that have begun testing with us appear to be very pleased with the way it's working.
    - e. One point I'd like to stress—if you're a bank that needs to test with us, do it as early as possible. We'd all like to avoid a last-minute rush at the end of the year.
  2. In addition, we've completed an assessment of our remaining applications and will be testing them during the remainder of 1998.
  3. We've also completed the initial development of contingency plans for all our departments.
  4. We're coordinating with our vendors and manufacturers to make sure their hardware and software are ready.
- D. Testing will be crucial. It's estimated that testing will consume 50 to 60 percent of the time, funding, and personnel needed to make financial institutions Year 2000 ready.
1. We're encouraging banks to view testing like a Chicago election – test early and often.
  2. Early because the longer you wait, the less time you have to detect problems and correct them.
  3. And often, because there are various types of tests to do, and one may not be enough.
- E. So far I've focused on domestic preparations, but year 2000 is also a global issue.
1. We've worked with CHIPS and SWIFT, the two major international settlement networks. So that we can test Fedwire, CHIPS and SWIFT at the same time, we've established a common test day for customers on September 26, 1998.
  2. The New York Clearing House is working to establish a common global testing date for major funds transfer systems. They don't have a date yet, but are looking for one in the spring of 1999.

### III. Banking industry preparations

- A. Let me move now to the Fed's oversight of banking industry preparations.
- B. First, it's important to clarify that the banking supervisors cannot solve the problem for the industry.
  - 1. Every institution must complete its own program, test its own applications, and manage the additional risk.
  - 2. Ultimately, each bank's board of directors and senior management are responsible for assuring their institution is ready.
  - 3. For this reason, the Fed and the other federal regulators strongly encourage each bank to regularly report its Year 2000 progress to its board of directors.
  - 4. And just like testing – reports to the board should be early and often. We're suggesting at least quarterly.
- C. The main responsibility rests with individual institutions, but the Fed and the other banking supervisors are working to help. Our approach is two-pronged: education and guidance, on the one hand, and strong incentives on the other.
- D. The education and guidance program includes eight advisory statements from the Federal Financial Institutions Examination Council (FFIEC), as well as supervisory letters, bulletins and newsletters, and an extensive series of seminars and conferences from the Federal Reserve.
  - 1. Here in the Seventh District, for example, the Chicago Fed has already held seminars attended by 543 financial institutions.
  - 2. In addition, the supervisory agencies have web sites devoted to Year 2000 issues.
  - 3. You can access Year 2000 information through the Chicago Fed's web site.
- E. On the incentive side, the Fed and other banking supervisors are monitoring and enforcing Year 2000 readiness for banks.
  - 1. We're taking a micro approach to reaching our macro goal.
  - 2. In other words, we're examining the readiness of each bank and establishing milestones that each must meet in an effort to reach our ultimate goal –compliance well before January 1, 2000.
- F. What are we looking for?
  - 1. Each bank must already have a written testing strategy and plan and should be in the process of testing its interfaces.

2. And by June 30, 1999, each bank must complete the testing of its most critical applications and should be well on the way toward making sure its systems are compliant.
- G. There are several areas of particular concern for us as supervisors. One is whether hardware and software products from third-party vendors are Year 2000 compliant.
1. More than 90 percent of banks use service providers or vendor software to process critical information.
  2. Banks must not take the vendors' word that products are compliant. They need to verify for themselves.
    - a. And they need to test the applications in an integrated environment. We've seen too many instances of renovated vendor software that failed when it was run with a bank's existing systems.
    - b. Banks must also review contracts for Year 2000 compliance agreements
    - c. They must develop contingency plans in case vendors fail to perform. As I said earlier, banks are responsible for their own readiness.
    - d. But I should add that they can help themselves by participating with user groups so they have access to best management practices and participate in effective proxy testing.
- H. Another area of focus is whether a bank's customers are compliant.
1. Even if a bank is a model of Year 2000 preparedness, it may be exposed to risks such as credit and liquidity risks if its customers are not compliant.
  2. Banks should encourage customers to be compliant. However, if they don't extend credit to qualified borrowers with manageable Year 2000 risks, they could subject themselves to lender liability litigation.
  3. The key is to monitor the progress of borrowers and avoid making arbitrary credit decisions.
- I. It's also essential to ensure that any Y2K risk from customers is well-controlled.
1. All banks were required to implement a risk management process to assess the Year 2000 risks posed by customers by June 30th of this year.
  2. The emphasis here is on controlling risk, not managing the borrower's compliance of Y2K. Our goal is to help avoid business interruption.
- J. Another issue I'd like to mention is liquidity — because it's been in the press so much lately.
1. A Gartner Group survey indicated that 38 percent of information technology professionals say they may withdraw their personal assets from banks before the millennium.
  2. Individual banks can help alleviate these types of concerns by clearly presenting their program for compliance, as recommended by the FFIEC.

- K. For our part, the Federal Reserve is prepared to meet any unusual demand.
  - 1. Banks can check their balances with us, through regular channels any time during the day. They can identify any shortfalls, and seek funding in the market.
  - 2. The Fed's discount window is available as an alternative to market funding. We're prepared to lend to institutions with adequate collateral and in appropriate circumstances.
  - 3. We've been doing this in banking emergencies since the Fed was created in 1913.
  - 4. One word of caution on borrowing from us: Take the time now to have the formal legal documents in place so you don't have to scramble in an emergency.
- L. The Fed will also be prepared to meet any increased demands for currency. As always, we will work with financial institutions to ensure that they have enough currency on hand to meet customer demands.

#### IV. Contingency planning

- A. Finally, I'd like to stress the importance of contingency plans. They're a crucial component to any Year 2000 program. Why?
  - 1. Well, first, Murphy's law seems to have been made for computers – whatever can go wrong probably will.
  - 2. And second, Y2K is one of those situations where you can do everything right and still be affected by others who aren't prepared.
  - 3. And third, the Federal Reserve has been involved in contingency planning for years. It's part of our responsibility.
    - a. In the past, we've worked with financial institutions during disasters such as Hurricane Andrew to ensure an adequate supply of cash.
    - b. We've also worked to insure that backup systems are in place to support our operations without interruption during a crisis.
- B. I don't want to imply that we expect a disaster situation. But anticipating the unexpected is the essence of good planning.
  - 1. We're giving contingency planning special attention, both in our own preparations and in our supervisory function.
  - 2. It's imperative that each bank has a contingency plan. No institution can be ready for the Year 2000 without one.
  - 3. There are just too many external forces that could affect even the best-prepared bank.

## V. Conclusion

- A. In conclusion, I'd like to reiterate the importance of resolving the Year 2000 problem.
  - 1. We don't expect the doomsday scenarios to become a reality.
  - 2. But success will depend on all of us taking this issue very seriously. That's why Year 2000 preparations have the highest priority at the Fed.
- B. We're making preparations – both to our own systems and to applications and interfaces in the payments system.
  - 1. We're helping the industry prepare for the millenium through education and guidance.
  - 2. And as a bank supervisor, we're monitoring and enforcing compliance.
- C. We can all be proud that the banking industry is further along in resolving this problem than many others. We've made significant progress, but we shouldn't be complacent. We still have a way to go. And the stakes are very high.
- D. As we enter the new millenium, we'll require a banking system that's able to meet the needs of its customers and enjoy the confidence of the public.
- E. If we continue to work together and build on the progress we've made so far, we can do it.
- F. Thank you.