



FEDERAL RESERVE BANK  
OF DALLAS

ROBERT D. McTEER, JR.  
PRESIDENT  
AND CHIEF EXECUTIVE OFFICER

DALLAS, TEXAS  
75265-5906

July 17, 1998

**Notice 98-61**

**TO:** The Chief Executive Officer of each  
financial institution and others concerned  
in the Eleventh Federal Reserve District

**SUBJECT**

**Year 2000 Supervisory  
Review Plan—Phase II**

**DETAILS**

As part of the federal banking agencies' efforts to assess the Year 2000 compliance efforts of financial institutions, the Federal Financial Institutions Examination Council (FFIEC) issued a statement entitled *Year 2000 Project Awareness* in May 1997. The Federal Reserve initiated a Phase I Year 2000 supervision program (SR 97-16, dated May 1997) calling for supervisory reviews of financial institutions' Year 2000 compliance efforts by June 1998. Phase II calls for examiners to focus attention on the specific efforts of financial institutions and service providers in the areas of testing, implementation, contingency planning, and compliance with the key dates established by various FFIEC guidelines.

**ATTACHMENT**

Attached is SR 98-17, which summarizes the Federal Reserve's Supervisory Review Plan for assessing Year 2000 compliance efforts during Phase II of our supervisory program, running from July 1998 through March 1999.

**MORE INFORMATION**

For more information, please contact Ann Worthy at (214) 922-6156. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

*Robert D. McTeer, Jr.*

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For additional copies, bankers and others are encouraged to use one of the following toll-free numbers in contacting the Federal Reserve Bank of Dallas: Dallas Office (800) 333-4460; El Paso Branch *Intrastate* (800) 592-1631, *Interstate* (800) 351-1012; Houston Branch *Intrastate* (800) 392-4162, *Interstate* (800) 221-0363; San Antonio Branch *Intrastate* (800) 292-5810.



**BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM**

**WASHINGTON, D. C. 20551**

**DIVISION OF BANKING  
SUPERVISION AND  
REGULATION**

**SR 98-17 (SUP)  
June 23, 1998**

**TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE  
SUPERVISORY AND EXAMINATION STAFF AT EACH FEDERAL  
RESERVE BANK AND TO EACH DOMESTIC AND FOREIGN  
BANKING ORGANIZATION SUPERVISED BY THE FEDERAL RESERVE**

**SUBJECT: Year 2000 Supervisory Review Plan -- Phase II (July 1998 - March 1999)**

**Introduction and Objectives**

As part of the federal banking agencies' efforts to assess the Year 2000 compliance efforts of financial institutions, the Federal Financial Institutions Examination Council (FFIEC) issued a statement entitled "Year 2000 Project Awareness" in May 1997. The Federal Reserve initiated a Phase I Year 2000 supervision program (SR 97-16, dated May 1997) calling for supervisory reviews of financial institutions' Year 2000 compliance efforts by June 1998. This SR letter summarizes the Federal Reserve's Supervisory Review Plan for assessing Year 2000 compliance efforts of financial institutions and certain service providers and software vendors during the second phase (Phase II) of our supervisory program, running from July 1998 through March 1999.

Phase II calls for examiners to focus attention on the specific efforts of financial institutions and service providers in the areas of testing, implementation, contingency planning and compliance with the key dates established by various FFIEC guidelines.<sup>1</sup> Updated examination procedures focusing on these areas will be contained in an FFIEC Phase II Year 2000 Work Program that will be released in the near future.

The Federal Reserve's Phase II examination cycle has been shortened to nine months in view of the importance of monitoring Year 2000 compliance efforts. The Phase II Supervisory Review Plan requires at least one on-site Year 2000 review by March 31, 1999, of all state member banks, and certain bank holding companies and foreign banking organizations supervised by the Federal Reserve. Top 50 bank holding companies will be reviewed at least once on-site and monitored on a quarterly basis. In addition, national and regional service providers and software vendors which the Federal Reserve examines under the FFIEC's coordinated examination program will be reviewed by December 31, 1998. In cases in which a supervisory review results in the preparation of a report of findings and assignment of a rating (discussed below), Reserve Banks should provide the report and rating to the subject institution.<sup>2</sup> Phase II will continue to require intensive monitoring of institutions rated less than satisfactory as outlined in SR 98-3, dated March 1998, which also describes the interagency Year 2000 rating system.

Based on the criteria outlined below, Reserve Banks should identify the population of institutions to be reviewed, and commence planning so that Phase II examinations can be completed on schedule. It is important for Reserve Banks to coordinate efforts as much as possible with the other federal agencies and state banking departments to promote information-sharing among the supervisory authorities and reduce the significant regulatory burdens associated with Year 2000 preparations. Each Reserve Bank should prepare a Phase II Supervisory Review Plan applicable to institutions in its district, consistent with the criteria discussed below, and forward it to Division staff (Howard Amer) by July 15, 1998.

## **Supervisory Review Population**

The Federal Reserve will continue to rely on a risk-based approach to determine the necessary frequency and scope of supervisory reviews for Year 2000 preparations. High priority should be assigned to the largest financial institutions that present the greatest degree of national or regional systemic risk, those that have been previously identified as less than satisfactory, and to the largest service providers and software vendors given their significance in providing services to the banking industry.

### **State Member Banks**

State member banks should be reviewed on-site, resulting in written findings and assignment of a rating by March 31, 1999. In addition, Reserve Banks should monitor compliance of state member banks with key FFIEC preparedness dates through meetings, off-site contacts and other appropriate means. A summary of the FFIEC Year 2000 key preparedness dates is attached.

### **Bank Holding Companies**

#### *Top 50 Bank Holding Companies*

The top 50 bank holding companies should be reviewed on-site, resulting in written findings and assignment of a rating by March 31, 1999. In addition, Reserve Banks will be expected to have direct contact with these companies at least quarterly to monitor Year 2000 progress, noting the status of testing, contingency planning and compliance with FFIEC key dates. If a quarterly contact indicates a potential downgrade in the company's rating, an on-site review should be scheduled as soon as possible. Reserve Banks are encouraged to coordinate reviews with the primary federal bank regulator to the extent possible and adjust the scope of review as appropriate.

#### *Bank Holding Companies with Consolidated Assets Greater than \$1 Billion, or with a Nonbank Information Systems Subsidiary*

Reserve Banks should assess the Year 2000 risk posed by these bank holding companies to determine which companies warrant on-site review. The risk assessment should consider the extent of information systems activities, national or regional systemic risk posed to the banking community, severity of any Year 2000 deficiencies at subsidiary banks, and the involvement of other bank regulatory agencies. Other bank holding companies that present less risk may be monitored for Year 2000 compliance through meetings, off-site contacts and other appropriate means. Reserve Banks are encouraged to coordinate closely with the federal or state bank regulator of the subsidiary bank and adjust the scope of supervisory reviews and monitoring as appropriate. Written findings should be prepared and a rating assigned by March 31, 1999.

#### *Shell Bank Holding Companies with Consolidated Assets of \$1 Billion or Less*

Consistent with the Phase I program and instructions in SR 98-3, shell bank holding companies meeting this criterion that do not engage in information services activities need not be reviewed during Phase II. However, in cases in which a subsidiary bank has been rated less than satisfactory, the Reserve Bank should determine whether it is appropriate to initiate supervisory follow-up by the Federal Reserve. In this regard, consideration should be given to the extent of any material nonbank activities that could be adversely affected by the bank's lack of preparedness; the extent of activities at the holding company that are critical to the achievement of Year 2000 compliance by subsidiary banks; and the extent of supervisory efforts of the subsidiary banks' regulators. Based on its evaluation, a Reserve Bank may monitor the shell bank holding company through reports provided by the lead bank's regulator. In cases in which a supervisory review of the shell bank holding company is conducted, the Reserve Bank should consult and coordinate with the subsidiary bank's primary federal regulator (and where applicable state bank supervisory authority) and adjust the scope of review, as appropriate. To the extent supervisory reviews are conducted by Reserve Banks, written findings should be prepared and ratings assigned.

## **Foreign Banking Organizations**

The responsible Reserve Bank, in coordination with local Reserve Banks, should assess the Year 2000 risk posed by the combined U.S. operations of foreign banking organizations to determine which branches, agencies or other offices pose high risk and, therefore, warrant on-site review (at selected locations) by March 31, 1999. The risk assessment should consider the extent of the organization's in-house information systems activities, the breadth of its U.S. operations and the extent of any systemic risk posed by the combined U.S. banking operations.

At the discretion of the responsible Reserve Bank, foreign banking organizations that pose moderate risk may be monitored through meetings, telephone contacts or other means to assess their Year 2000 readiness and to review their contingency plans. Those that pose low risk because of their minimal size (e.g., less than \$100 million in assets) and limited activities, may not warrant a supervisory review during Phase II. To the extent that foreign banking organizations are subject to on-site review or are monitored by Reserve Banks, written reports or findings should be prepared and ratings assigned.

## **National and Regional Service Providers and Software Vendors**

The FFIEC agencies have committed to conduct supervisory reviews of national and regional service providers and software vendors (if they consent) on a quarterly basis through the Year 2000, as discussed in SR 98-15, dated June 1998. At least one on-site review of each organization for which the Federal Reserve is the responsible agency must be conducted by December 31, 1998, using the standard report form. On-site reviews are required in all cases in which a service provider or software vendor previously was rated less than satisfactory or appears to have experienced a significant change in condition (either positive or negative). If an entity was rated satisfactory at its last quarterly review, the Reserve Bank, at its discretion, may determine whether subsequent quarterly reviews may be conducted off-site. Review reports and ratings should be distributed to Board staff, other Reserve Banks, banking agencies, and serviced financial institutions in accordance with the procedures set forth in the SR letter referenced above.

## **Supervision of Institutions Rated Less than Satisfactory**

The supervision program presented in SR 98-3 remains in effect. Reserve Banks should continue to issue deficiency notification letters to banking organizations that are assigned a less than satisfactory rating and provide a copy of the letter to Division staff (Jamie Lenoci). The banking organization must file a plan within 30 days of receipt of the notification letter and should be placed on an intensified monthly monitoring program. In addition, the banking organization's future prospects for expansion through mergers or acquisitions, or ability to engage in new activities requiring regulatory approval, may be restricted. At a minimum, the organization should be advised to consult with a senior official at a Reserve Bank before entering into any commitment to merge or expand, or publicly announcing any such proposal. Moreover, receipt of a less than satisfactory assessment with regard to Year 2000 compliance may result in a downgrade to ratings pertaining to risk management, or overall management or condition, and may also serve as the basis for a supervisory action.

## **Outreach**

The Federal Reserve, together with the other banking agencies, has been conducting for the past year seminars and conferences for bankers and others on the Year 2000 challenge. In March 1998, the "Examination Parity and Year 2000 Readiness for Financial Institutions Act" was enacted. Among other things, the law requires the federal banking agencies to offer seminars to banks on the safety and soundness implications of the Year 2000 computer issue, including information on conducting transactions with Federal Reserve Banks. In this regard, several prepared programs addressing Year 2000 supervisory issues have been distributed to the Reserve Banks to facilitate the conduct of seminars for bankers. The Reserve Bank supervision function needs to coordinate with the operations function to arrange for seminars that satisfy the requirements of the new law and specifically address testing with the Federal Reserve. Reserve Banks also are encouraged to continue coordinating with other federal and state banking agencies in organizing these seminars and conferences.

## **Supervisory Review System**

The Supervisory Review system was introduced in February 1998, to collect examination and other information regarding the Year 2000 efforts of supervised institutions. The system is being modified to collect information pertaining to Phase II reviews based on the FFIEC Phase II Year 2000 Work Program. The information will be used to monitor progress and prepare reports to Congress, the Board and others. Reserve Banks are expected to input information required in accordance with prior instructions on the Supervisory Review System (AD 98-22, dated April 1998).

## **Resource Requirements**

The number of examinations, and other efforts pertaining to supervisory follow-up, training and outreach activities will require a significant utilization of examination and supervision resources. It is likely that Reserve Banks will need to rely on examination personnel beyond those formally trained in information systems supervision. Accordingly, training opportunities are available to safety and soundness examiners and supervisory staff with other expertise who are participating in various Year 2000-related initiatives. Year 2000 contacts in each Reserve Bank should ensure that appropriate policy statements, supervision letters and other educational materials are provided to personnel involved in year 2000 initiatives.

## **Conclusion**

Phase II of the Federal Reserve's supervisory review program will focus on critical elements of Year 2000 compliance efforts of financial institutions. It is incumbent on Reserve Banks to devote sufficient attention to the development and conduct of an effective Year 2000 supervision effort so as to minimize the potential for disruptions to operations and services at financial institutions supervised by the Federal Reserve.

A copy of this letter should be distributed to the domestic and foreign banking organizations supervised by the Federal Reserve to enhance communication and ensure that the industry understands the Federal Reserve's Phase II Supervisory Program. In addition, Reserve Banks are instructed to distribute this SR letter to the Chief Executive Officers of the information systems service providers examined by the Federal Reserve and to state banking departments.

Should there be any questions pertaining to this letter, please contact Howard Amer, Assistant Director, (202) 452-2958, or Angela Desmond, Special Counsel, (202) 452-3497.

Richard Spillenkothen  
Director

Cross References: SR 98-15, SR 98-3, SR 97-16, AD 98-22

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## **Footnotes**

<sup>1</sup> FFIEC policy statements are available through the Board's Year 2000 web page: <http://www.bog.frb.fed.us/y2k/>. SR 98-8 contains a summary of key preparedness dates.

<sup>2</sup> Instructions pertaining to distribution of review reports for service providers and software vendors are contained in SR 98-15, dated June 11, 1998.

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# YEAR 2000 KEY PREPAREDNESS DATES

	FINANCIAL INSTITUTION	VENDOR	SERVICE PROVIDER	REFERENCE POINTS	EXAMINATION PROCESS
<b>By September 30, 1997</b>	Identify, assess and prioritize mission critical systems, software and support equipment for remediation	Identify, assess and prioritize mission critical systems and software for remediation	Identify, assess and prioritize mission critical systems and software for remediation	FFIEC May 5, 1997 Project Management Guidance	First cycle of on-site Year 2000 exams underway to determine adequacy of identification and assessment processes
	Begin remediation of noncompliant products	Begin remediation of noncompliant products	Begin remediation of noncompliant products		
<b>By June 30, 1998</b>	Remediation ongoing	Remediation ongoing	Remediation ongoing	FFIEC March 17, 1998 Customer Impact Guidance	Complete first cycle of on-site Year 2000 exams
	Implement a customer due diligence program				
	Complete development of written Year 2000 testing strategies and plans	Complete development of written Year 2000 testing strategies and plans	Complete development of written Year 2000 testing strategies and plans	FFIEC April 10, 1998 Testing Guidance	
<b>By September 1, 1998</b>	Remediation ongoing	Remediation complete	Remediation ongoing		
	Institutions processing in-house have begun testing of internal mission critical systems, both those programmed in-house and purchased from software vendors	Internal testing and implementation of mission critical systems substantially complete. Vendors should have distributed products to financial institutions.	Internal testing of mission critical systems has begun		
<b>By September 30, 1998</b>	Remediation ongoing		Remediation ongoing	FFIEC March 17, 1998 Customer Impact Guidance	
	Customer impact assessments complete and reported to board of directors				
<b>By December 31, 1998</b>	Remediation complete	All products should have been delivered to financial institutions	Remediation complete	FFIEC April 10, 1998 Testing Guidance	Additional cycles of on-site Year 2000 exams underway to determine adequacy of testing plans, customer impact assessments and contingency plans
	Institutions processing in-house have programming changes and internal testing of mission critical systems substantially complete, including testing of applications purchased from software vendors		Programming changes and internal testing of mission critical systems substantially complete		
	Institutions reliant on service providers ready to test with them		Service providers ready to test with financial institutions		
<b>By March 31, 1999</b>	Testing with service providers substantially complete		Testing with financial institutions substantially complete		
	External testing with material other third parties begun				
<b>By June 30, 1999</b>	Testing of mission critical systems complete				
	Implementation of mission critical systems substantially complete				
<b>Ongoing</b>	Reporting to Board of Directors			FFIEC December 17, 1997 Guidance on Business Risk	
	Vendor and service provider due diligence and contingency monitoring			FFIEC March 17, 1998 Vendor and Service Provider Due Diligence Guidance	
	Remediation and business resumption contingency planning			FFIEC May 13, 1998 Contingency Planning Guidance	
	Customer awareness programs			FFIEC May 13, 1998 Customer Awareness Guidance	

FFIEC Guidance Papers indicated in the Reference Points column can be found on the Federal Reserve Board of Governors Year 2000 web site: [www.bog.frb.fed.us/y2k](http://www.bog.frb.fed.us/y2k)