

Mr Ferguson looks at the challenges to the US payments system posed by the Year 2000 problem

Remarks by Mr Roger W Ferguson Jr, a member of the Board of Governors of the US Federal Reserve System, before the National Automated Clearing House Association in Atlanta, Georgia on April 13, 1999.

The Payments System and Year 2000: Current Preparations and Challenges

Thank you for your invitation to speak today on the timely and critical topic of the Year 2000 challenge to the payments system. As an industry, we have a tremendous responsibility to the public to ensure the smooth operation of the payments system through the Year 2000 and beyond.

This morning I would like to discuss the global challenge presented by the Year 2000 problem and describe international efforts, particularly those of the Joint Year 2000 Council, to assist the worldwide financial services industry to be ready for the century date change. In particular, I would like to focus on contingency and risk management initiatives undertaken by central banks and the state of readiness of Federal Reserve payment systems, such as Fed ACH. Finally, I will discuss our need to recognize our responsibility to the general public and our need to continue to develop cooperative efforts between public-sector and private-sector organizations.

Global Challenge

With less than a year left before the millennium change, it still remains difficult to judge its global impact. The good news is that we are not faced with inaction and there are early indications that the financial industry, in general, is working diligently to be prepared. The euro conversion, which I will elaborate on later, demonstrates that the financial industry can manage significant changes to its systems. It is also important to note, however, that the Year 2000 deadline is not a single event; it is arriving in stages based on dates typically used in financial systems that give us an “early warning” of potential problems. As an example, for any financial systems that look ahead one year, the early January 1999 dates provided a test of their Year 2000 readiness. During 1999, other application look ahead dates will provide further indications of our readiness as well as our ability to initiate our contingency plans.

Given the sheer number of computers and chip-based systems, and the manual nature of the fixes that have emerged to date, we are likely to experience some degree of disruption. I believe most disruptions will prove to be mild and short-lived and, as reported in a recent article, their severity effect will be labeled as “headaches, not disaster.” Consequently, I do not think that we will face global recession. Ultimately I believe the number and extent of computer system disruptions will not be used as the measure of our success in addressing the Year 2000 problem. Instead, our success will be measured by our ability, and the public’s confidence in our ability, to conduct business operations effectively for the balance of this year, on January 3, 2000, and thereafter.

Current State of International Year 2000 Efforts

Some foreign governments and institutions started their Year 2000 program years ago, while others were initially reluctant to recognize that a problem even existed. This reluctance hindered efforts to take early action. In some areas, already limited resources were dedicated to other activities, such as the euro conversion or attempts to restructure weakened economies. Those countries that recognized the problem early and had sufficient resources assembled technical experts from whatever source was available. Recognizing these challenges, in April 1998 the Bank for International Settlements hosted a Year 2000 roundtable to raise international

awareness. At the close of the conference, the sponsoring organizations, the Basle Committee on Banking Supervision, the G-10 Committee on Payment and Settlement Systems, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions established the Joint Year 2000 Council. The Council was formed as a direct result of the recognition of the complexity of the global financial services industry and the need to communicate proactively with regulatory and supervisory authorities.

As Chairman of the Joint Year 2000 Council, I work with other members of the Council to ensure that a high level of attention is given to the challenge within the global financial supervisory community and to serve as a point of contact with national and international private sector initiatives. To that end, the Council operates with the participation of central banks, insurance and securities regulators, and banking supervisors. It is the first international body that brings together such a range of financial regulators. It is important to note that the Joint Year 2000 Council is not the "international Year 2000 enforcement agency." We do not have on-site examiners, nor are we meant to replace the efforts of national regulators.

The Council established an External Consultative Committee, or ECC, to enhance the degree of information sharing between the public and private sectors. This committee includes representatives of internationally-oriented organizations including the Global 2000 Coordinating Group, the International Monetary Fund, the World Bank, and financial service providers, such as S.W.I.F.T., Euroclear, and Cedel. Our most important role may be to provide a forum to facilitate information sharing and cooperation among supervisors. To accomplish this, we have developed a global supervisory contact list of over 600 financial regulators and have initiated several mechanisms for communicating with them. Our most visible may be a series of bulletins, which come out monthly, on different themes and topics. Additionally, the Council has, and will continue to, support, cosponsor, and provide assistance in planning conferences and roundtables on the Year 2000 challenge. To date, we have conducted meetings for regulators from Europe, Asia-Pacific, North and South America and the Caribbean, Africa, and the Middle East, which have provided an excellent means of bringing supervisors together to discuss common interests within specific geographic areas.

What is the state of "international readiness?" As you can understand, it is difficult to measure accurately the level of international Year 2000 readiness, and certainly no one can predict with confidence exactly how the century date change will unfold internationally. There are three reasons for this difficulty. First, there is no single indicator that can be used to judge the overall Year 2000 readiness of any country, including the United States. Second, the state of readiness is a moving target. Judgements are usually based on anecdotal information obtained either first-hand through interviews or surveys or second-hand through other sources. The best information is subject to change. Finally, while it may be possible to reach conclusions about the Year 2000 readiness of individual industry sectors, it remains difficult to assess the interdependency of critical systems across industry sectors. In addition, the state of Year 2000 readiness of a country's public sector may not be an accurate indicator of the status of its private sector.

With that said, I believe that, as with the United States, in most countries the financial sector was probably somewhat ahead of other sectors in recognizing the Year 2000 problem, and is probably somewhat more advanced in testing and business continuity planning. The banking agencies here in the United States have recently finished Phase II evaluations. Of the banks that the Federal Reserve supervises, about 95 percent are making satisfactory progress. Of importance, the same number of 95 percent applies to foreign banking organizations operating here, which as a group had been behind their U.S. counterparts. I can also report that, through the regional meetings of regulators that I referred to earlier, we have now had contact with regulators from over 100 countries, and the degree of awareness among regulators is, I find, uniformly high.

Similarly, with respect to regulators, I should mention the recent release of a statement by the Basle Committee on Banking Supervision discussing the results of its second supervisory survey on the Year 2000 issue. The statement highlights the need for continued efforts, especially in several smaller jurisdictions. It is noteworthy, however, that the Committee's survey of more than 100 regulators identified significant progress within the global financial community. A large majority of regulators indicated that they have issued specific Y2K-related guidance to their banks and believe their banks are taking appropriate steps to address the issue. I believe that these results illustrate the benefits of global supervisory cooperation in raising the financial industry's awareness of the issue and in spurring action.

Overall, no one can know with certainty the global impact of the century date change. While much good work is being done, much remains. Banking institutions, both domestic and foreign, must not allow complacency to set in.

Lessons Learned

As I noted earlier, there were concerns last year that scarce programming resources in Europe were primarily focused on the euro conversion and that Year 2000 readiness efforts lagged. The euro conversion is completed and its success can best be measured by its perception by the media and public as a non-event. While the scale of system changes involved in the euro conversion was significantly less than the Year 2000, the characteristics of the problem are similar and the Global 2000 Coordinating Group conducted a workshop on the euro conversion to identify "lessons learned" that could improve Year 2000 preparedness. The results are valuable and I would like to use them as a framework for describing payment system readiness efforts underway at the Federal Reserve.

The first lesson was the need for suppliers of liquidity and credit management to offset payment and funding dislocations. Central banks were urged to accept responsibility for these issues and be able to make decisions with "less than perfect information." The Federal Reserve has taken steps to increase its currency order and to be prepared to provide any necessary liquidity over the year-end through open market operations and discount window lending. We are reminding depository institutions that the Federal Reserve is available to meet liquidity needs under appropriate circumstances and encouraging those that are including the Federal Reserve, as a lender of last resort, in their Year 2000 liquidity contingency plans to complete necessary discount window documentation and collateral arrangements as soon as possible. We are also meeting with agencies such as the Federal Housing Finance Board and the National Credit Union Administration to discuss liquidity issues that might affect the institutions they supervise.

Another lesson of the euro conversion was the need to provide for timely and accurate information sharing between industry participants and with regulators. Effective information sharing structures, such as communication centers, must be set up that enable fast and reliable communications between market participants; among commensurate organizational levels, from senior management through operations; and with regulators. Although the Federal Reserve has demonstrated its ability to manage crisis situations, we are evaluating and augmenting our existing communication structures where appropriate. We are developing local and national event management centers to maintain a consistent flow of information within the Federal Reserve, with our business partners, and with the public at large.

Regarding this last point, we are in the process of improving our information sharing with our most critical supplier, the telecommunication industry, through our participation in the Telecommunications Sector Group of the President's Council on Year 2000 Conversion and links with the Federal Communications Commission (FCC). The Joint Year 2000 Council is

undertaking initiatives that will improve cross-border information sharing between countries, particularly plans for business resumption and event management.

The third lesson is the need to expand contingency planning beyond operations, to address business continuity, coordinate planning with third-party providers, and test these plans. We established a Century Date Change Council, comprised of senior management officials, to direct the Federal Reserve's approach to business continuity and contingency planning for the Year 2000. The Council considers risk mitigation actions to lessen the likelihood of a problem occurring and to reduce the impact if a problem should occur; and oversees development of contingency response procedures in the event problems do occur.

The Federal Reserve's planning for Year 2000 business continuity is well underway. Each business completed an assessment of the adequacy of its existing contingency scenarios for Year 2000 problems last June. In addition, last November each Federal Reserve entity servicing customers documented its plans to respond to the possibilities of customer problems. Although the responsibility for having sound contingency plans lies with the management of the depository institutions, we recognize that Federal Reserve preparations to deal with potential customer problems are an important component of our business resumption planning. Our emphasis now is on continuing to monitor, and where possible, reducing risk and on refining the Federal Reserve's plans through testing, independent reviews, and other means of coordination.

Lastly, and not surprisingly, many problems that did occur with the euro conversion could have been identified with more thorough testing. Since mid-year 1998, the Federal Reserve has offered customers the opportunity to test future-dated transactions for payment applications, such as Fed ACH, and other services with electronic data exchanges. We are continuing to offer testing opportunities both during the week and on weekends through early 2000 and, in the second half of 1999, opportunities will be provided to revalidate application readiness and to test contingency procedures. As of the beginning of April 1999, over 6,200 institutions had tested with Fed ACH and approximately 94 percent of our larger-volume ACH customers have tested.

I am also encouraged by the testing efforts of private service ACH operators. In February, all ACH operators exchanged files future dated to the rollover weekend and a second test is scheduled for May 10. The Federal Reserve and NYACH will test using leap year dates this weekend.

We strongly support domestic and international testing efforts by major market participants, such as the New York Clearing House, the Securities Industry Association, and S.W.I.F.T. to test critical data exchanges. Under the leadership of the New York Clearing House and with the support of the Federal Reserve, cross-border testing of major payment transactions and S.W.I.F.T. is planned to take place in June 1999. For all countries participating in this test, June 12 will conform to January 3, 2000; and June 13 will conform to January 4, 2000, the first business day on which all major international money markets are open after the century rollover.

Public Outreach

The Joint Year 2000 Council strongly recommends enhanced information sharing as critical to readiness efforts and to avoid unnecessary uncertainty in financial markets. In many countries, there is currently a lack of adequate information on Year 2000 readiness. This is of concern because it impedes efficient preparations by market participants and may exacerbate negative perceptions in the marketplace. Financial institutions should share information in order to strengthen confidence that the Year 2000 challenges are being met in all financial sectors worldwide. In February 1999, the FFIEC issued guidance to financial institutions on how to

address customer expectations. It emphasizes that maintaining customer confidence in the financial services industry now and after the Year 2000 needs to be a top priority of the institution and its senior management.

In 1999, our outreach program will focus on business resumption activities, including Year 2000 risk mitigation and contingency response actions. The first outreach program occurred in December 1998, when officials from the Federal Reserve presented, via videoconference, an interactive session with its depository institution customers on the Federal Reserve's contingency planning for the Year 2000.

Banks are urging their regulators and other government officials to promote public confidence by speaking clearly and forcefully about Year 2000 preparedness. Regulators can play a constructive role in making sure that Year 2000 information disseminated to the public is factually accurate, balanced, and broadly distributed. Communications are a shared responsibility. Research tells us that customers want to hear directly from their bank and that the public is interested in specifics, not generalities, about our preparations. The Federal Reserve is expanding its program of outreach, with every Reserve Bank working on an aggressive program of local communications. I urge you to do the same. The public needs to know that the Year 2000 is like other challenges we have met through careful preparation, risk reduction, and contingency planning to allow us to work around any problems that might occur.

Public Obligations and Patterns of Behavior

As we get closer to the century date change, there will no doubt be more sensational coverage in the media. It is our obligation to be smart consumers of information and to listen to responsible, not alarmist, voices. Remember, as with anything that has a degree of uncertainty, there will always be those who predict the most dire outcomes. They have generally been wrong in the past, and I expect that they will be wrong again. There are likely to be some disruptions from the century date change; nothing this large and complex can be perfectly faultless. We should remember, however, that there have been serious disruptions to service in daily life before, from storms, temporary power outages, disruptions of telephone service, etc. In general, these prove to be annoying and inconvenient, but nothing more.

We also need to maintain reasonable and responsible patterns of behavior. It is possible that market participants may reduce clearing and settlement activity on December 31 and January 3. Several participants, however, have indicated plans to reduce activity over a substantially longer period, up to a month. While such a reduction may appear to be prudent to an individual firm, such action by multiple participants raises the possibility of thin markets with accompanying erratic price behavior. Our perspective has been to encourage market participants, especially those who hold themselves out as intermediaries, to consider carefully the overall implications, including for market liquidity, of reductions in trading volume so that risks and benefits of such initiatives are appropriately balanced.

I understand that some organizations that normally make payroll or other payments using the ACH are thinking about whether they should make these payments by cheque in the days immediately following the rollover to the Year 2000 as part of their contingency planning. I hope these organizations carefully consider all of the implications of such a step before making a final decision in this regard. We have a high degree of confidence in the ability of the Federal Reserve and the banking industry to continue to process electronic payments during this period. The drawbacks to the payment recipients of this change to business-as-usual practices may well outweigh any perceived benefits.

Conclusion

I believe that the financial services industry has made great progress in addressing Year 2000 issues. During this next year you will not only need to do your best to continue to repair and test your own systems, but will also need to evaluate the risk of potential failures and the effect of these failures on your business. Further, you will need to test fallback procedures or work-around processes that mitigate the effect of such failures on your ability to continue to conduct business. Finally, we must continue to be a reliable source of accurate and sound information to maintain the public's trust. I do not doubt that we can collectively rise to these challenges.