COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF BANKING
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TO: ALL CHIEF EXECUTIVE OFFICERS OF PENNSYLVANIA STATE-CHARTERED BANKS, SAVINGS AND LOAN ASSOCIATIONS, CREDIT UNIONS AND TRUST COMPANIES

At approximately this time last year, I sent a letter to state-chartered banks and savings and loan associations addressing revisions we and the federal agencies would be making to the Uniform Financial Institutions Rating System to incorporate an increased emphasis on risk management processes in our component and composite evaluations of the institutions we supervise. We began to implement these changes without incident in 1997 and will continue to do so in 1998 for the institutions which are on a two-year examination cycle. I take this opportunity to alert you that at this point in time, there are two specific risk management issues the Department of Banking will focus on in 1998 -- **Year 2000 readiness** and **credit underwriting criteria.**

A number of Year 2000 advisories have been issued by the Federal Financial Institutions Examination Council (FFIEC) and by the individual component agencies in the past eighteen months. I sent a letter to state-chartered institutions about the matter in April, 1997 and we have been addressing the issue in recent examination reports. Our 1998 examination program will reflect the guidelines and the expectations outlined in the May 5, 1997 and the December 17, 1997 FFIEC advisories entitled, respectively, "Year 2000 Project Awareness" and "Safety and Soundness Guidelines Concerning The Year 2000 Business Risk." The basic points in the most recent policy statement are:

- Senior management and the board of directors must be actively involved not only in overseeing internal Year 2000 efforts but in monitoring the potential risks posed by vendors, counter parties and loan customers.

- The board must require, and management must provide to the board, at least quarterly status reports on your vendors' Year 2000 corrective efforts as well as status reports on internal progress. The ability of your institution's vendors to provide Year 2000-ready software, and other compliant products and services, should be determined by means of due diligence inquiries and appropriate internal testing and verification processes. It is not sufficient to receive certification from a vendor that a product or a system would function properly in the unique environment of your institution if actual testing has not been performed.

- Contingency plans should be developed for all vendors that provide or service critical applications, and a trigger date for implementing alternative solutions should be established in the event that conversion efforts of vendors are not appropriate.

- Finally, management must allocate sufficient financial and human resources to this important project.

The Department of Banking wholeheartedly endorses the Year 2000 guidelines provided by the FFIEC. I have asked that our examiners apply them to their evaluation of Pennsylvania state-chartered financial institution programs to address the systems, product, credit, documentation and other potential Year 2000 risks during your regularly scheduled examination. To prepare for examinations of Year 2000 readiness by the Department of Banking and/or your federal regulator, and to preclude the need for follow-up supervisory action, please take the time to review the guidelines and to determine that senior management and the board of directors are actively managing efforts to plan, allocate resources and monitor progress to address Year 2000 problems.

The second matter I need to address briefly is that of credit risk management. A number of factors -- the uncertain impact of troubled overseas financial markets on the U.S. economy, problematic interest rate scenarios for certain loan/investment portfolios and spread management in a stagnant or low economic growth environment, high levels of consumer debt and bankruptcies, the tempting high yields of subprime loans and volume building potential of high loan-to-value home equity loans -- show troublesome potential for negative impact on financial institution performance in general and on credit quality in particular. While all this suggests that now is the time for management to be particularly diligent about assessing and managing credit risk, our examiners are noting evidence of compromised standards of creditworthiness, pricing, documentation and collateral requirements either to retain customers or to generate new business. Since the stable interest rates and earnings we have enjoyed for the past few years may not be sustainable in the face of external economic factors, we need to be all the more diligent about maintaining a sound credit culture in the face of a potential economic downturn.

Sincerely,

Richard C. Rishel

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