

April 1999

YEAR 2000

Financial Institution
and Regulatory Efforts
to Address
International Risks



General Government Division

B-281294

April 27, 1999

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

Dear Mr. Dingell:

On July 29, 1998, you requested that we review the international risks that the Year 2000 computer problem poses to U.S. financial institutions.¹ These institutions are active participants in international financial markets as dealers of foreign exchange and derivative products, lenders to foreign organizations, and investors in foreign securities. You were concerned that U.S. financial institutions could encounter significant difficulties in operating internationally and could potentially incur substantial losses on their trading and investment activities if foreign markets and financial institutions have not adequately prepared their computer systems to correctly process Year 2000 dates.

To address your request, we assessed the extent to which (1) large, internationally active U.S. financial institutions were addressing international Year 2000 risks; (2) U.S. banking and securities regulators were overseeing these risks for the institutions they regulate; (3) large foreign financial institutions and their regulators are addressing Year 2000 risks; and (4) other issues may require attention before 2000 arrives.²

Results in Brief

Large U.S. financial institutions have financial exposures and relationships with international financial institutions and markets that may be at risk if these international organizations are not ready for the date change occurring on January 1, 2000. However, the seven large U.S. banks and securities firms we visited were taking actions to address these risks. They had identified the organizations with which they had critical foreign business relationships, had assessed the Year 2000 readiness status of these organizations, and were developing plans to mitigate the risks that would be posed by the lack of Year 2000 readiness of one or more of these

¹For this assignment, we addressed the activities of large U.S. banks and securities firms.

²You also asked us to review Year 2000 issues for the insurance industry. We are providing the results of that work in a separate report to be issued at a later date.

organizations. They told us that they did not expect potential Year 2000 disruptions to have much long-term effect on their global operations.

U.S. banking and securities regulators were also addressing the international Year 2000 risks of the institutions they oversee. Banking regulators had issued guidance for banks on addressing international Year 2000 risks and were assessing bank preparations for these risks during bank examinations. Securities regulators, although not directly responsible for securities firms' foreign activities, were assessing these firms' efforts to address international and other external Year 2000 risks using information obtained through the regulated U.S. broker-dealer affiliate.

Foreign financial institutions reportedly have lagged behind their U.S. counterparts in preparing for the Year 2000 date change. One of the major reasons cited for the lag was that these firms also had to make systems modifications to prepare for the introduction of a new European currency in January 1999. Officials from four of the seven large foreign financial institutions we visited said they had scheduled completion of their preparations for Year 2000 about 3 to 6 months after their U.S. counterparts, but they planned to complete their efforts by mid-1999 at the latest. The officials also said they were assessing the readiness of the entities with which they did business. Foreign regulators in France, Germany, Japan, Korea, and the United Kingdom said they were assessing the readiness of the institutions they oversee, but their efforts generally appeared less extensive than those of U.S. regulators. In addition, key international market support organizations, such as those that transmit financial messages and provide clearing and settlement services, told us that their systems were ready for the date change and that they had begun testing with the financial organizations that depended on these systems. Two international organizations created to assist international Year 2000 efforts, the Global 2000 Coordinating Group and the Joint Year 2000 Council, were also playing a major role in assessing readiness and helping global financial market institutions and regulators address Year 2000 issues.

As the Year 2000 approaches, some issues will continue to require the attention of U.S. and foreign financial institutions and regulators. For example, officials from the large U.S. and foreign financial institutions we visited said they were concerned about the readiness of foreign infrastructure providers, such as those that supply telecommunications, power, water, and other services. The readiness of these organizations is important because financial institutions and their international counterparts depend on these providers for their continued business

operations. Another issue that financial regulators and financial institutions said they were addressing that will require continued attention was the need for mechanisms to coordinate actions and information among regulators and other organizations during the date change period. Promoting additional Year 2000 readiness disclosure by foreign organizations was an additional issue for which regulators have taken steps and which financial institutions saw a continued need to address. As 2000 approaches, the availability of such disclosures will be critical for financial institutions in planning for and addressing Year 2000 risks. In addition, regulators acknowledged the need to continue developing strategies for communicating the readiness status of the financial sector to alleviate concerns among members of the public.

Background

The Year 2000 problem exists because the data that computers store and process often use only the last two digits to designate the year. On January 1, 2000, such systems may mistake data referring to 2000 as meaning 1900, possibly leading to numerous errors and disruptions in processing. Financial markets in the United States and countries throughout the world are highly dependent upon the accurate transmission of electronic information, and thus the systems they use must be readied to correctly process Year 2000 dates.

If the computer systems used by foreign financial markets and institutions are not ready for the Year 2000 date change, U.S. financial institutions could be adversely affected in various ways. If systems used by foreign markets fail, U.S. institutions may not be able to alter their holdings of foreign financial assets. Market closures and the resulting uncertainty could also cause dramatic drops in prices, thereby producing large losses for U.S. institutions holding such assets. If foreign financial institutions' systems are not ready, U.S. institutions may not be able to access financial assets held by their foreign business partners and customers or may not receive payments owed by such institutions. If the systems used by foreign infrastructure providers, including those providing telecommunications, power, water, and other services, are not also ready for 2000, U.S. institutions may not be able to communicate with its foreign business partners and customers. They may also be unable to conduct financial transactions with such institutions or within affected countries.

Scope and Methodology

To gather information on the extent of U.S. financial institutions' international activities, we obtained data on U.S. banks' lending exposures from U.S. banking regulators. For information on U.S. entities' investments in foreign securities, we obtained information from the U.S. Bureau of Economic Analysis and from Morningstar, Inc., which is a private investment research firm that maintains a proprietary database of U.S. mutual funds' investment portfolios. We obtained data on foreign exchange and over-the-counter derivatives markets from the Bank for International Settlements. To gather information on how U.S. financial institutions were addressing international Year 2000 risks, we interviewed officials and reviewed available Year 2000 documentation from the headquarters offices of seven major banks and securities firms that were among the most internationally active financial institutions. We interviewed additional representatives of some of these firms in countries outside of the United States. We also interviewed U.S. banking and securities regulators to obtain information on how U.S. financial institutions were assessing their international Year 2000 risks.

To gather information on how U.S. regulators were addressing international Year 2000 risks, we reviewed guidance and other issuances and discussed international Year 2000 risks with representatives of the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC). We also reviewed these organizations' internal analysis summaries of U.S. and foreign financial institutions' progress in addressing Year 2000 and securities firms' regulatory reports by discussing their Year 2000 efforts.

To determine how foreign financial institutions and regulators were addressing Year 2000 risks, we interviewed representatives of seven large financial institutions, three market support organizations, and regulatory agencies in France, Germany, Japan, Korea, and the United Kingdom. We also reviewed reports and statements by other organizations³ that have assessed the Year 2000 readiness of foreign financial institutions. The foreign countries whose Year 2000 efforts we evaluated included 4 of the top 10 countries in which U.S. organizations had significant lending and mutual fund investment exposures. In addition, we interviewed officials from and reviewed Year 2000-related documents provided by international market support organizations that are responsible for clearing and settling transactions, transmitting payment instructions, and other financial

³These included organizations such as the Gartner Group, which is an information technology consulting firm, and the Global 2000 Coordinating Council, which is a private sector group set up to address international Year 2000 issues.

messages. We also interviewed officials from and reviewed documents of key international organizations that were established to address Year 2000 problems in global financial markets, including the Global 2000 Coordinating Group and the Joint Year 2000 Council.

To identify issues that may require further attention, we interviewed officials at the organizations we contacted. We also reviewed reports and other documents issued by U.S., foreign, and international organizations. Information on foreign institutions and regulation in this report is based on interviews and secondary sources, not our independent technical or legal analysis.

We did our work from July 1998 to March 1999 in accordance with generally accepted government auditing standards. We obtained oral comments on a draft of this report from staff of the Board of Governors of the Federal Reserve System and SEC and written comments from the OCC (see app. I). We discuss their comments at the end of this letter.

Large, Internationally Active U.S. Financial Institutions Were Assessing International Risks

Large, internationally active U.S. financial institutions, which account for most of the financial exposures and relationships with foreign financial institutions and markets, may be at risk if the foreign organizations are not ready for the Year 2000 date change. However, officials from the U.S. institutions we visited told us that they have mostly completed the changes required to ready their own computer systems to process Year 2000 dates. With financial relationships around the world, these officials also said they were assessing the Year 2000 readiness of their customers, business partners, and financial counterparties. Further, they said that they are preparing plans to mitigate the risks their international activities pose to their operations, but that they generally did not anticipate Year 2000 problems in other countries to have a significant long-term impact on their business operations.

Large U.S. Financial Institutions Are Active in Global Financial Markets

Although many financial institutions may be active internationally, fewer than 25 large institutions account for most of the total foreign financial exposures of U.S. banks and securities firms. The Year 2000 readiness of foreign organizations' computer systems is important to these large U.S. financial institutions because they have substantial international financial exposures.

U.S. financial institutions are active in various global financial activities. Large U.S. banks and securities firms are active participants in the foreign exchange markets in which transactions valued at \$1.5 trillion were estimated to be occurring daily as of April 1998. Determining the portion of

U.S. financial institutions' foreign exchange activities that are conducted with foreign entities is difficult, but about 18 percent of the daily volume of foreign exchange trading is reported to occur in the United States. The comparable share of global daily trading volume in London, which is the most active foreign exchange trading center, was about 32 percent. U.S. firms are active in London and other world foreign exchange centers as well. Over-the-counter derivatives dealing is another global financial market activity in which U.S. financial institutions actively participate.⁴ About \$70 trillion in notional principal was outstanding in June 1998, with U.S. banking institutions having an estimated \$28.2 trillion outstanding as of that time.⁵

U.S. banks are also active globally as lenders of funds and, as of June 30, 1998, had a total foreign lending exposure of about \$487 billion. Six U.S. banks accounted for over 75 percent of this total exposure. As shown in table 1, U.S. banks' largest lending exposures were concentrated in the major European markets and Japan.

Table 1: Top 10 Foreign Country Lending Exposures for U.S. Banks as of June 30, 1998

Dollars in millions	
Country	Lending exposure
Germany	\$47,845
United Kingdom	36,835
Japan	36,531
France	32,709
Italy	26,464
Brazil	25,602
Canada	21,868
Netherlands	19,940
Switzerland	19,820
Spain	18,751
Total	\$286,365

Source: U.S. Federal Financial Institutions Examination Council.

⁴Derivatives are financial products whose value is determined from an underlying reference rate, index, or asset. The underlying include stocks, bonds, commodities, interest rates, foreign currency exchange rates, and indexes that reflect the collective value of various financial products. Over-the-counter derivatives are distinguished from exchange-traded derivatives because they are privately negotiated financial contracts.

⁵Notional principal amounts, which are the amounts upon which payments are often based, are one way that derivatives activity is measured. Although these amounts are indicators of volume, they are not necessarily meaningful measures of the actual risk involved. The actual amounts at risk for many derivatives vary by both the type of product and the type of risk being measured.

Although most of their lending was in developed countries, large U.S. banks also had exposures to organizations in various emerging market countries. As shown in table 1, exposures to organizations in Brazil ranked among the top 10 for U.S. banks as of June 30, 1998. U.S. banks also had lent over \$16 billion to Mexico and had exposures to other emerging market countries in Latin America and the Caribbean totaling about \$31 billion. U.S. banks' lending exposures to Asian countries, excluding Japan, were about \$41 billion and to Eastern Europe were about \$11 billion.

U.S. entities are also active in securities investing internationally. As of year-end 1997, U.S. entities held foreign financial stocks or bonds worth about \$1.45 trillion, according to data compiled by the U.S. Bureau of Economic Analysis. However, SEC officials told us that only about 12 securities firms engage in substantial international activities. Other entities active in investing in other countries include U.S. mutual fund organizations. According to information compiled by Morningstar, Inc., U.S. mutual funds' foreign equity investments were also concentrated in the major European markets and Japan (see table 2).

Table 2: Top 10 Foreign Country U.S. Mutual Fund Equity Investments as of January 1999

Dollars in millions	
Country	Investment value
United Kingdom	\$69,958
France	36,975
Netherlands	34,073
Japan	33,377
Germany	25,960
Canada	22,429
Switzerland	18,990
Italy	15,181
Sweden	14,689
Finland	12,474
Total	\$284,106

Source: Morningstar, Inc.

Equity investments by U.S. mutual funds outside of the largest countries generally represented a much smaller portion of the mutual funds' total foreign activity. According to the data compiled by Morningstar, Inc., investments in markets outside of the largest countries accounted for only 25 percent of the mutual funds' total foreign investments.

Large U.S. Financial Institutions Are Assessing the Readiness of Their Key International Financial Relationships

U.S. financial regulators have determined that large U.S. financial institutions are assessing the Year 2000 readiness of their key financial relationships. Bank regulators required all U.S. banks to complete assessments of their internal exposures, including international exposures, by September 30, 1998. Bank regulators told us that their most recent examinations showed that large U.S. banks had adequately completed these assessments. SEC officials told us that large U.S. securities firms have reported that they are also gathering information about the Year 2000 readiness of organizations in which they have key financial exposures, including international exposures.

At the large U.S. banks and securities firms we contacted, representatives of these institutions described (1) the progress they had made in readying their own systems to process Year 2000 dates and (2) the actions they had taken to assess their international exposures. Officials at each of the seven institutions we contacted told us that the work and testing needed to make nearly all of their systems ready for 2000 was completed by the end of 1998. The securities affiliates of six of these institutions participated in a securities industry test in July 1998, which required them to have part of their systems Year 2000 compliant by that date.

Officials at these institutions said they also have incorporated into their overall Year 2000 programs assessments of the readiness of key domestic and international customers, business partners, and their counterparties in financial transactions. The officials said they had detailed programs to both prioritize and assess the readiness of their key suppliers, electronic linkages, business partners, and customers. In most cases, they described using questionnaires to make these assessments. The officials also said they were sending teams to make on-site visits and to personally review the Year 2000 programs of the entities that were their highest priority exposures. For example, representatives of one of the financial institutions we contacted told us that they had determined that, of the over 15,000 relationships the firm had worldwide, 4,000 were deemed to be critical to its operations. They said they prioritized these relationships using various factors, including the extent of business the firm did with each organization.

The firm identified about 450 domestic and foreign organizations that it considered most critical to its operations, which included about 200 providers of information technology and infrastructure services and about 250 financial institutions. To assess the readiness of these organizations, officials at this firm told us that they sent survey to the organizations and were conducting on-site visits during which they were attempting to

review these organizations' Year 2000 project plans. The officials said they also were holding discussions with the organizations' staff on at least 10 areas of concern, such as management involvement and testing procedures.

Officials of the U.S. financial institutions we contacted said that contingency planning would be the primary focus of their Year 2000 efforts in 1999, because they have generally completed system remediation and are continuing with testing efforts. Among the efforts that officials at these institutions described were those designed to minimize disruptions to their businesses operations arising from problems encountered by their own institutions, their business partners, or infrastructure providers. Such steps included having alternate power or telecommunication sources or arranging to conduct financial transactions with more than one institution in other countries in the event that their normal partner experienced Year 2000 problems.

Large Financial Institutions We Contacted Anticipated a Limited Year 2000 Impact on Their Activities

Representatives of the U.S. financial institutions we contacted said they planned to use the results of their assessments of outside organizations in making business decisions regarding whether they should maintain the same levels of exposure or activity with these organizations. Most of these financial institutions expected their main foreign counterparts to be ready and did not anticipate having to alter large numbers of business relationships for Year 2000 readiness reasons. We talked to four representatives of financial institutions about their firms' foreign financial relationships. The representatives said that they chose to do business in different foreign markets because they believed these relationships and investments were sound. The representatives also said that they were determined to remain committed to these investments until the business fundamentals in these countries were altered.

The Year 2000 readiness of the organizations in some countries, including those considered to have made less progress in their preparations than U.S. financial firms, is less likely to have a serious impact on the U.S. firms because of recent events in world markets. For example, officials in Russia have already acknowledged that they lack the resources to adequately address Year 2000 problems. However, according to officials of most of the U.S. financial institutions we contacted, exposures in markets such as Russia, Eastern Europe, and Southeast Asia have already been substantially reduced due to the market turmoil that has occurred in those regions since 1997. According to Morningstar, Inc., data, U.S. mutual fund investments in Russia totaled just \$181 million in January 1999, or less than 1 percent of all such funds' foreign investments. Banks were more exposed

to Russian organizations, with over \$6 billion in loans outstanding, but this was just 1.3 percent of U.S. banks' total foreign lending exposure in 1998.

Officials from most of the U.S. financial institutions we contacted said that, in their view, the impact of Year 2000 disruptions in other countries' markets was not expected to be severe. For example, they said that their firms were advising clients with investments in countries that were more likely to experience Year 2000-related disruptions to, at worst, be prepared for periods of difficulty with payments and settlements in these regions ranging from a few hours to a few weeks. Because these officials believe the duration of any Year 2000-related problems will likely be short, they are advising their clients not to alter their investments solely on the basis of Year 2000-related concerns. Instead, they suggested balancing the impact of these potential, temporary disruptions against the merits of the investments they have made in these regions.

One of the large U.S. securities firms we contacted issued a research report on Year 2000 readiness in January 1999.⁶ The report stated that, although significant failures by foreign organizations to make payments or to deliver securities could conceivably disrupt segments of the U.S. financial system, the U.S., European, and other monetary authorities have the capability to cover any resulting liquidity shortfalls. Also, a research analysis done by another of the securities firms we contacted examined the Year 2000 readiness of various industrial sectors in the United States and at least 19 other countries.⁷ This report noted that Year 2000 problems would probably not cause a major disaster, but that the problems had more potential for disruption in emerging markets. Nevertheless, the report stated that companies will likely cope with Year 2000 problems in the same ways they do during power outages or other disruptions of telecommunications or computer services.

U.S. Banking and Securities Regulators Are Assessing International Year 2000 Risks

U.S. bank and securities regulators are assessing the international risks faced by the entities they oversee. These regulators have approached oversight of Year 2000 issues on the basis of their overall regulatory mandate. The approach taken by bank regulators focuses on their regulatory mandate to protect the safety and soundness of the banking system. Without direct authority to regulate the foreign affiliates of U.S. broker-dealers, SEC has also assessed the international risks that Year 2000 problems may pose to the securities market participants it regulates.

⁶Getting Over the Bug: An Assessment of the Y2K Preparedness of the S&P 500 Companies, Morgan Stanley Dean Witter (New York, NY: Jan. 1999).

⁷Y2K: Implications for Investors, Merrill Lynch (New York, NY: June 1998).

U.S. Bank Regulators Are Concerned About Bank Safety and Soundness

U.S. bank regulators view the Year 2000 problem, including the risks posed by banks' international activities, as potentially threatening the safety and soundness of individual institutions. The regulators have jointly issued at least three sets of guidance that address the risks posed to banks from potential Year 2000 problems experienced by their customers, suppliers, and other business partners, including those in other countries. In a March 1998 statement, bank regulators required banks to assess the Year 2000 readiness of both their domestic and international customers, including organizations that borrow from, provide funds to, or conduct capital market transactions with their institutions.⁸ The regulators required banks to have these assessments substantially completed by September 30, 1998.

Since 1997, bank regulators have reported that they conducted at least one examination of all U.S.-chartered banks, including the foreign branches of overseas banks. On the basis of these reviews, bank regulators rated the Year 2000 progress of about 96 percent of the institutions examined as satisfactory. The regulators started a second round of examinations in September 1998. This round is to focus primarily on testing, contingency planning, and efforts to assess the readiness of external parties. According to representatives of the Federal Reserve and the OCC, which oversee banks with international operations, large banks appear to have conducted their customer assessments adequately, but some smaller institutions had failed to conduct assessments of all the organizations whose Year 2000 readiness could affect their banks.

Securities Regulators Lack Direct Authority Over International Issues

SEC is charged with protecting U.S. investors and ensuring fair and orderly markets, but SEC does not have the authority to regulate the international activities of U.S. securities firms that are done outside of the regulated broker-dealer.⁹ However, SEC has assessed the readiness of U.S. securities markets and the organizations that participate in them, including any relevant international activities of these organizations. SEC has conducted examinations of securities markets, broker-dealers, investment companies, investment advisers, and other organizations they regulate as part of their Year 2000 oversight effort. In addition, since 1990, SEC has had the authority to assess the degree of risk that the securities firms' unregulated

⁸Interagency Statement: Guidance Concerning the Year 2000 Impact on Customers, Federal Financial Institutions Examination Council (Washington, D.C.: Mar. 17, 1998).

⁹Large U.S. securities firms generally consist of many legal entities under a parent or holding company structure. Legal entities that conduct securities activities with U.S. customers must register with SEC as broker-dealers and subject themselves to regulation by that agency.

activities pose to the regulated entity.¹⁰ Under this authority, SEC requires securities firms' regulated broker-dealer affiliates to report on the exposures of their foreign affiliates and holding companies. Finally, SEC requires the entities it regulates to provide supplemental reporting on their Year 2000 efforts.

SEC officials have concluded that the Year 2000 risks posed by U.S. securities firms' international activities are not significant. They said that the foreign exposures of U.S. securities firms are relatively modest compared to their U.S. operations. Moreover, the U.S. securities firms' most significant international exposures were largely concentrated in their U.K. affiliates. These firms conduct considerable over-the-counter derivatives activities in the United Kingdom, although derivatives exposures may arise from business being conducted with entities in other countries. SEC officials told us that U.K. regulators were active in overseeing these firms' operations.

Since the end of 1998, SEC has required the entities it regulates to file reports discussing their efforts to address Year 2000 problems.¹¹ In these reports, organizations are to provide additional information on their Year 2000 readiness efforts beyond that required in other statements filed with SEC. Organizations required to submit these reports include all but the smallest securities firms' regulated broker-dealer affiliates and investment advisers with over \$25 million under management or that provide advice to an investment company registered under the Investment Company Act of 1940. The primary purpose of these reports is to provide SEC with more specific information on these entities' actions to address their Year 2000 problem. In the reports, the firms are required to describe their plans, including the resources they have committed, their progress against the various milestones in the process, and their contingency planning efforts. For broker-dealers, the first reports were required to be filed no later than August 1998 and are to be filed again no later than April 1999. In addition, the regulated entities are also to submit a separate report completed by the firms' external auditors that serves as an independent verification of the accuracy of the firms' April 1999 submission. These reports are to be made publicly available, and SEC has posted the August 1998 submissions on its Web site.

¹⁰The Market Reform Act of 1990 authorized SEC to collect information from regulated broker-dealer about the financial condition of their holding companies, foreign affiliates, and other entities that are reasonably likely to have a material impact on the financial and operational condition of the firm.

¹¹See 17 C.F.R. §240.17a-5, 17 C.F.R. §275.204-5, and 17 C.F.R. §240.17Ad-18 (1998).

These reports also provide SEC with some information on the extent to which the entities it regulates are addressing the risks posed by the Year 2000 readiness of external organizations, including those in other countries. One section of the report seeks information on the activities firms have undertaken to assess the readiness of any third parties that provide mission-critical systems, including clearing firms, vendors, service providers, counterparties, and others. In their submissions, the broker-dealer affiliates are to identify the number of the entities they rely upon, whether they have contacted these entities regarding their Year 2000 readiness, and whether their contingency plans address the potential failure by third parties to be ready. Although these reports were technically just required to be filed by the securities firms' broker-dealer affiliates subject to SEC regulation, SEC officials told us that the firms submitting these reports have generally provided information that addresses the global operations of their firms outside of the regulated U.S. entity, when relevant.

We reviewed the August 1998 submissions by 11 of the largest U.S. securities firms. All of these broker-dealer affiliates' reports indicated that they covered the firms' global operations and activities with foreign clients. The officials said that they would use the information gathered in these reports to identify entities that they may select for an on-site examination concerning their Year 2000 preparations. SEC officials told us that, as of March 1999, no organizations had been selected specifically for their international operations. However, they said that they have begun developing plans for examining the international operations of selected firms, particularly for those firms active in over-the-counter derivatives.

Foreign Financial Institutions and Regulators We Visited Were Also Addressing the Year 2000 Problem

Like their counterparts in the United States, officials of the foreign financial institutions we visited said they were also working to ready their systems for the date change in 2000, although their progress generally lagged those of U.S. institutions. Financial institutions in the countries we visited were also attempting to assess the Year 2000 readiness of their customers and the organizations with which they do business. Financial regulators in these countries told us that they were also assessing the Year 2000 efforts of the entities they oversee, although their activities varied and appeared less extensive than efforts made by U.S. regulators. Other key participants in international financial markets include organizations that provide market support services, such as financial message transmission and clearing and settlement activities. The market support organizations we contacted were also readying their systems for 2000. Finally, two international organizations, including one focusing on regulatory issues and another focusing on issues of concern to financial

institutions, provided guidance and other assistance to financial regulators and institutions attempting to address the Year 2000 problem.

Foreign Financial Institutions We Visited Were Ready to Address Their Systems and Assessing Readiness of External Parties

According to external assessments by consulting groups, regulators, and others, foreign financial institutions have generally made less progress in addressing the Year 2000 problem than have institutions in the United States. Officials of financial institutions in the countries we visited said they were readying their systems for the date change in 2000, but not all of these institutions expected to complete their work in the same time frame expected of U.S. institutions. One reason these institutions' time frames are different is because many institutions, particularly those in France and Germany, had placed a higher priority on modifying their systems for the introduction of the new European common currency, called the euro, in January 1999.¹²

To prepare for the date change in 2000, U.S. regulators expected banks and securities firms to have completed both internal systems modifications and testing by December 1998. We obtained Year 2000 readiness information from seven large foreign financial institutions. Officials from two Swiss institutions and one U.K. bank said that they had mostly completed their internal systems modifications and testing by December 1998. Officials from a German institution we visited said that they had also completed their internal systems modifications by December 1998, but that they had completed the testing of only about 40 percent of their systems by February 1999. Officials from one of the French institutions we contacted expected to complete systems modification and testing by the first quarter of 1999, and officials of the remaining two institutions—including one French and one U.K. bank—expected to be finished by the second quarter of 1999.

Although their work on the euro has delayed their Year 2000 efforts, officials representing financial institutions in France and Germany indicated that their euro efforts would help them complete their Year 2000 work on time. For example, these officials said they already had detailed inventories of their information systems and applications, existing test facilities, and project management teams with experience and personnel that could be used for completing their Year 2000 programs. However, some officials of financial institutions and regulators in the United States

¹²On January 4, 1999, 11 member countries of the European Union, including Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain, took a major step toward merging their national currencies into a single currency, the euro. From this date, the currencies of these countries can be exchanged for a fixed amount of euros and financial transactions can be conducted in euros. Eventually, the euro is to replace the currencies of these nations.

and United Kingdom expressed concerns over whether institutions in countries that had focused on the euro conversion would be ready for the date change. These officials said they expected the larger financial firms would have sufficient resources to address the euro conversion and Year 2000 efforts simultaneously. However, they said they were concerned that small to medium-sized firms would not be able to adequately complete both projects in such short time frames.

Like financial institutions in the United States, officials in the foreign financial institutions we contacted said they also were assessing the Year 2000 readiness of their vendors, electronic linkages, business partners, and customers. These officials said they were also generally using surveys to assess external entities' readiness and were conducting selected on-site visits to review such organizations' Year 2000 programs in more detail.

Foreign Financial Regulators Had Some Year 2000 Oversight Programs That Appeared Less Extensive Than Those of U.S. Financial Regulators

The financial regulators in the foreign countries we contacted said that they had taken steps to assess the Year 2000 efforts of the entities they oversee. However, their oversight program approaches varied across countries and, in some cases, appeared to be less extensive than those made by U.S. financial regulators.

The guidance issued by foreign regulators and regulatory requirements for disclosing the readiness of foreign financial institutions appeared to be less extensive than those mandated for U.S. financial institutions. In the United States, bank regulators issued at least 11 statements to provide guidance for banks on a variety of topics to help them prepare for the Year 2000. In contrast, foreign regulators in the countries we had visited had issued guidance to the institutions they oversee only once or twice, and this guidance covered a narrower range of topics than the U.S. regulators' guidance. Regulators and financial institution officials in several of the countries we visited indicated that the U.S. regulators' guidance had proved helpful.

For firms operating in these countries, the requirements regarding publicly disclosing their Year 2000 efforts also differed. In March 1998, the U.K. accounting standards body required firms to discuss the following in public financial statements: Year 2000 risks, efforts to address those risks, and the costs of those efforts. In France, the securities regulatory body mandated that firms issuing publicly available securities make similar disclosures. Germany required no such disclosures, but an official with a German bank indicated that financial institutions were making disclosures for competitive reasons. Financial regulators in Japan had issued a checklist addressing Year 2000 issues to financial institutions in their

country, and regulatory examiners reviewing firms' activities also were using this document. Regulators in Korea had issued guidance on Year 2000 issues, but examiners in that country had also reviewed guidance issued by and received training from U.S. banking regulators.

Foreign regulators had also placed less emphasis than U.S. regulators on having the financial institutions they oversee assess the Year 2000 readiness of their key financial relationships. U.S. bank regulators required the institutions they oversee to complete assessments of the readiness of their key financial relationships by September 30, 1998. U.S. securities regulators required U.S. securities firms to report on their own readiness and the extent to which their contingency planning assessed the readiness of external organizations. In general, regulators in France, Germany, Japan, Korea, and the United Kingdom had not specifically directed their financial institutions to make assessments of the Year 2000 readiness of their customers or other entities with which they have critical financial relationships. However, regulators in France and Japan had included questions relating to third-party or customer assessments in the surveys they had administered to financial institutions. In Germany, banks had worked through industry associations to develop a standardized questionnaire for use in obtaining information on customer readiness. Korean regulators had recommended that banks take the Year 2000 readiness of their customers into account when making credit decisions.

Approaches to examinations also varied in these countries. In Germany and the United Kingdom, external auditors rather than regulatory bodies usually conduct examinations of banks. Financial regulators in both of these countries said they have tasked the external auditors to address Year 2000 issues as part of the reviews they conduct of banks. Financial regulators in the United Kingdom also said they were making their own limited visits to banks to discuss Year 2000 issues and have incorporated Year 2000-related questions into their regular examinations of securities firms. In France, financial regulators said they were conducting specific Year 2000 examinations of all banks and securities firms. In Japan and Korea, multiple regulatory bodies said they were involved in conducting periodic and ad hoc reviews of financial institutions' Year 2000 efforts.

Major International Market Support Organizations Report Completing Modifications for Year 2000

Conducting international financial transactions frequently requires the involvement of market support organizations, which perform clearance and settlement or other necessary services. For example, many financial institutions use the services of the Society for Worldwide Interbank Financial Telecommunication (SWIFT) in Belgium, which provides a proprietary network for transmitting messages pertaining to financial transactions. SWIFT transmits information among as many as 7,000 institutions in 160 different countries and processes messages relating to an average of \$3 trillion per day. Two other key support organizations based in Europe are Euroclear in Belgium and Cedel Bank in Luxembourg. These organizations perform clearance and settlement services on behalf of many internationally active financial institutions, with Euroclear having about 2,200 participants in 70 countries and Cedel Bank providing services to customers in 80 countries. Because of the role they play in international finance, these organizations' ability to successfully ready their systems for the date change in 2000 is important.

Officials from SWIFT, Euroclear, and Cedel Bank told us that they had completed most of their internal systems modifications and testing by December 1998. These officials said that they have testing programs under way with the financial institutions they service. These organizations are also scheduled to participate in a June 1999 global test of worldwide central banks and payment systems that is being sponsored by the New York Clearing House Association. This association operates an electronic payments system for international dollar payments.

Two International Organizations Are Active in Ensuring the Readiness of Global Financial Markets and Institutions

Two organizations have taken the lead in addressing Year 2000 issues from the perspective of how these issues affect financial institutions and markets internationally. The Global 2000 Coordinating Group is a private sector organization comprising many of the world's largest banks and securities firms and is leading efforts to ensure the readiness of the global financial system. This group was formed in April 1998 with the mission of identifying and providing resources to areas where coordinated initiatives would assist the financial community in improving its readiness for the date change in 2000. As of January 1999, the group had participants from 244 institutions in 53 countries.

To assist financial institutions in addressing the Year 2000 problem, the Global 2000 Coordinating Group has encouraged its members to self-disclose the status of their readiness efforts and has developed a template to standardize the presentation of this information. The group has also developed country assessments that attempt to assess the level of readiness of the financial sector and infrastructure providers such as

telecommunications, power, water, and government. Although not being released publicly, these country assessments are being shared with selected public and private sector officials in their respective countries. The group has also published guidance on contingency planning and is attempting to compile a comprehensive list of testing activities being conducted globally.

The Joint Year 2000 Council is the other organization actively addressing international Year 2000 issues. The council was formed in April 1998 and comprises senior representatives of the Basle Committee on Banking Supervision, the Committee on Payment and Settlement Systems, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions. Currently, a member of the U.S. Federal Reserve Board of Governors chairs the council. Other staff from the U.S. banking regulators and SEC also participate in several of the activities of the Joint 2000 Council and have also been active in other international forums on a variety of Year 2000 concerns.

The council's main goals have been to (1) share information on Year 2000 oversight strategies and approaches and contingency planning and (2) serve as a focal point for other national and international Year 2000 remediation initiatives. The council has issued various sets of guidance for financial regulators and financial institutions, including papers on testing and procedures for assessing financial institutions. In February 1999, the council released a series of papers on contingency planning.

Various Issues Require Continued Attention by the Financial Industry and Other Organizations

Although the financial sectors in the United States and the other countries we contacted were actively addressing the Year 2000 problem, other issues will require continued attention from financial regulators, financial institutions, and other organizations as 2000 approaches. The readiness of infrastructure providers—including telecommunications, power, water, and other services—were a concern to financial institution officials with whom we spoke. Other areas that financial regulators and financial institutions said they are addressing that will require continued efforts include (1) developing mechanisms for coordinating between regulators and other organizations during the date change period, (2) promoting additional Year 2000 readiness disclosure by foreign organizations, and (3) developing strategies for communicating the readiness status of the financial sector to public. Lastly, financial institutions' experiences as they participate in the recent introduction of the new currency in Europe and the results of various Year 2000 tests slated to occur around the world in 1999 will likely provide lessons learned and indications of the prospects for a successful Year 2000 transition.

Readiness of Foreign Infrastructure Is Important to the Financial Sector

The Year 2000 readiness status of infrastructure providers in foreign markets, such as telecommunications firms and power providers, is a major concern to the U.S. and foreign financial institutions operating internationally that we contacted. Regardless of their own readiness and contingency planning, financial markets and the firms participating in them will not likely be able to continue operating after the date change unless the various infrastructure providers are also ready. Regulatory and financial institution officials in the countries we visited expressed several concerns about the readiness of infrastructure providers in their own and other countries.

First, officials indicated that they did not have adequate information about the readiness status of many infrastructure providers in other countries. This lack of information contributed to uncertainty about the readiness status of these providers. Many of the officials we contacted said that the providers should make more information publicly available to reduce this uncertainty. The Joint Year 2000 Council has attempted to address the infrastructure readiness issue, noting in its October 1998 bulletin that the scarcity of information available from operators of key infrastructure components has inhibited prudent planning by users of these services.¹³ The council also noted that in many areas, no existing public sector body has been directed to require action by providers or the oversight structure is too disjointed to allow one authority to lead such an effort.

Another concern of financial market officials regarding infrastructure is that Year 2000 problems in one country's infrastructure could create problems for other countries because of cross-border linkages. In a September 1998 report, the Organization for Economic Cooperation and Development noted that, along with international financial transactions, sectors such as transport, telecommunications, power provision, and other activities depend on cross-border interconnections that could be vulnerable to Year 2000 breakdowns.¹⁴ In addition, regulatory and financial institution officials told us that they were concerned that inadequate attention was being paid to cross-border dependencies among infrastructure providers. For instance, officials indicated that some German power providers rely on natural gas from Russia, a country that has already acknowledged lacking resources to address Year 2000 issues. Officials expressed concerns that no organization appears to have taken the lead to address this and other such cross-border dependencies.

¹³Council Bulletin Issue Two, Joint Year 2000 Council (Basle, Switzerland: Oct. 6, 1998).

¹⁴The Year 2000 Problem: Impacts and Actions, Organization for Economic Cooperation and Development (Paris, France: Sept. 30, 1998).

An official with the Global 2000 Coordinating Group noted another example of these dependencies, explaining that Swiss power companies supply power to other countries during peak periods. However, over 1,000 power suppliers exist in Switzerland and determining what actions these organizations have taken to ready their systems for the date change has been difficult. Because power supplies are shared among neighboring countries, in December 1998, the European Commission urged that relevant authorities in each country closely monitor progress in this sector, exchange information with their counterparts, and publicly disclose such information.¹⁵ The commission also urged that such information be shared about air, rail, maritime, and road transport sectors because it also found that little cross-border coordination and information exchange has occurred in these areas.

Various organizations are addressing infrastructure issues within individual countries and internationally. As we previously recommended,¹⁶ the banking regulators have been meeting to develop contingency plans addressing domestic and international infrastructure issues. According to an OCC official, a Federal Financial Institutions Examination Council (FFIEC)¹⁷ working group on contingency planning meets monthly and has various subgroups addressing specific issues including international payment systems and the readiness of major institutions in key markets. This official also told us that U.S. banking regulators obtain information from their counterparts in other countries on the readiness of infrastructure providers in those countries and emphasize to these counterparts the importance of having more information publicly disclosed on the status of key infrastructure sectors.

In addition to the financial regulators' efforts, the President's Council on Year 2000 Conversion has working groups addressing issues relating to various infrastructure sectors in the United States and has also taken actions related to cross-border concerns. For example, national Year 2000 coordinators from the United States and as many as 120 countries discussed infrastructure issues at a meeting held at the United Nations in December 1998. Officials of the President's Council have also met with

¹⁵Communication from the Commission: How the European Union is Tackling the Year 2000 Computer Problem, European Commission (Brussels, Belgium: Dec. 2, 1998).

¹⁶Year 2000 Computing Crisis: Federal Depository Institution Regulators Are Making Progress, But Challenges Remain (GAO/T-AIMD-98-305; Sept. 17, 1998).

¹⁷This body is an interagency forum for the Federal Reserve, OCC, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of Thrift Supervision and prescribes uniform principles, standards, and report forms for these agencies.

their counterparts in other countries to discuss cross-border infrastructure issues. Internationally, individual infrastructure sectors also have taken steps to address Year 2000 issues. For example, the International Telecommunications Union has attempted to gather readiness information and coordinate cross-border testing of telecommunications services.

**Coordination, Disclosure,
and Communication Are
Among Issues Requiring
Attention as 2000
Approaches**

Other important issues, including coordination, disclosure, and communication issues, require attention by U.S. regulators, financial institution officials, and others as the date change in 2000 approaches. For example, regulators and financial institution officials with whom we spoke said that regulators will have to be involved in creating a mechanism for managing information collection shortly before and immediately after the date change. The Joint Year 2000 Council stated, in February 1999, that the accurate exchange of information in late 1999 and the beginning of 2000 between the public, private, and financial market sectors both domestically and across borders would be vital to a smooth transition.¹⁸ As a result, the council encouraged financial market authorities to establish communication channels that could be used before, during, and after the date change. The council also noted that authorities could consider establishing a centralized location for collecting and exchanging information among financial regulators, other authorities, and financial market participants. Such information centers may be useful in coordinating contingency plans in the event of disruptions and failures and may reduce the information demands on financial institutions, which would allow them to concentrate their resources on fixing problems that may occur.

Some of the financial institution officials we contacted also called for the establishment of such a coordination mechanism. These officials said that their main concern was the need for a centralized mechanism for gathering and disseminating accurate information about events during the date change to avoid panic. They suggested that government regulators act in this capacity because they generally have access to government counterparts in other countries and could provide more complete and accurate information to the markets. For instance, a representative of one financial institution told us it would be good to have some organization in place that could be contacted in the event institutions were having difficulty with a telephone system in one of the foreign markets in which they conduct business. A Federal Reserve official noted that the U.S. banking regulators were considering how to facilitate this type of

¹⁸Planning by Financial Market Authorities for Year 2000 Contingencies, Joint Year 2000 Council (Basle, Switzerland: Feb. 1999).

communication and were discussing it as part of the contingency planning efforts with other regulators and private-sector financial officials. An OCC official explained that each of the banking regulators was developing its own plans for having coordination mechanisms in place, and that eventually they plan to integrate these efforts through the FFIEC contingency planning working group. As part of this, the banking regulators were also developing a list of contacts among the staff of financial regulators in other countries from whom information about the status of the date change outside of the United States could be readily obtained.

Another issue that should concern U.S. and foreign regulators before 2000 arrives involves the need for additional disclosure by organizations in other countries of their Year 2000 readiness status. Many of the financial institution officials we contacted indicated that more information about readiness status should be publicly disclosed by entities in other countries. Because of the need to disclose information to other countries that have an economic interest in their member nations, the European Commission noted in a December 1998 report that member state governments should accelerate or establish mechanisms for coordinating and monitoring Year 2000 readiness.¹⁹ The commission also noted that it is better to have information that problems exist and are being addressed than to have uncertainty created by a total lack of information. On January 29, 1999, the Global 2000 Coordinating Group called for (1) financial firms to redouble their efforts to disclose their Year 2000 readiness and (2) governments to provide more detailed public disclosure of the readiness of sectors that are critical to the safe functioning of the financial industry. Banking regulatory officials told us that, whenever possible, they discuss with foreign regulatory organizations the need for more public disclosure on the Year 2000 readiness status of financial and other organizations. An OCC official said that the December 1998 issuance by the Joint Year 2000 Council²⁰ on information sharing, which encourages foreign regulatory and other organizations to disclose more information, was an example of how U.S. regulators were supporting this issue.

A final issue concerning regulators before the Year 2000 date change occurs involves the need to communicate accurate information about the readiness status of the financial sectors to the public. In the December

¹⁹Communication From the Commission: How the European Union is Tackling the Year 2000 Computer Problem, European Commission (Brussels, Belgium: Dec. 2, 1998).

²⁰Year 2000 Information Sharing and Disclosure, Joint Year 2000 Council (Basle, Switzerland: Dec. 1998).

1998 paper on information sharing, the Joint Year 2000 Council stated that financial market authorities should set an example by implementing a comprehensive information-sharing program that includes communicating with the general public. The council noted that promoting and preserving public confidence requires strategic coordination. It stated that financial market authorities should develop communication plans to reinforce, as appropriate, the public's confidence in the financial system. In an additional issuance in February 1999, the council stated that, by providing periodic status reports on the readiness of the financial sector, authorities could shape the perceptions and expectations of the public and minimize irrational and potentially destabilizing behavior.²¹

U.S. and foreign financial institution and regulatory officials told us that regulators and governments would have to inform the public about the financial sectors' Year 2000 status. The U.S. regulatory officials we contacted acknowledged that this need existed, and that they intended to address this issue in the future.

Events in 1999 May Indicate the Potential Success of Year 2000 Efforts of Financial Market Participants

Various upcoming events may indicate the potential success of Year 2000 remediation efforts. Many industry and regulatory officials told us that the degree of success experienced during the euro conversion would provide some indication of how well financial institutions may be able to manage the Year 2000 date change. Like the Year 2000 problem, the euro conversion required financial institutions to identify, modify, and test internal computer systems to ensure accurate processing.

According to U.S. banking officials, the euro conversion in early January 1999 was mostly successful. However, they said some institutions did experience problems in processing transactions. In addition, adequate information about firms' operating status during the conversion was not always available. In particular, these officials said that organizations that experienced processing difficulties were reluctant to report any problems they had during the conversion. Financial institutions involved in the conversion had contracted with a private-sector information provider to arrange for dedicated display space on its proprietary network as a means for reporting and sharing information about the status of the financial institutions' operations. However, when problems began occurring, the institutions involved did not report them using this network. They noted that the failure to disseminate information about problems being experienced by some institutions could have created more serious

²¹Planning by Financial Market Authorities for Year 2000 Contingencies, Joint Year 2000 Council (Basle, Switzerland: Feb. 1999).

problems. However, many firms continued transmitting their portions of payments due despite a lack of information about the operating status of other institutions or assurance that they would receive the corresponding payments from other institutions.

A U.S. banking official said that, although the institutions involved handled the problems that did arise during the euro conversion, the problems could have been more serious if the U.S. institutions had not continued to make their payments when problems arose. A U.S. banking regulatory official said that the regulators and financial institutions should take action to decrease the likelihood that similar information-sharing problems will occur during the Year 2000 date change.

The results of testing by markets and institutions around the world in early to mid-1999 should provide another indicator of the international financial markets' Year 2000 readiness. Many major markets are to conduct tests of their Year 2000 readiness in 1999 and several tests involving multiple firms are also to be conducted, including the U.S. securities industrywide test that began in March 1999 and a global payments system test planned for June 1999. If successful, these tests should provide more assurances that financial markets and financial institutions will be ready for the actual date change in 2000. Although industrywide testing can demonstrate the coordinated and smooth functioning of U.S. financial markets, some officials cautioned that the results of tests such as these should not be considered definitive proof that participating financial institutions are completely ready for 2000. Large financial institutions may participate in a wide variety of financial activities, and all of their systems would not necessarily be tested in any one industrywide test. For example, officials of two organizations, which conduct a wide range of financial activities in the United States and other countries, said that less than 10 percent of their total systems were used during the U.S. securities industry test in July 1998.

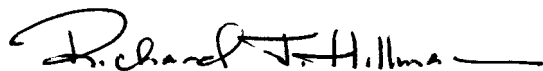
Agency Comments and Our Evaluation

We obtained oral comments on a draft of this report from staff of the Board of Governors of the Federal Reserve System and SEC and written comments from OCC (see app. I). Each of the agencies that commented on this report said that it was an accurate summary of the activities that their organizations and the financial institutions they oversee are undertaking to address international Year 2000 risks. They also agreed that the issues we highlighted as requiring their continued attention were important. OCC's written comments are reprinted in appendix I. SEC staff also suggested some technical changes that we incorporated where appropriate.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 days from its issue date. At that time, we will send copies of this report to Representative Thomas Bliley, Chairman, House Committee on Commerce; Senator Robert F. Bennett, Chairman, Senate Special Committee on the Year 2000 Technology Problem; The Honorable Arthur Levitt, Chairman, Securities and Exchange Commission; The Honorable Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System; and The Honorable John D. Hawke, Jr., Comptroller of the Currency, Office of the Comptroller of the Currency. We will also make copies available to others upon request.

Please contact me on (202) 512-8678 if you or your staff have any questions. Major contributors to this report are listed in appendix II.

Sincerely yours,

A handwritten signature in black ink that reads "Richard J. Hillman" followed by a horizontal line.

Richard J. Hillman
Associate Director, Financial
Institutions and Markets Issues

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Abbreviations

FFIEC	Federal Financial Institutions Examination Council
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission
SWIFT	Society for Worldwide Interbank Financial Telecommunication

Comments From the Office of the Comptroller of the Currency



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

April 6, 1999

Mr. Thomas J. McCool
Director, Financial Institutions and Markets Issues
General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. McCool:

We have received and reviewed your draft report entitled Year 2000: Financial Institution and Regulatory Efforts to Address International Risks. We believe the report to be an accurate summary and agree with its conclusions.

Specifically, we believe that large, internationally active U.S. banks and U.S. bank regulators are assessing international Year 2000 risks. Foreign financial institutions and regulators are addressing the Year 2000 problem; although, in most countries, their efforts are not as intensive as those of their U.S. counterparts. Finally, there are important issues that require continued attention by the international banking and regulatory community. These issues include the need for more disclosure of Year 2000 readiness information, cross-border coordination, and an international communication network that will facilitate gathering and disseminating information during the century date change.

The OCC will continue to work closely with individual U.S. and international financial industry supervisors and through groups such as the FFIEC, the President's Council on Year 2000 Conversions Financial Sector Group, the Basle Committee on Banking Supervision, and the Joint Year 2000 Council. We will continue to promote appropriate disclosure and sharing of Year 2000 readiness information, cross-border supervisory coordination and communication, and contingency planning. In addition, the OCC, along with the other U.S. bank supervisors, will continue to encourage our foreign bank supervision counterparts to expand their coordination and information-sharing efforts with key infrastructure providers -- telecommunications, power, transportation, and other services -- in their countries.

Appendix I
Comments From the Office of the Comptroller of the Currency

Thank you for the opportunity to comment on the draft report.

Sincerely,



Edward J. Hanley
Senior Deputy Comptroller for Administration
and Chief Financial Officer

Major Contributors to This Report

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