BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
MANAGEMENT DIVISION

DATE: June 30, 1999

TO: Board of Governors

VIA: Stephen R. Malphrus and Governor Roger Ferguson

FROM: Stephen J. Clark

SUBJECT: 2000 – 2001 Budget Objective

ACTION REQUESTED

Approval of a 2000 – 2001 operating budget objective of 4.9 percent per year.

EXECUTIVE SUMMARY

The requested operating budget objective would result in a two-year budget of $387.6 million, an increase of $35.3 million. This objective does not apply to the capital budget or extraordinary items budget, although depreciation and other operating expenses associated with capital outlays are in the objective. The capital budget will increase by $3.9 million. Without the 2000 – 2001 portion of the Eccles Building Infrastructure Project, the capital budget would decline by $1.1 million over the two-year period. The extraordinary items budget will decline with the completion of work to prepare the Board for the century date change.

DISCUSSION

Process

On a biennial basis, the Board and staff undertake a process that includes strategic planning for the next four years and formulation of a budget for the next two years. For the 2000 – 2003 planning period and 2000 – 2001 budget period, the Committee on Board Affairs, assisted by a senior-level Staff Planning Group (SPG), guided the process. Each division director, working with their oversight committee, examined the division's operations to see whether the mission, organization and resources could be adjusted to enable the Board to carry out its missions more efficiently and effectively.

Planning

The planning materials prepared by the division directors were reviewed by the SPG. Overarching issues were identified and used to shape resource decisions reflected in the recommended budget objective. These include:

- Mission and goals
- Human resources and Board organization;
- Financial modernization and reform;
- Assistance and support to foreign governments, central banks, and international organizations;
- Technology investments;
- Communications with the public;
- Operations and activities of the System; and
- Facilities.

In the course of planning, divisions identified a number of areas in which they anticipated the need for increased resources over the next four years. While there were many worthwhile areas for investment, the Committee on Board Affairs focused on initiatives related to these overarching issues. For example, over half of the recommended increment is sought for human resources issues such as a larger cash award pool, a placeholder for the 2000 and 2001 merit increases, and other salary adjustments.

Budget Objective

The amount needed to efficiently perform the Board's functions represents an increase of $35.3 million, over the 1998 – 1999 budget. This is equivalent to a 4.9 percent per year increase. Approximately one-quarter of the increase is for new work approved in the current budget period such as the Banking Organization National Desktop (BOND) Project and the Eccles Building Project. Approximately two-thirds of the increase is for the 2000 – 2001 merit placeholder (discussed below), rate increases for health insurance and other benefits, full-year costs of actions implemented during 1998 – 1999, and assumed small increases in the cost of goods and services. Programmatic increases, net of reductions, amount to approximately one-tenth of the increase. There is no adjustment in resources included in the objective to account for financial modernization legislation that may be adopted later this year.

Funding for the 2000 and 2001 merit increases represents the largest component of the increment in the budget objective. Consistent with general compensation data available from public sources, merit increases of 4.4 percent ($9.6 million over the two years) and 4.0 percent ($5.0 million for 2001) were used as placeholders for 2000 and 2001, respectively. In addition to general compensation trends, the Board will have specific market information when it makes its determination of the 2000 merit increase in October, and, following the Board's decision, we will adjust the objective, up or down, as

appropriate. The budget estimate also includes $4.6 million to cover the incremental cost of the 1999 merit increase in 2000 – 2001. The three amounts total $19.2 million or 54 percent of the objective. In addition, salaries will increase by $2.0 million as a result of the annualization of personnel actions that occurred during the 1998 – 1999 time period.

We expect fringe costs will increase by $3.9 million during the period. Of this amount, $1.9 million results from rate increases, primarily for health insurance, and other benefits. The higher salary base affects costs for the Thrift Plan and Social Security ($1.0 million). The remaining $1.0 million of the increase comes from a one-time saving in 1999 from the buyout of the retiree health insurance and the transfer of those individuals to the Federal Employees Health Benefit Program.

In general, the cost of goods and services is expected to increase by 2.0 percent per year or a total of $3.0 million. This rate is based on assumptions stated in the 2000 federal budget. Increased costs associated with additional leased space for the Eccles Building Infrastructure Project ($1.3 million) and further implementation of the BOND project ($3.0 million) add to the increase in costs for goods and services.

The net cost of programmatic change is $3.3 million. There are $5.5 million worth of additions partially offset by $2.2 million worth of reductions.

Programmatic additions affecting personnel costs amount to $2.6 million. The increased cash award pool accounts for $1.0 million. Increases for enhanced analytical capabilities in the Division of International Finance ($1.0 million) as well as in the Division of Research & Statistics ($0.4 million) amount to $1.4 million. Varied smaller requests throughout the Board account for the remainder.

Programmatic additions affecting goods and services amount to $2.9 million. The additions are largely for: central automation support to the divisions provided by the Division of Information Technology ($2.1 million); legal support and record imaging in the Management Division ($0.5 million); and enhanced domestic travel to improve supervision of large complex banking organizations and an increase for the BOND project[1] in the Division of Banking Supervision and Regulation ($0.4 million).

Savings of $2.2 million result from program reductions throughout the Board. These savings partially offset the increases discussed above. Staff reductions in areas affected by automation and changes in priority account for most of the savings. Lower travel and other support costs will also result from changes made to fund higher priority work.

[1] In addition to the work approved by the Board in 1998.

Positions

The objective includes a net reduction of one position. Proposed initiatives include nine new positions: two in the Office of the Secretary to meet workload increases for records automation; four Economist positions in the Division of International Finance to meet the expanding need for risk assessment and analysis; and one Consumer Affairs Assistant position in the Division of Consumer and Community Affairs to assist with processing an increased volume of consumer complaints. The Division of Research and Statistics is requesting two new positions to expand its analysis of financial markets data and to continue development of a sectoral productivity data base. Division management will reallocate existing resources to fund these positions. A total of ten positions from various divisions will be eliminated as part of the budget.

Capital Funding

The requested level of programmatic additions and more routine items of a capital nature, particularly automation equipment and facilities support projects amounts to $10.4 million during the two-year budget period. This is $1.1 million less than the 1998 – 1999 capital expenditures. Much of the reduction is because, with declining prices, some automation investments formerly considered capital are now expensed.

Automation investments that are recommended in the objective include equipment for network and distributed processing support, software to implement the FR System standard for desktop computing, improved security, and upgraded facilities in the data center. These investments will allow the replacement of obsolete networks that are over eight years old, improve reliability, expand capacity to meet division requirements and reduce costs over the life-cycle of the equipment.

As approved earlier this year by the Board, capital funding for the Eccles Project will be $11.6 million in the 2000 – 2001 period. This is an increase of $4.8 million over the amount budgeted for 1998 – 1999 and reflects expenditures over a full budget period.

Extraordinary Items

Although not included in the guidance objective, the Board should be aware that three items totaling $7.4 million have been identified for inclusion in the extraordinary items budget. This is significantly less than last year because work to prepare Board information systems for the Century Date Change (CDC) is completed.

The 2001 version of the Survey for Consumer Finances will cost approximately $5.5 million. A small portion of that funding may be expended in 2002. The Small Business Survey will begin data collection in 2003 and will not be included in the 2000 – 2001 budget. However, the current survey will not be completed and delivered until mid-2000. Therefore, an underexpenditure of approximately $1.85 million will occur in 1999 tied to timing and those funds will be needed in the 2000 – 2001 budget.

In the 1997 budget, $2.4 million was expended for the CDC Project. During the current biennium, we anticipate that $15.2 million will be expended to remediate, test and implement year 2000-ready versions of the Board's information systems. The remainder of this year, the CDC project will focus on business continuity and contingency activities and Event Management planning. In the 2000 – 2001 budget, funding of $0.8 million will be required for six months to complete: system monitoring over the leap year day (February 29th); work related to the Event Management activities in January; and standing down test facilities and equipment for the CDC project that are no longer necessary.

Attachments

Attachment

ASSUMPTIONS

The 2000 - 2001 budget objective is based upon the following assumptions.

Budget Baseline
The baseline amount is the approved 1998 – 1999 operating budget, a total of $352.3 million.

2000 - 2001 Salary Increments
An estimated merit increase of 4.4 percent and 4.0 percent is assumed for 2000 and 2001, respectively. This increment is based on general sources available from personnel firms on labor market conditions. When market survey information is available and the Board approves a larger or smaller merit increase, the objective will be adjusted accordingly.

Other 2000 - 2001 Personnel Costs
In general, health insurance rate increases, including rate increases for active employees in the Federal Employees Health Benefit plan, are assumed to average 10.0 percent each year and 5.0 percent for dental coverage for 2001 only.

Increased salary levels will affect the Board's Thrift Plan expense, and a continued increase in the proportion of employees in the Bank retirement plan will result in higher Social Security costs in 2000 – 2001. As the number of people enrolled in the Bank portion of the Retirement Plan increases, the Social Security cost increases. Also, the cap on wages subject to Social Security tax increases each year.

Goods and Services
The federal budget includes a projected increase of 2.0 percent in the price of goods and services. The recommended objective mirrors this assumption.

Attachment

2000-2001 Budget Guidance Summary

Listed below are the key factors in the determination of the Board's 2000-2001 Budget Objective. The underlying assumptions are discussed in the attached text.

1998 - 1999 Approved Budget	$ 352,254,343	
Adjustments Impacts		
Personal Services		
Increases		
Merit Increases (4.4 in 2000 and 4.0 in 2001)	$ 14,608,279	
Annualized Cost of 1999 Merit	4,584,145	
Annualization of Personnel Actions in 1998-1999	1,965,993	
Fringe Cost Increases (Higher Salaries and Rate Increases)	3,880,856	
Total Personal Services	$ 25,039,273	
Goods & Services		
Increases		
Estimated cost increases (2.0%)	$ 2,983,456	
Additional lease space for EBIEPS	1,360,000	
BOND	3,134,000	
Miscellaneous Increases/Decreases	(478,068)	
Total Goods & Services	$ 6,999,388	
Sub-Total 2-Year Net Budget Objective before Committee on Board Affairs Recommendations	**$ 32,038,661**	4.5% per year
Committee on Board Affairs Recommendations		
Programmatic Reductions	$ (2,231,400)	
Programmatic High Priority Initiatives	$ 5,541,360	
2-Year Net Committee on Board Affairs Guidance Objective	**$ 35,348,621**	4.9% per year
2000 - 2001 Total Board Objective	***$ 387,602,964***	***4.9%*** per year