BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: June 21, 1999

To: Board of Governors

From: Edward W. Kelley, Jr.

Subject: 2000 Reserve Bank Budget Objective

The Committee on Federal Reserve Bank Affairs has reviewed the 2000 Reserve Bank budget objective and is forwarding the attached staff memorandum to the Board for its consideration.

The proposed 2000 Reserve Bank budget objective is $2,285.3 million, $126.1 million or 5.8 percent higher than the approved 1999 budget. There is no Special Project expense included in the 2000 budget objective. Employment is projected to be 23,639 ANP, an increase of 368 ANP or 1.6 percent over the 1999 budget.

Attachment

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
DIVISION OF RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS

Date: June 21, 1999

To: Board of Governors

From: Division of Reserve Bank Operations and Payment Systems
(Catherine Jordan, Dorothy LaChapelle, and Paul Bettge)

Subject: 2000 Reserve Bank Budget Objective

Action Requested

Staff recommends that the Board approve a 2000 Reserve Bank budget objective (RBBO) of $2,285.3 million. This target represents an increase of $126.1 million, or 5.8 percent, compared to the approved 1999 budget. The Conferences of Presidents and First Vice Presidents have reviewed the objective and recommend Board approval. The suggested level of funding appears reasonable given ongoing Reserve Bank and FRIT operations and current information related to System initiatives. [1]

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[1] FRIT is the acronym for Federal Reserve Information Technology, which encompasses both Federal Reserve Automation Services (FRAS) and Information Technology Planning and Standards (ITPS).

Executive Summary

Table 1
Historical Budget Increases

Year	Board Approved Objective	Board Approved Budget[1]	Actual to Actual Comparison
1993	8.4%	7.9%	7.7%
1994	5.7%	5.2%	5.0%
1995	4.9%	3.6%	3.8%
1996	5.8%	5.1%	4.9%
1997	3.5%	1.9%	2.4%
1998	2.8%	2.1%	3.6%
1999	4.4%	4.2%	NA

[1] The percentage increase for the Board approved budget is based on a comparison of estimated current year expenses to projected budget expenses.

The proposed 2000 RBBO of $2,285.3 million represents an increase of $126.1 million or 5.8 percent above the 1999 approved Budget.[2] As shown in Table 1, the 5.8 percent increase is the highest recommended percentage increase since 1994[3]. This increase incorporates ambitious plans by the Reserve Banks to invest in a new check operating infrastructure, process growing check and cash volumes, provide new and expanded Treasury initiatives, increase the allowable limits for variable pay, and expand supervision resources to address asset growth in large banking organizations. The RBBO also includes a targeted reduction in expenses of $18.8 million or 0.9 percent from the operating expenses projections submitted by the Reserve Banks and FRIT. Employment is projected to be 23,639 ANP, an increase of 368 ANP or 1.6 percent over the 1999 budget to support these initiatives.[4]

[2] The budget objective is established as a System level target for Reserve Bank operating expenses and includes the projected depreciation expense associated with planned capital acquisitions.

[3] Because the RBBO represents the projected change from the current-year budget, the size of the 2000 budget increase is attributable in part to overruns in the 1999 Reserve Bank budgets. These overruns, which are currently projected to be about one percent, are attributed primarily to resource demands associated with higher than anticipated check and currency volume.

[4] Average number of personnel (ANP); one ANP equals one employee working 40 hours per week for a 52-week year.

Approximately one-half of 2000 expenses will be recovered through revenues from priced services to financial institutions and reimbursements for services provided to the Treasury, Postal Service, and other government agencies (reimbursable claims). Remaining expenses are for "Central Bank" functions, including monetary policy, economic research, cash operations, and supervision and regulation activities.

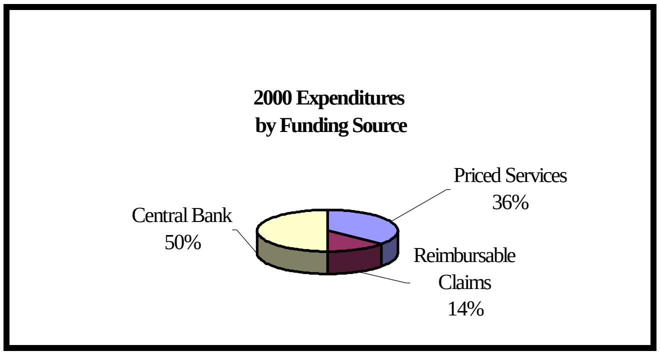

Table 2
2000 Reserve Bank Budget Objective
by Business Line
(dollars in millions)

	1999 Budget	2000 Projection	Variance Amount	Variance Percent	Excluding Unique Major Factors[5]
Priced Services	$768.0	$832.5	64.5	8.4%	4.7%
Reimbursables	298.4	319.0	20.6	6.9%	4.4%
Central Bank	1,092.8	1,152.6	59.8	5.5%	4.9%
Total	$2,159.2	$2,304.1	144.9	6.7%	3.6%
Target Reduction	--	-18.8	-18.8	--	--
Budget Objective	$2,159.2	$2,285.3	126.1	5.8%	--

Expense growth segmented by funding source, before a System-wide target reduction, ranges from 5.5 percent to 8.4 percent (Table 2). Growth in the priced services sector, 8.4 percent, is higher than in previous years and is due primarily to volume growth and multi-year

[5] Major factors affecting the Reserve Bank Budget Objective are identified on Table 3.

retail payments strategic initiatives. Revenue is projected to more than offset these additional expenses. Reimbursable service costs reflect work performed for the U.S. Treasury and other government agencies, which will be claimed for reimbursement. Reimbursable initiatives included in the RBBO as major factors include expansion of the Treasury Offset Program, consolidation of Treasury Tax and Loan and Treasury Direct processing, Treasury Check reengineering, and the Savings Bond architecture project. Central bank costs continue to grow due to increased currency volume and the expansion of supervision resources to address asset growth in large banking organizations and the increase in the number of state member banks in some districts. Partially offsetting these staff increases is a reduction in supervision staff in one district.

Table 3

2000 Reserve Bank Budget Objective
Major Factors
(dollars in millions)

	1999 Budget	2000 Projection	Variance Amount	Variance Percent	Incremental ANP
Total System Budget	2,159.2	2,304.1	144.9	6.7%	368
Targeted Reduction[6]		(18.8)			
Reserve Bank Budget Objective	**2,159.2**	**2,285.3**	**126.1**	**5.8%**	
Less Major Factors:					
Affecting Priced Services					
Infrastructure Investment:					
Check Standardization Projects7	3.2	18.4	15.2		22
Enterprisewide Check Adjustments	1.7	2.7	1.0		4
Check Volume Growth	0.0	6.7	6.7		174
Commercial Check Image	29.4	33.3	3.9		49
Check Relay	39.1	42.6	3.5		1
ACH Promotion and Education	3.0	4.5	1.5		0
Total Priced Services Factors	**76.4**	**108.2**	**31.8**		**250**
Affecting Reimbursable Services					
Treasury Offset Program (TOP)	3.0	4.7	1.7		11
Treasury Tax & Loan Consolidation (TT&L)	0.4	1.8	1.4		30
Treasury Direct Consolidation[8]	0.0	1.6	1.6		--
Electronic Transfer Account (ETA)[8]	0.0	1.1	1.1		--
Treasury Check Reengineering	0.0	0.5	0.5		10
Savings Bond Architecture Project (SNAP)	0.9	2.3	1.4		3
Total Reimbursables Factors	**4.3**	**12.0**	**7.7**		**54**
Affecting Central Bank Services					
Growth in Examination Staff	0.0	2.9	2.9		37
Currency Volume Growth	0.0	2.2	2.2		20
Strategic Inventory Locations (SILs)[8]	0.0	1.5	1.5		--
Total Central Bank Factors	**0.0**	**6.6**	**6.6**		**57**
Affecting Cross-Functional Areas					
Variable Pay Increase	0.0	4.6	4.6		0
Y2K Incremental Costs	10.7	3.4	(7.3)		(47)
Electronic Access Improvements	5.3	7.5	2.2		8
FRIT Initiatives	0.0	6.1	6.1		32
Total Cross-Functional Factors	**16.0**	**21.6**	**5.6**		**(7)**
Total Less Target Reduction and Major Factors	**$2,062.5**	**$2,136.9**	**$74.4**	**3.6%**	**14**

[6] The targeted reduction will be achieved, in part, by productivity improvements, which will most likely result in fewer incremental ANP in 2000. At this point in the budgeting process the specific reductions are not known.

[7] The check standardization project has projected costs of $21.0 million in 2000. A portion of that cost, however, consists of reallocated support and staff resources, which has no bottom line impact. The $18.4 million depicted in this table is net of those resources.

[8] Estimated incremental ANP associated with these initiatives is not yet available.

Factors Driving the Budget Objective

FACTORS AFFECTING PRICED SERVICES

Check Standardization: The Reserve Banks plan to undertake a multi-year initiative to standardize check hardware and software, consolidate processing under FRIT, and develop common applications that all Reserve Banks will use. Some of the benefits of this effort will be improved delivery of checks, greater flexibility to address volume shifts, better contingency, and lower ongoing operating costs. Incremental costs of $15.2 million were included in the objective. The expenses in 2000 are primarily related to software and equipment depreciation, travel and fees for consultants, and for incremental staff required to support the initial development, testing, and training efforts to support a standardized check-processing environment.

The increase represents costs for the initially approved direction using the dual vendor strategy. The Reserve Banks' Retail Payments Office is currently undertaking a reevaluation of the dual vendor/single vendor decision. After this analysis is complete a new cost projection will be provided. While many questions remain to be answered prior to finalizing the System's strategy for this initiative, this cost estimate represents the best projection available at this. Check standardization project management believes that, regardless of the decision resulting from the current review, costs in 2000 will not exceed the estimate included in the RBBO.

Enterprisewide Check Adjustments: Costs associated with implementing the Enterprisewide Check Adjustment System are projected to increase $1.0 million in 2000. The increase is to establish a centrally staffed function to manage the day-to-day operations for the nationwide standard application for check adjustments.

Check Volume Growth: Systemwide, check processed volume increased 5.3 percent in 1998 compared with the 1998 budgeted growth of 3.3 percent, with some districts experiencing double digit growth. Actual volume year-to-date through April has increased 8.1 percent over1998 levels, or five percent over the annual target for 1999. Seven districts specifically noted that they will need more resources than budgeted during 1999 to handle the unanticipated volume growth. The 2000 increase of $6.7 million and 174 ANP reflects the full year effect of staff hired, or expected to be hired, in 1999 and planned additions in 2000.

Commercial Check Imaging: Projected increases for equipment, software, and staff associated with commercial check image services total $3.9 million and 49 ANP. The 2000 projection includes a $2.1 million increase to support pilot projects in the Utica and Helena check offices and $1.0 million in salary costs for an additional 20 ANP for check imaging in the San Francisco district in response to customer demand. Approximately $0.7 million of the cost increase is for implementation of the national commercial image archive.

Check Relay: The Check Relay function (formally called Interdistrict Transportation System is projecting an increase of $3.5 million primarily due to new transportation contracts ($1.0 million), changes required by FAA regulations ($0.7 million), and higher fuel costs ($0.6 million).

ACH Promotion and Education: An increase of $1.5 million is projected to expand the national ACH promotion and education campaign begun in 1998 in collaboration with NACHA, local ACH associations, the Treasury, and the Social Security Administration. Approximately $1.0 million will be used to support local Reserve Bank and ACH association direct deposit and direct payment promotion campaigns. The remaining $0.5 million will be used for outside consultants for various ACH initiatives.

FACTORS AFFECTING REIMBURSABLE SERVICES

Treasury Offset Program: The Treasury Offset Program (TOP) enables government agencies to collect debts owed by delinquent debtors by offsetting government payments due to them. Initiatives in 1999 and 2000 include continuing to bring in additional delinquent debt and new payment types for processing, and redesigning the automated application to accommodate increasing volumes and to utilize new technologies. An additional 11 ANP and $1.7 million will be needed in 2000 to respond to the Treasury's directive.

Treasury Tax & Loan Consolidation (TT&L): The implementation of the Treasury Investment Program (TIP) and Paper Tax System (PATAX) operations at the St. Louis Reserve Bank will replace the TT&L functions at all Reserve Banks. TIP is a centralized application that will be used to manage Treasury's deposits in depository institutions. When implemented in mid-2000, the application will provide enhanced investment capabilities and collateral monitoring abilities. Costs of approximately $1.4 million and 30 ANP will be incurred as the central site staffs up to support the consolidated environment and the Reserve Banks close down their TT&L operations. Savings from the consolidated operations are expected to begin in the fourth quarter of 2000.

Treasury Direct Consolidation: Treasury Direct will be consolidated in three Reserve Bank offices (Boston, Minneapolis, and Dallas) in the 2000-2001 timeframe. Initial estimates are $2.8 million in operating expenses primarily for salaries, training, and travel as sites prepare for consolidation; $1.6 million of this amount has been included in the 2000 projections. Similar to the TT&L consolidation, staff will be required at both the consolidated and nonconsolidated sites during the transition period. Staff savings are expected upon completion of the consolidation effort.

Electronic Transfer Account: The Debt Collection Improvement Act of 1996 requires that most Federal payments be made by electronic funds transfer.[9] Accordingly, the Treasury is developing the Electronic Transfer Account (ETA^{SM}) to give recipients access to low-cost transaction accounts at financial institutions. The program is voluntary for financial institutions and payment recipients. The Treasury has asked the Federal Reserve to provide support to the Financial Management Service (FMS) in the rollout and ongoing operation of the ETA program. The program includes marketing support to depository institutions; processing the enrollment of ETA providers; and providing access to the database of authorized ETA providers to payment recipients and other stakeholders. Business requirements and related capital and expense budgets for 2000 are being developed. It is expected that expenses in 2000 will be approximately $1.1 million for the ongoing operations and customer service function.

Treasury Check Reengineering: The 2000 projection includes costs of $0.5 million to work jointly with the FMS to improve operations related to Treasury check accounting, reconciliation, collections, and claims. The 2000 RBBO includes costs related to depreciation expense for capital purchases planned for 1999, software, and salaries for 10 ANP.

Savings Bond Architecture Project (SNAP): The $1.4 million increase over the 1999 budget will provide a new automation architecture (hardware and software) for Savings Bonds processing at the five consolidation sites. This initiative supports the Bureau of Public Debt's goal for a more effective and efficient automation platform for Savings Bond processing. The 2000 projection also includes an additional three ANP.

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[9] The regulation provides for liberal waivers from the mandatory requirements.

FACTORS AFFECTING CENTRAL BANK SERVICES

Growth in Examination Staff: Growth in examiner staff is concentrated in Chicago and Richmond to support the significant growth in supervised assets at their large, complex banking organizations. Most of these staff additions are occurring in 1999. Special Y2K examinations in 1999 were accomplished largely by deferring regularly scheduled examinations of information systems and small bank holding companies and redeploying those examiners. In 2000 these examiners will return to their regular duties to meet normal mandates for examination frequency.

Currency Volume Growth: In 1999 and 2000 currency volumes are projected to continue to increase rapidly across the System. The Reserve Banks' Cash/Fiscal Product Office estimates the Reserve Banks will process 30 billion notes in 2000—an 8.9 percent increase over the budgeted 1999 volume and a 16 percent increase over 1998 actual volume. The $2.2 million expense increase includes the costs associated with an additional 20 ANP (the majority of which have been added during 1999) and additional currency processing equipment.

Strategic Inventory Locations: Cash off-site strategic inventory locations (SILs) will be established in the latter part of 1999 and will remain operational through early 2000 to respond to expanded currency demands related to the century date change. Approximately 100 SILs will be established to enable the Federal Reserve to respond more quickly to unexpected demand for currency. These off-site inventories of Federal Reserve currency will be located at depository institutions and armored carrier facilities.

FACTORS AFFECTING CROSS FUNCTIONAL AREAS

Variable Pay: The Reserve Banks have recommended an increase in the variable pay to make them more comparable with the private sector practice. The budget objective for 2000 assumes variable pay of 5.0 percent of salary liability for officers and 1.5 percent of salary liability for employees. The objective includes $4.6 million incremental expense associated with the gap between the current guidelines of 3.5 percent for officers and 1.3 percent for employees and the proposed higher guideline.

Incremental Y2K Costs: Incremental Y2K costs and staff at the Reserve Banks and FRIT are projected to decline by $7.3 million and 47 ANP from budgeted 1999 levels. Reserve Banks and FRIT have included in the 2000 RBBO $3.4 million incremental costs and 15 ANP, which represents about 30 percent of the incremental resources budgeted in 1999. Incremental staff will be available to address any problems that may occur and complete administrative duties to bring closure to the project. Funds for the final stages of retention and incentives programs also are included in the 2000 projection. Reallocated staff resources that have been dedicated to the Y2K effort will be redeployed to address significant pent-up demand for various information technology projects and will not produce any bottom-line cost and ANP reductions.

Electronic Access Improvements: The $2.2 million increase is primarily for electronic access products. This projected increase will support enhanced security and the planned rollout of Version 4 of Fedline for Windows, which will be the first release available for widespread customer installation. It is currently scheduled to be available to the districts in third quarter 2000

FRIT Initiatives: The $6.1 million increase for FRIT initiatives respond to increasing customer demands. These initiatives include: 1) supporting check standardization (incremental staff only); 2) establishing the infrastructure for secure browser access; 3) providing central server support and processing for distributed applications; and 4) FEDNET modernization initiatives and Interfed expansion.

OTHER BUDGET ASSUMPTIONS

Planned Merit Program: The Reserve Banks and FRIT submitted merit programs that range from 3.7 percent to 5.0 percent, with a weighted average of 4.3 percent, which is in line with current national projections. This merit increase is slightly higher than budgeted in 1999 and reflects district management's desire to remain competitive with local market conditions. Planned promotions and structure changes bring the total salary administration increase to a weighted average of 5.5 percent. Merit projections were made using the best currently available data, but without the benefit of full local compensation survey data that will be available for the actual budget process.

Retirement and Other Benefits Costs: Retirement and Other Benefits (R&OB) costs are projected in the 2000 RBBO to increase 5.9 percent, reflecting both staff growth and higher costs per person. A significant portion of the per-person increase is in active employee medical costs, which comprise 22 percent of total R&OB costs. The employer-paid portion of active employee medical is currently projected to increase approximately 8.0 percent on average. These estimated medical cost increases at the Reserve Banks and FRIT range from 5 percent to 15 percent. Actual employee medical costs will not be known until later this fall after contract negotiations are finalized.

Budget Challenges

The following risk factors identify potential costs that have not been included in the RBBO projections. Each of these factors could put upward pressure on 2000 expenses.

Conversion to Standard Groupware: The Information Technology Oversight Committee approved the adoption a standard System e-mail and groupware product. Each Reserve Bank is expected to implement the standards as soon as reasonably possible, but no later than January

1, 2002. It is estimated that one-time implementation costs for this conversion will be approximately $7.0 million. This initiative could affect the 2000 budget if some Reserve Banks elect to begin implementation during 2000.

Information Security: Recently the System adopted new information security requirements. These new requirements, such as longer passwords, enhanced virus protection, strengthened password administration, emergency response teams, and active penetration testing are expected to increase resource demands and costs for training and software. The effect on individual districts will vary. At the time of the RBBO submission, many districts did not have adequate information to include estimates for these costs. Although some districts did include additional ANP for the new security requirements, those projections represent very early estimates.

Lease Writeoff: The New York Reserve Bank is scheduled to vacate leased space at 59 Maiden Lane in June of 2000 (the lease expires in 2002). In the event the lease is not assumed at that time, the Bank will be required, under generally accepted accounting principles, to recognize a net, one-time expense of approximately $13.7 million in 2000. Most of this expense will be recovered as a result of incentives the Bank will receive from the lessor of the new occupied space through reductions in rent expense each year through 2022.

Check Volume Growth: Check volume growth has generally been difficult to project accurately. In 1998-99 volume has exceeded expectations in most Reserve Banks. Based on evidence that some correspondent banks are reducing their involvement in check processing, the risk that volume growth will exceed projections seems greater than the risk it will fall short.

Retention Incentives Related to the Treasury Consolidations: Discussions are underway concerning retention incentives and severance payments for some employees affected by the Treasury Tax & Loan (TIP/PATAX) and Treasury Direct consolidations. Both efforts will require the retention of key staff to continue to provide services and maintain operations during the transition. It is estimated that these programs could add approximately $1.3 million in personnel costs.

Capital Outlays

Capital outlays of $402.6 million are projected in 2000, a decrease of $3.0 million or 0.7 percent from budgeted 1999 outlays, as shown in Table 4. Large reductions in New York, from the completion of the 33 Maiden Lane renovation project, are mostly offset by capital acquisitions for the check standardization initiative. FRIT plans a $0.9 million increase in capital outlays, which is the net of higher costs for data communication capital for network upgrades and lower software capital.

Table 4

2000 Reserve Bank Budget Objective

Capital Outlays

(dollars in millions)

	1999	**2000**	**Variance**	
Description of Expense	**Budget**	**Projection**	**Amount**	**Percent**
Reserve Bank Total	$366.9	$363.0	($3.9)	(1.1%)
FRIT Total	38.6	39.6	0.9	2.4%
System Total	**405.6**	**402.6**	**(3.0)**	**(0.7%)**