Chapter 3

Federal Reserve Banks

The final budgets of the twelve Reserve Banks for 2000 total $2,325.9 million, an increase of $127.3 million, or 5.8 percent, from 1999 estimated expenses.[1] When the cost of the check standardization special project is excluded from the 2000 budget, the Reserve Bank budgets total $2,311.9 million, an increase of $113.3 million, or 5.2 percent, from the 1999 estimate (table 3.1). The Reserve Banks' 2000 budgets are above the 1999 approved budget by $166.7 million, or 7.7 percent. The budget increase, as detailed later in this chapter, is largely a result of the full-year effect of factors that created a net 1999 expense overrun of $39.4 million.

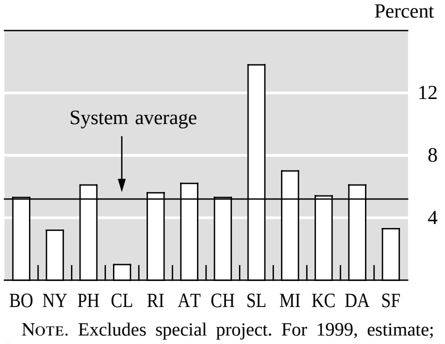
Approximately 54 percent of Reserve Bank expenses in the 2000 budget are offset by priced service revenues, reimbursable claims for services provided to the U.S. Treasury and other agencies, and income from funds settlement fees associated with the transfer of Treasury securities. Priced service revenues are budgeted to increase 6.2 percent because of higher check volumes and price increases. Reimbursable claims will increase 6.6 percent, primarily because of transition costs associated with the Treasury Direct consolidation initiative.

The total Reserve Bank increase of $113.3 million provides funding for each District's salary administration and benefit programs, District projects and centralized operations, and various System-defined factors, including check standardization, check imaging, and the installation in several Districts of a check-adjustment system based on local-area-network (LAN) computer technology.

At individual Reserve Banks, 2000 budgeted expenses exceed 1999 estimated expenses by 1.0 percent to 13.8 percent (chart 1.1). The variation among Districts reflects a movement toward centralization of functions and the degree to which a District supports Treasury projects and System factors. For example, St. Louis will become the consolidation site for the Treasury Investment Program during 2000. Also, Treasury Direct operations will be

Chart 3.1

Change in Operating Expenses of the Federal Reserve Banks, 1999–2000



NOTE. Excludes special project. For 1999, estimate; for 2000, budget.

1. Excludes capital outlays. Includes expenses budgeted by Federal Reserve Information Technology (FRIT) and the System's Office of Employee Benefits (OEB); expenses from these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets. Because of their unique roles within the System, FRIT and the OEB have prepared their own budgets. Data for FRIT are included in this document; the OEB's staffing level of 36 ANP and proposed capital budget of $2.7 million are not discussed further here.

consolidated at the Boston, Minneapolis, and Dallas Banks.

The average number of personnel (ANP) projected to be employed during 2000 at the Reserve Banks and FRIT is 23,751, an increase of 265 ANP, or 1.1 percent, from 1999 estimated staff levels (table 3.2).[2] The expected increase of 240 ANP, or 1.0 percent, in Reserve Bank employment is largely the annualized effect of 1999 staff additions and, to a lesser extent, initiatives planned for 2000. FRIT employment is expected to increase 25 ANP, or 4.0 percent, resulting from several initiatives, including expanded services to FRB New York,

2. The term *average number of personnel* describes levels and changes in employment at the Reserve Banks. ANP is the average number of employees in terms of full-time positions for the period. For instance, a full-time employee who starts work on July 1 counts as 0.5 ANP for that calendar year; two half-time employees who start on January 1 count as 1 ANP.

Table 3.1

Expenses of the Federal Reserve Banks, Net of Receipts and Claims for Reimbursement, 1999–2000

Millions of dollars except as noted

Item	1999 estimate	2000 budget	Change	
			Amount	Percent
Operations	2,198.6	2,311.9	113.3	5.2
Special project[1]	.0	14.0	. . .	. . .
Total	2,198.6	2,325.9	127.3	5.8
LESS				
Revenue from priced services	871.4	925.5	54.1	6.2
Other income	2.0	1.9	–.1	–5.0
Claims for reimbursement	296.1	315.6	19.5	6.6
EQUALS				
Net expenses	**1,029.1**	**1,082.9**	**53.8**	**5.2**

NOTE. See text note 1; see also notes to table 1.1, chapter 1.

1. Check-processing standardization.

Table 3.2

Employment at the Federal Reserve Banks, 1999–2000

Average number of personnel except as noted

Item	1999 estimate	2000 budget	Change	
			Amount	Percent
Operations	22,867	23,107	240	1.0
Federal Reserve Information Technology	620	644	25	4.0
Total	23,487	23,751	265	1.1
Special project[1]	0	5	. . .	. . .
Total	**23,487**	**23,756**	**270**	**1.1**

NOTE. See notes to table 3.1. See text note 2 for definition of average number of personnel.

1. Includes Federal Reserve Information Technology.

the check standardization project, and modernization of the production environment (for expenses and ANP by District and by operational area, see appendix D, tables D.1 through D.4).

1999 Budget Performance

The Reserve Banks estimate that 1999 expenses will be $2,198.6 million, an increase of $39.4 million, or 1.8 percent, from the approved 1999 budget of $2,159.2 million and an increase of $121.6 million, or 5.9 percent, above 1998 actual expenses. ANP for 1999 is estimated at 22,867, an increase of 216 ANP, or 1.0 percent, from the approved 1999 level (tables 3.3, D.5, and D.6).

Estimated 1999 expenses at eleven of the twelve Banks are above the approved 1999 budgets by amounts ranging from 0.9 percent in Philadelphia to 4.0 percent at Kansas City. New York is estimating its 1999 expenses to be $0.8 million, or 0.2 percent, below budget (table D.5).

Unanticipated volume increases in the check and currency areas are contributing $43.6 million to the 1999 overrun. The check service accounts for the majority of the expense overrun and is 249 ANP over budget. System-processed check volumes are estimated to increase about 3.5 percent over budget, with percentage volume growth in the double digits in both Philadelphia and Kansas City. The increase in volume is attributable to several factors, including market-based pricing, new product offerings, and the withdrawal of some correspondent banks from the check processing service. The Reserve Banks have estimated that 1999 check revenues will fully cover all check costs.

The currency service has also experienced unforeseen volume increases. Additional shifts to process the currency and increased supply and shipping costs are contributing 62 ANP and $9.9 million to the overrun. The rise in currency paying and receiving volumes, which are now expected to be 12 percent higher than budgeted, is due in part to the Board's decision to reduce backlogs to less than ten days to ensure that Reserve Banks were prepared to handle year-end processing demands.

Expenses related to century date change (Y2K) initiatives throughout the System are estimated to be $39.4 million, $10.3 million higher than approved 1999 budget levels. The main factor behind this overrun is an increase in overtime related to testing. The number of weekends that depository institutions tested with a Reserve Bank was greater than budgeted.

Table 3.3

Budget Performance of the Federal Reserve Banks, Operational Expenses and Employment, 1999

Item	1999 budget	1999 estimate	Change	
			Amount	Percent
Operating expenses (millions of dollars)	2,159.2	2,198.6	39.4	1.8
Employment (average number of personnel)	22,651	22,867	216	1.0

NOTE. See notes to table 3.2.

The 1999 estimate includes another Y2K project—the creation of strategic inventory locations (SILs) in the fall of 1999 for the precautionary storage of currency. The Districts estimate that the unbudgeted expenses for shipping, insurance, and other costs related to establishing the SILs will add $4.9 million to 1999 expenses.

The final factor contributing to the overall increase in 1999 expenses is lower-than-anticipated capitalized software costs related to internally developed applications. Beginning in 1999, Reserve Banks began to capitalize costs related to certain software development projects. Delays in a number of projects throughout the System are estimated to add $3.7 million to 1999 expenses, with a corresponding reduction in capital projects.

Partially offsetting these overruns are lower-than-anticipated occupancy costs in the New York District ($3.6 million) and, over the System as a whole, an estimated net underrun of $1.1 million in expenses related to the check-imaging initiative.

Factors Affecting the 2000 Budget

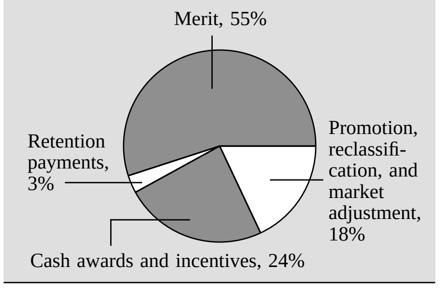
Personnel expenses, which include both salaries and benefits, represent 64 percent of Reserve Bank expenses and are the principal source of the year-over-year budget increase. Reserve Bank budgets include $80.3 million to fund salary administration programs (merit increases, promotions, and so on) for officers and employees (table D.7).[3] The budgets include average merit increases of 4.4 percent for officers and 4.2 percent for employees, totaling $44.2 million, or 55 percent, of the total salary administration budget (chart 3.2). Promotions, reclassifications, and market adjustments represent $14.1 million; retention payments represent $2.4 million; and officer and employee cash awards and incentive payments represent $19.6 million. The merit and other salary-related expenses are in line with trends in both the public and private sectors.

Officer turnover (including retirement) continues to be low, with five Banks projecting no turnover in 2000. The remaining Banks project officer turnover in a range from 2.0 percent (Minneapolis) to 7.4 percent (San Francisco). Employee turnover in 2000 is projected to range from 8.5 percent (Chicago) to 14.7 percent (Cleveland). Banks are reporting higher turnover in checks and some professional and technical areas. Turnover in the information technology area appears to have stabilized in 1999 and is expected to remain low in 2000. In 2000, however, continuing market pressures will increase the risk of losing employees with critical skills. As a result, the Banks plan greater

3. Salary administration represents the budgeted funds that are available to increase compensation to officers and employees in the coming year. It does not include adjustments for changes in staffing levels, turnover and lag in hiring, and overtime.

Chart 3.2

Components of Salary Administration at the Federal Reserve Banks, 2000



NOTE. See text note 3.

use of variable pay, retention incentives, and other monetary and nonmonetary rewards for key officers and employees.

Retirement and other benefit expenses, which account for 13 percent of Reserve Bank budgets, are anticipated to increase $18.3 million, or 6.3 percent, in 2000. The primary factors include increases in salary-related benefits such as social security and employee thrift plan contributions, which are directly related to the increased number of ANP. Other contributing factors include higher postretirement and postemployment valuations, which are directly related to changes in actuarial assumptions. Employer costs for health and dental plans are also budgted to increase in 2000.

The 2000 budgets are also being affected by several other initiatives at the Reserve Banks (table 3.4). Many of these initiatives are the same as those identified as factors influencing the 1999 budget overrun. For example, the full-year effect of the dramatic increases in check volume this year are reflected in salary, benefit, equipment, and depreciation costs in the 2000 budgets. Projects in their infancy in 1999, such as check standardization and enterprisewide check adjustments, will demand much greater resources in 2000, while century date change and SIL costs in 2000 are projected to be lower.

Priced Services Provided to Depository Institutions

Factors affecting the budget for services provided to depository institutions include standardization of the check-

Table 3.4

Changes in Expense and Employment for Major Initiatives at the Federal Reserve Banks, 1999–2000

Millions of dollars except as noted

Initiative	1999 estimate	2000 budget	Change	
			Amount	Average number of personnel
Priced services provided to depository institutions				
Check standardization	12.6	20.9	8.3	34
Enterprisewide check adjustment	2.4	4.3	1.9	12
Commercial check imaging (total)	23.3	27.1	3.9	30
Reimbursable services				
Treasury Direct consolidation	18.7	24.2	5.5	81
Treasury Tax and Loan consolidation	5.7	6.5	.8	–1
Imaging for government agencies (total)	13.7	16.1	2.4	22
Central bank services				
Strategic inventory location	4.9	3.1	–1.7	0
Cross-functional areas (incremental costs)				
Century date change				
Federal Reserve Banks	9.7	3.9	–5.8	–31
Federal Reserve Information Technology	4.9	1.7	–3.3	–21
Total	**95.9**	**107.8**	**11.9**	**126**

NOTE. See notes to table 3.2.

processing hardware and software, enterprisewide check adjustments, and commercial check imaging.

Check-Processing Standardization

The Reserve Banks plan to undertake a multiyear initiative to standardize check hardware and software, consolidate processing at 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. The increase in the 2000 budgets represents costs for the recently approved directive to use a single-platform strategy. The costs associated with this effort have been segregated in a System project and a special project.

The check standardization System project was established to capture and track expenses associated with the standardization and conversion to a single operating platform. System project expenses reflecting incremental increases of $8.3 million and 34 ANP are included in the 2000 budget.

In addition to these expenses, a check standardization special project has been established to capture excess capacity and unique transition-related expenses during the conversion. The budget for the 2000 check standardization special project is $14.0 million and 5 ANP.

Enterprisewide Check Adjustments

Expenses included in the budget associated with implementing the Enterprisewide Check Adjustment System are $4.3 million and 25 ANP, an increase of $1.9 million and 12 ANP from 1999 estimated expenses. These costs are to establish a centrally staffed function to manage the day-to-day operations for this nationwide, standard, LAN-based application for check adjustments. Additional costs for personnel, software licensing, and maintenance have been included in the budget. Installation is currently projected to be completed by the end of 2000.

Commercial Check Imaging

Equipment, software, and staff expenses associated with commercial check image services are projected to be $27.1 million in 2000, an increase of $3.9 million and about 30 ANP above 1999 estimates. The 2000 budget includes funding to support commercial check pilot projects in the Utica and Helena offices, as well as costs incurred in the other Districts to support increased customer demand and implementation of the national commercial image archive.

Reimbursable Services

Factors affecting the budget for reimbursable services include the consolidation of support for Treasury Direct, changes in the Treasury Tax and Loan system, and the introduction of imaging for government agencies. Costs in these three areas are fully reimbursable.

Treasury Direct Consolidation

The processing of requests from the public to purchase Treasury securities through the Treasury Direct program will be consolidated in three Districts . . . The three Districts have budgeted $12.3 million in 2000 for the equipment costs and 182 ANP associated with this project. Budgets for the Districts losing Treasury Direct operations include staff reductions for 2000 totaling 56 ANP. The cost savings resulting from these staff reductions are partially offset by budgeted retention incentives necessary to ensure a smooth transition. Processing at all sites will continue until the three consolidation sites are fully operational. Further ANP reductions are expected upon the completion of the transition, tentatively planned for December 2000.

Consolidation of Treasury Tax and Loan Operations

The consolidation of the operations supporting the Treasury Investment Program (TIP) and Paper Tax System (PATAX) at the St. Louis Reserve Bank will replace the existing TT&L software and staff at all Reserve Banks. TIP is a centralized application that will be used to manage the Treasury's tax receipts that are invested in depository institutions. TIP and PATAX, to be implemented in 2000, will improve capabilities for monitoring investment activity and monitoring collateral and make the tax-collection process fully electronic. The 2000 budget includes an increase of 20 ANP in St. Louis, which is offset by a reduction of 21 ANP in the other Reserve Banks. When centralized processing is fully implemented in 2000, additional ANP reductions are expected.

Imaging for Government Agencies

Imaging projects for government agencies total $12.6 million in 2000 and include the imaging and archiving of government checks and EZ Clear savings bonds. The 2000 budget also includes $3.5 million and 22 ANP associated with the postal money order image project. Production implementation of the money order project has been deferred from 1999 to the second quarter of 2000.

Central Bank Services

The largest factor affecting the budget for central bank services is the Y2K-related strategic inventory location (SIL) project. The project created seventy-nine supplemental cash-storage sites apart from Reserve Bank offices to facilitate cash access for depository institutions around the time of the century date change, should circumstances demand it. The Reserve Bank budgets for 2000 provide $3.1 million to cover SIL-related transportation, storage, and insurance fees through the first quarter of 2000, when the sites were closed.

Cross-Functional Areas

The largest factor affecting the budgets for the cross-functional areas is the century date change effort. Reserve Banks and FRIT have included $13.0 million and 102 ANP in their 2000 budgets for both reallocated and incremental resources related to Y2K issues. The 102 ANP is a decrease of 387 ANP, or 79.2 percent, from 1999 estimated staffing levels. The Y2K-related staff included in the 2000 budgets was available to address potential problems and to complete administrative duties to bring the century date change project to a close during the first quarter of 2000. Funds for the final stages of retention and incentive programs are also included in the 2000 budgets.

The reallocated staff resources that had been dedicated to the Y2K effort will be deployed to address demands for other information technology projects. Incremental Y2K costs are budgeted to decline $5.8 million at the Reserve Banks and $3.3 million at FRIT. Incremental staff associated with this initiative will decline 52 ANP from

1999 estimates, of which 31 are located in the Reserve Banks and 21 at FRIT.

Risks in the 2000 Budget

Reserve Banks have noted several common risks associated with the 2000 budgets. First, key projects for the Treasury could create budget uncertainties. Modifications to implementation and consolidation schedules or application requirements could affect costs for software, equipment, and human resources.

The System's check standardization project may present significant risk for the 2000 budget as well. When scheduling for the project is completed, several Districts may find they are facing higher-than-budgeted expenses in 2000, particularly if the implementation schedule is accelerated.

Finally, the market for skilled employees remains very tight. Initiatives that are contingent upon successful staffing efforts present additional uncertainties in the 2000 budget.

2000 Capital Plan

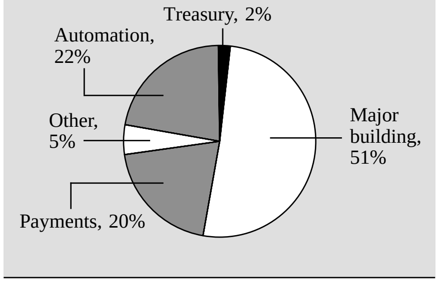
The 2000 capital budgets submitted by the Reserve Banks and FRIT total \$514.3 million, an increase of \$132.1 million from the 1999 estimated levels. The budget includes \$469.3 million for the Banks and \$45.0 million for FRIT. As in previous years, the 2000 capital budgets developed by the Reserve Banks and FRIT include funding for projects that support the strategic direction outlined in the Banks' plans. These strategic goals include improving operational efficiency and effectiveness, improving services to Bank customers, and providing a safe, high-quality work environment. In support of these strategies, the 2000 budget includes four major categories of capital outlays—buildings and facilities, automation, payment services, and Treasury-related initiatives (chart 3.3; see tables D.8 and D.9 for details by District and asset classification).

Buildings and Facilities

The proposed capital budget includes an estimated \$260.0 million for the modernization or replacement of physical facilities and replacement or upgrading of critical systems. Of the total building-related expenses, \$183.4 million (70.5 percent) is attributable to eight initiatives with budgets greater than \$4.0 million. These include two in the Atlanta District (new Atlanta and Birmingham buildings), one in the San Francisco District (Phoenix cash facility), one in the Dallas District (new Houston building), three in the New York District (improvements at 33 Maiden Lane and restorations and renovations at the main building), and one in the St. Louis District (check department renovations). The Kansas City District has also budgeted for a facility space evaluation project for the head office. In addition to the larger projects described, funding is also provided for the replacement of routine

Chart 3.3

Major Capital Projects at the Federal Reserve Banks, 2000



NOTE. Includes Federal Reserve Information Technology.

building-related equipment and the replacement of furniture and fixtures.

Automation

The proposed capital budget includes $110.6 million in funding for major automation initiatives. These projects do not include the automation components of building, payments, or Treasury-related initiatives that are discussed separately. The strategic directions outlined in the individual Bank budgets linclude enhanced technological capabilities, the continued implementation of LAN technology, the development of common office environments and web-based applications, and various enhancements and replacements that were deferred to ensure Y2K preparedness.

Aside from the $45.0 million included for FRIT, the automation total includes $22.7 million in funding for major software application development, enhancements, and purchases. New York's Transaction Processing System initiative ($2.7 million) and the Statistics and Reserves System ($1.9 million) for all the Districts, as well as a number of smaller projects, contribute to software outlays.

The largest share of the remaining funds supports the Districts' distributed technology strategies and replacement of personal computers. Nearly all Banks are operating under a three-year replacement strategy and continue to convert applications from the mainframe to a LAN environment and, to a lesser extent, web-based solutions.

Payment System Improvements

The 2000 capital budget includes $105.3 million for initiatives related to payment system improvements. These initiatives include the acquisition and installation of high-speed check imaging equipment, replacements for check reader–sorters and endorsers, the ongoing development of a common check platform and related applications, the implementation of the enterprisewide check adjustment system, and settlement-related initiatives.

Treasury-Related Initiatives

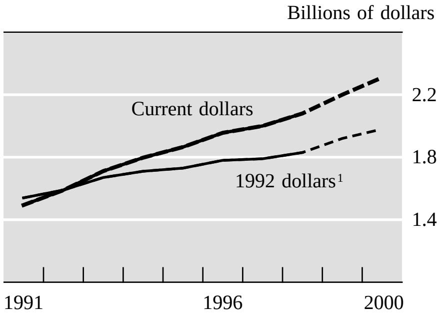
Major Treasury-related initiatives account for $11.6 million of the capital budget. These projects include $4.1 million related to the Treasury Direct consolidation, $1.5 million for the continued development of the EZ-Clear Savings Bond Image and Archive Retrieval System, and $1.1 million for the Savings Bond Architecture Project. In addition to these major initiatives, funding is also included for the continued development of the system for Intragovernmental Payment and Collection, the Automated Standard Application for Payments, and the TIP and PATAX applications.

Trends in Expenses and Employment

Over the ten years ending with the 2000 budget, Reserve Bank expenses have increased an average of 5.0 percent per year (chart 3.4), and the average number of employees at the Reserve Banks (including FRIT) has increased 160, from 23,596 in 1991 to 23,756 in 2000 (chart 3.5). Over the five years ending with the 2000 budget, Reserve Bank expenses have increased an average of 4.4 percent per year when special projects are excluded, and 4.0 percent when special projects are included. Overall, expenses have been affected during this five-year period by increases in check and cash volumes, higher retirement and benefits costs, and information technology requirements,

Chart 3.4

Operating Expenses of the Federal Reserve Banks, 1991–2000

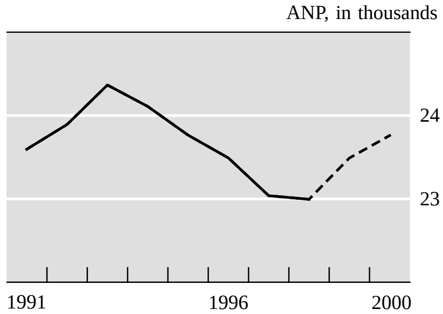


Note. Excludes special projects. For 1999, estimate; for 2000, budget.

1. Calculated with the GDP price deflator.

Chart 3.5

Employment at the Federal Reserve Banks, 1991–2000



Note. Includes Federal Reserve Automation Services and special projects. For 1999, estimate; for 2000, budget. See text note 2 for definition of ANP.

including the century date change initiative.

Since 1996, overall staff levels have increased 198 ANP. Staff increased in services provided to financial institutions and the public (417 ANP), primarily as a result of increases in the volume of processed checks. Support services also increased (185 ANP), primarily because of needs in the information technology area. Partially offsetting the increases are reductions to staff in the supervision and regulation area (163 ANP), services to the Treasury and other government agencies (148 ANP), overhead services (90 ANP), and the monetary and economic policy service (3 ANP). These staff reductions have been due largely to consolidation of operations and increased operational efficiencies throughout the System. ■

Chapter 3

Federal Reserve Banks

The operating budgets of the twelve Reserve Banks for 2001 total $2,442.2 million.[1] The 2001 total is an increase of $116.3 million, or 5.0 percent, above the 2000 approved budget and an increase of $144.4 million, or 6.3 percent, over estimated 2000 expenses (table 3.1).[2] The Reserve Banks' estimated 2000 expenses were $28.1 million under budget. This underrun is explained in the 2000 Budget Performance section of this chapter.

Approximately 40 percent of Reserve Bank expenses in the 2001 budget are offset by priced service revenues, and an additional 12 percent are offset by reimbursable claims for services provided to the U.S. Treasury and other government agencies. Revenues from priced services are budgeted to increase 6.7 percent in 2001, primarily as a result of projected increases in automated clearinghouse (ACH) volume, check

1. This total includes the cost of a special project. Special projects are major efforts that have Systemwide significance and are outside the budgets of the individual Reserve Banks. The only special project currently in effect reflects $16.4 million in costs associated with the check standardization initiative. (See tables D.1–D.4, appendix D.)

2. Includes expenses budgeted by Federal Reserve Information Technology (FRIT) and the Office of Employee Benefits (OEB); expenses of these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets. Because of their unique roles within the System, FRIT and the OEB have prepared their own budgets. Data for FRIT are included in this document; the OEB's staffing level of 29 ANP is not discussed further. Unless otherwise noted, expenses also include costs associated with the check standardization special project. Special project costs are estimated to be $6.7 million in 2000 and are projected to be $16.4 million in 2001.

Table 3.1

Expenses of the Federal Reserve Banks, Net of Receipts and Claims for Reimbursement, 2000 and 2001

Millions of dollars except as noted

Item	2000 (estimated)	2001 (budgeted)	Change	
			Amount	Percent
Operations	2,297.8	2,442.2	144.4	6.3
LESS				
Revenue from priced services	916.1	977.8	61.7	6.7
Other income	1.0	.3	–.7	–70.0
Claims for reimbursement[1]	310.2	290.1	–20.1	–6.5
EQUALS				
Net expenses	**1,070.5**	**1,174.0**	**103.5**	**9.6**

NOTE. Excludes capital outlays. Includes expenses budgeted by Federal Reserve Information Technology (FRIT) and the System's Office of Employee Benefits (OEB). For more detail on FRIT and OEB, see text note 2. Components may not sum to totals and may not yield percentages shown because of rounding.

Operating expenses reflect all redistributions for support and allocations for overhead.

1. Costs of fiscal agency and depository services provided to the U.S. Treasury and other government agencies that are billed to these agencies.

volume, and check fees as well as the introduction of new priced check products. Reimbursable claims will decrease 6.5 percent, primarily because of the consolidation of the Treasury Tax and Loan and Treasury Direct servicing functions.

At individual Reserve Banks, 2001 budget expenses vary from a decrease of 4.2 percent from estimated 2000 expenses to a 19.3 percent increase (see table D.1, appendix D). The wide range is directly related to recent Reserve Bank accounting changes that shifted costs among the Reserve Banks and between cost centers.[3] The total Reserve Bank increase of $144.4 million provides funding for each District's salary administration and benefit programs, local operations, nationally provided support services, and consolidated operations.

3. These cost shifts were recommended in three studies concerning the accounting practices of Federal Reserve Banks (the Accountability, Integrity, Decision-making, and Efficiency (AIDE) Report; the Treatment of National Costs and Revenues Study; and a capitalization threshold change proposal). Because of the cost shifts, budget data from previous years are not completely comparable with current-year data. An overview of the accounting changes and the corresponding effects on the 2001 budget is included later in this chapter.

The average number of personnel (ANP) projected to be employed during 2001 at the Reserve Banks and FRIT is 23,458, an increase of 68 ANP, or 0.3 percent, from estimated 2000 staff levels (table 3.2).[4] Reserve Bank employment is expected to increase 38 ANP, or 0.2 percent, largely because of the effect of 2000 staff additions and, to a lesser extent, initiatives planned for 2001. FRIT employment is expected to increase 30 ANP, or 4.5 percent, to carry out several initiatives, including Fednet modernization, the image services system (ISS) and check standardization projects, and new distributed processing services. (For more detail on expense and ANP changes by District, see tables D.1 and D.2, appendix D. For trends over the last ten years, see charts 3.3 and 3.4 at the end of this chapter.)

2000 Budget Performance

The Reserve Banks estimate 2000 expenses to have been $2,297.8 million,

4. The term *average number of personnel* describes levels and changes in employment at the Reserve Banks. ANP is the average number of employees in terms of full-time positions for the period. For instance, a full-time employee who starts work on July 1 counts as 0.5 ANP for that

Table 3.2
Employment at the Federal Reserve Banks, 2000 and 2001
Average number of personnel except as noted

Item	2000 (estimated)	2001 (budgeted)	Change	
			Number	Percent
Reserve Banks	22,721	22,760	38	.2
Federal Reserve Information Technology	668	698	30	4.5
Total	**23,389**	**23,458**	**68**	**.3**

NOTE. See note to table 3.1. See text note 4 for definition of average number of personnel.

Table 3.3
Budget Performance of the Federal Reserve Banks,
Operating Expenses and Employment, 2000

Item	2000 (budgeted)	2000 (estimated)	Change	
			Amount	Percent
Operating expenses (millions of dollars)	2,325.9	2,297.8	–28.1	–1.2
Employment (average number of personnel)	23,751	23,389	–362	–1.5

NOTE. See note to table 3.1. See text note 4 for definition of average number of personnel.

a decrease of $28.1 million, or 1.2 percent, from the approved 2000 budget of $2,325.9 million (table 3.3) and an increase of $104.0 million, or 4.5 percent, above 1999 actual expenses. Eight of the twelve Reserve Banks have estimated their 2000 expenses to have been below the approved 2000 budget, ranging from a 0.1 percent underrun in Kansas City to a 3.0 percent underrun in New York. The remaining four Reserve Banks were over their approved budgets, ranging from 0.1 percent in Atlanta to 2.5 percent in Richmond. Tables D.3 and D.4 in appendix D detail 2000 performance for each District.

Reserve Bank underruns are partly explained by staffing levels that were substantially lower than budgeted. ANP for 2000 is estimated at 23,389, which is 362 ANP below the 2000 approved level and 22 ANP below the 1999 actual level. Reserve Banks with lower-than-budgeted staffing levels projected a correlated underrun in officer and employee salaries of $16.4 million. New York's budget underrun of $13.7 million, for example, was largely due to the Bank's staffing underrun of 84 ANP, which resulted in a personnel cost underrun of $7.4 million. Reserve Banks report that staffing level variances were due primarily to turnover and delays in new hiring because of tight labor markets and productivity improvements.

calendar year; two half-time employees who start on January 1 count as 1 ANP.

In addition to the effect of lower-than-budgeted ANP, more than half the Reserve Banks have identified lower-than-anticipated costs with respect to retirement and other benefits because of changes to the postretirement benefits plan (Financial Accounting Standard 106). These changes have resulted in savings of $3.3 million.

Despite common themes across the Reserve Banks, a variety of District-specific factors were also at work, and initiatives in several of the outlier Banks either added to or partially offset the underrun in 2000 estimated expenses. The staffing level decreases at the New York Bank, discussed above, continue a trend of dramatic ANP declines in that Bank that began in 1998. These declines were due primarily to productivity-improvement and operating-efficiency initiatives both at the Bank and resulting from System consolidation efforts. Other Banks were under budget because of the deferral or cancellation of capital projects, decisions to forgo system and equipment upgrade plans because of the move to the common platforms required in the check modernization initiative, and declining check volume combined with improved productivity in check-processing initiatives.

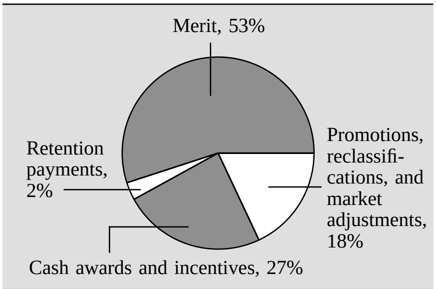
Richmond's overrun of $4.5 million has been partly attributed to unanticipated work on two projects for the Department of the Treasury and increased costs for an upgrade to the Bank's purchasing, accounts payable, and asset management system. Expenditures by the Retail Payments Office (RPO), which is accounted for in Atlanta's budget, were also substantially more than planned. The RPO projected increases associated with higher-than-anticipated fuel costs for Check Relay and for the creation of a check modernization implementation team. Other unbudgeted expenses included the establishment of a payment card research center at the Philadelphia Bank and the accelerated purchase of check-processing equipment in Kansas City to meet the check standardization conversion schedule.

Factors Affecting the 2001 Budget

Personnel expenses are the major driver of the year-over-year budget increase. These expenses include both salaries and benefits and represent 63.3 percent of projected Reserve Bank expenses. Reserve Bank budgets include a total of $88.7 million to fund salary administration programs for officers and employees.[5] FRIT has budgeted $4.2 million.

Merit increases are budgeted at $46.9 million, or 52.9 percent, of the total 2001 Reserve Bank salary administration budget (chart 3.1). The budget includes average merit increases of 4.5 percent for officers and 4.3 percent for employees. Promotions, reclassifications, and market adjustments account for $16.1 million; retention payments for $2.1 million; and officer and employee incentive payments and cash awards for $23.6 million. Merit increases and other salary-related expenses are in line with trends in both the public and private sectors.

Chart 3.1
Components of Salary Administration at the Federal Reserve Banks, 2001



Note. See text note 5.

In 2001, officer incentive payments and cash awards are expected to total $7.9 million, or 5.8 percent of officer salary liability. The officer variable pay threshold will increase to 6.0 percent of salary liability.

Employee incentive payments and cash award funds are budgeted at $16.6 million, or 1.7 percent of employee salary liability in 2001. The employee variable pay threshold will increase to 1.7 percent in 2001.

Officer turnover (including retirements) is projected to remain stable at 4.0 percent in 2001, ranging from 0.0 percent (Dallas) to 16.0 percent (San Francisco). Similarly, employee turnover in 2001 is projected to remain stable at 13.1 percent, ranging from

5. Salary administration represents the budgeted funds that are available to increase compensation to officers and employees in the coming year. It does not include adjustments for changes in staffing levels, turnover and lags in hiring, and overtime.

8.1 percent (Richmond) to 16.2 percent (San Francisco). Banks are reporting higher turnover in check processing and some professional and technical areas. If market pressures continue in 2001, the risk of losing employees with critical skills will increase. As a result, the Banks plan to maximize variable pay, retention incentives, and other monetary and non-monetary rewards for key officers and employees.

Retirement and other benefit expenses, which account for 14.0 percent of Reserve Bank budgets, are anticipated to increase $23.5 million, or 7.4 percent, in 2001. The higher costs are projected to result primarily from increases in salary-related benefits, such as social security and thrift plan contributions, which are expected to increase along with the number of ANP in 2001. Other contributing factors include higher postretirement and postemployment valuations (Financial Accounting Standards 106 and 112, respectively); these valuations are directly related to changes in actuarial assumptions. The budgeted increases in employer contributions for health benefits average 5.6 percent for non-HMO plans, 8.5 percent for HMO plans, and 6.4 percent for dental plans.

Other major factors affecting the 2001 budget are shown in table 3.4 and discussed below.

Fee-based Services to Financial Institutions

The factors affecting the budget for services provided to depository institutions are primarily related to the check modernization projects.

Table 3.4

Changes in Expense and Employment for Major Initiatives at the Federal Reserve Banks, 2000 to 2001

Millions of dollars except as noted

Initiative	2000 (estimated)	2001 (budgeted)	Change	
			Amount	Average number of personnel
Fee-based services provided to depository institutions				
Check modernization	27.3	84.1	56.8	223
Other check initiatives	48.6	52.3	3.7	–33
Reimbursable services				
Treasury Direct consolidation	19.5	15.9	–3.6	–53
Treasury Tax and Loan consolidation	4.1	1.4	–2.7	–30
Central bank services				
Cash initiatives	22.5	30.0	7.5	53
Supervision and regulation staffing	27.3	29.7	2.4	26
Cross-functional areas				
Infrastructure initiatives	39.0	58.8	19.9	25
FRIT initiatives	11.7	24.2	12.5	73
Capitalization threshold changes	.0	12.9	12.9	. . .
Total	**199.9**	**309.4**	**109.5**	**285**

NOTE. See notes to table 3.1. See text note 4 for definition of average number of personnel.

. . . Not applicable.

Check Modernization

The Federal Reserve Banks, under the leadership of the Retail Payments Office, have undertaken four major projects, collectively referred to as check modernization. The four projects—check standardization, enterprisewide adjustments, image services system, and electronic access and delivery—will standardize the check function's operating platform across all forty-five check-processing sites. (For more detail on the check modernization projects, see chapter 4.) The 2001 budget for the Reserve Banks includes $84.1 million for the four projects, which is an increase over estimated 2000 expenses of $56.8 million and 223 ANP. The budgetary effect of each of the check modernization projects is described below.

Check Standardization. Six Districts have identified costs for check standardization activities performed within their Districts on behalf of the other Reserve Banks, totaling $38.1 million. FRIT has budgeted $7.3 million for data processing support, and an additional $9.2 million has been included by the Banks for local incremental costs to implement the project. Costs vary significantly by District and are determined by the timing of each office's conversion in the four-year implementation schedule.

Enterprisewide Adjustments (EWA). San Francisco is the host Bank for the development and implementation of the EWA system. The 2001 budget includes $7.4 million for this project, which represents a $2.4 million increase over 2000 estimated expenses. Project plans call for the conversion of twenty-six check-processing sites to the system by the end of 2000, thirteen sites in 2001, and the remaining six sites in 2002.

Image Services System (ISS). The Boston District will manage the implementation and deployment of ISS to the four regional archive sites (Cleveland, Philadelphia, Helena, and Minneapolis). The 2001 budget includes $17.0 million for this project. Thirty-two sites currently are scheduled to transition to the regional archives in 2001, with the remaining sites converting in 2002.

Electronic Access and Delivery (EA&D). The Dallas Bank is responsible for development of this application. Initially, the project will develop web-based interfaces for check services currently offered through FedLine. The 2001 budget includes $5.1 million for the project. Web-based check services are scheduled to be available to depository institutions in 2001.

Other Check-Processing Initiatives

Five Districts have included a total of $52.3 million in their budgets to support other local check-processing initiatives. These initiatives include the Utica regional check-processing center check image effort, increased staff to process volume increases, and additional equipment (personal computers, high-speed and medium-speed reader–sorters, and image capture systems) needed in 2001 to accommodate check modernization project schedules.

Reimbursable Services

Factors affecting the budgets for reimbursable services include Treasury Direct consolidation and Treasury Tax and Loan consolidation.

Treasury Direct Consolidation

Customer support for the Treasury Department's Treasury Direct application will be consolidated into three sites

(Boston, Minneapolis, and Dallas). This initiative is projected to reduce Reserve Bank expenses by $3.6 million and 53 ANP in 2001. The three consolidation sites have budgeted an increase of $3.5 million above estimated 2000 costs; staff levels at the three sites are budgeted to increase by 52 ANP above the estimate for 2000, reflecting Treasury requirements. This cost increase is more than offset by cost reductions of $7.1 million and staff decreases of 105 ANP at the other Reserve Banks. This initiative is fully reimbursable.

Treasury Tax and Loan (TT&L) Consolidation

The implementations of the Treasury Investment Program (TIP) and the Paper Tax System (PATAX) operations at the St. Louis Reserve Bank have replaced the existing TT&L software and staff at all Reserve Banks. All Reserve Banks moved to this new system in October 2000. The 2001 budget includes a net decrease in Reserve Bank costs of $2.7 million and 30 ANP. Minimal staff will be retained in the other Reserve Banks for definitive collateral safekeeping.

Central Bank Services

Factors affecting the budgets for central bank services include cash initiatives and supervision and regulation.

Cash Initiatives

Cash initiatives, primarily the new Phoenix currency operations center and the addition of processing capacity at the Philadelphia and Atlanta Banks, are projected to increase costs $7.5 million and add 53 ANP in 2001.

Supervision and Regulation

Three factors are contributing to staffing increases in supervision and regulation: an increase in the number of state member banks, the Large Complex Banking Organization initiative, and development of the Risk Management Information System. These initiatives are expected to add $2.4 million and 26 ANP in 2001.

Cross-functional Areas

Factors affecting the budgets across functional areas include infrastructure initiatives, FRIT initiatives, and capitalization threshold changes.

Infrastructure Initiatives

The 2001 budget includes an expense increase of $12.0 million for new buildings, leased space, and enhanced security in five Districts. Reserve Bank automation initiatives add another $7.9 million, of which about $2.5 million is for efforts directly tied to System initiatives (electronic access projects, the Internet firewall, and the Groupware Leadership Center). The remaining expenses address a variety of needs, including support for Treasury-related projects, human resource information systems, and information security.

FRIT Initiatives

FRIT has undertaken several customer-driven projects to support web access and centralized distributed processing applications. These projects are projected to increase costs $8.2 million above estimates for 2000. Infrastructure improvements, primarily for distributed computing and Fednet modernization, add $4.3 million to costs.

Capitalization Threshold Changes

Beginning in 2001, the Reserve Banks will increase the thresholds above which they are required to capitalize certain acquisitions and then depreciate costs over time. As a result, some items formerly capitalized, most notably personal computers, will be expensed. Although the changes result in higher expenses in 2001, real spending is not increased, as depreciation expenses will be offset in future years. The one-time implementation effect of changing this accounting practice raises stated expenses by $12.9 million.

Additional Reserve Bank Accounting Changes

In addition to the capitalization threshold changes discussed above, the Reserve Banks approved recommendations made in two studies concerning the accounting practices of the Banks (the AIDE Report and the Treatment of National Costs and Revenues Study). Although the implementation of these recommendations in 2001 does not have a material effect on Reserve Bank total spending, some expenses have been shifted to different cost centers, thus limiting the comparability of budget and expense data across Districts and functions. Several of the tables and charts that previously were included in this book have been excluded this year for that reason. A summary of the accounting changes is provided below.

AIDE. In 1997, the Reserve Banks began an extensive review of the Federal Reserve's Planning and Control System (PACS) and private industry practices. The goal of the review was to incorporate industry "best practices" into the Reserve Bank cost accounting framework wherever possible, while ensuring that the cost accounting system maintained accountability, integrity, decisionmaking, and efficiency (AIDE).

The AIDE concepts result in new methods for assigning costs to the appropriate activity, a shift of some activities among operational areas, and a change in management responsibility related to statistical data. These changes have been implemented in PACS while maintaining the system's full costing foundation. The new processes and structural changes should improve efficiency by reducing some of the burden currently inherent in the PACS system.

Treatment of National Costs and Revenues. In 1999, the Reserve Banks also approved recommendations to eliminate geographic sharing of costs for all services and operations that are provided centrally to all Reserve Banks.[6] Under this new approach, the Reserve Banks report the associated expenses where the costs are incurred. To ensure consistent implementation, these recommendations are being addressed in conjunction with the structural changes previously discussed.

Over the past several years, the Reserve Banks have consolidated the development, processing, and management responsibilities of many operations. Cost accounting rules have not kept pace with this shift. Costs associated with these consolidation efforts have been shared among the Reserve Banks as defined in PACS. For example, before 2001 the costs of operating the Support Function Office (SFO) were incurred by the San Francisco Reserve Bank and shared with all other Reserve Banks so that each Bank's bottom line reflected one-twelfth of the costs of operating the SFO. The sharing of these

6. As a service provider, Federal Reserve Information Technology will continue to charge its costs to Reserve Banks and the Board.

costs reduced accountability, confused responsibility, and complicated monthly accounting processes. These costs are now reported in the Districts where the activities are provided.

Based on the accounting change described above, Banks that distributed more costs than they received in 2000 generally have the largest year-over-year increases in 2001. With the elimination of cost sharing in 2001, Banks have retained in their budgets the national service costs previously shared. Conversely, Banks that were net receivers have not included these national expenses in their budgets.

Risks in the 2001 Budget

Reserve Banks have noted several common risks associated with the 2001 budgets. First, issues and problems relating to the check modernization projects could divert significant amounts of resources, including management attention, as complex implementation schedules have the potential for costly delays. As these plans are refined and the projects progress, actual expenses may vary considerably from the 2001 budget. Second, most Banks have projected no increase in check volumes and only moderate increases in cash volumes for 2001. Volatility in production volumes could create capacity problems and affect the System's ability to meet cost performance expectations.

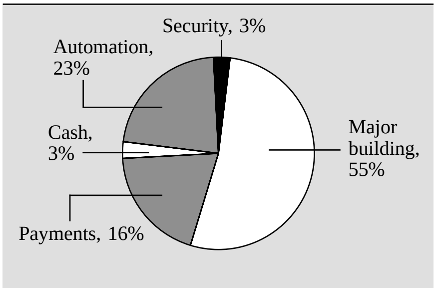
In addition, the passage of the Gramm–Leach–Bliley Act is expected to have significant implications for the bank supervision and regulation function. As the umbrella supervisor, the Federal Reserve has broad financial holding company oversight responsibilities. Resource implications on the supervisory function were unclear at the time the budgets were developed.

Finally, some Reserve Banks are finding it difficult to attract and retain key staff because of tight labor markets. Turnover poses a significant risk when compounded by the resource demands necessary to implement check modernization and expanded bank supervision and regulation responsibilities. Initiatives that are contingent upon successful staffing efforts present additional uncertainties in the 2001 budget.

2001 Capital Plan

The 2001 capital budgets submitted by the Reserve Banks and FRIT total \$361.3 million, a decrease of \$106.0 million from the estimated 2000 level. The budget includes \$323.0 million for the Banks and \$38.3 million for FRIT. The substantial decrease in budgeted 2001 outlays from estimated 2000 outlays results in part from the conclusion or near completion of several major building projects, including the new Birmingham Branch building project (\$22.7 million decrease in 2001 outlays), Atlanta's new building project (\$21.1 million decrease), and the Phoenix currency operations center (\$12.8 million decrease). After the land purchase in 2000, outlays for the new Houston Branch building project will decrease significantly in 2001 (\$24.2 million decrease). Capital for software and equipment acquisitions at FRIT for the check standardization and ISS projects is \$13.1 million lower in the 2001 budget than has been estimated for 2000. Other factors contributing to the reduction in capital outlays include the nonrenewal of software licenses and maintenance contracts associated with check standardization, a shift of outlays for check-processing equipment from future years into 2000 because of the check standardization project schedule, the completion of various building reno-

Chart 3.2
Major Capital Projects
at the Federal Reserve Banks, 2001



NOTE. Includes Federal Reserve Information Technology.

vation and software development projects, and the shift of funds from capital to expense resulting from the capitalization threshold changes. Tables D.6 and D.7 in appendix D provide detail of capital expenditures by District and asset classification.

As in previous years, the 2001 capital budgets developed by the Reserve Banks and FRIT include funding for projects that support the goals outlined in the Banks' strategic plans. These strategic goals include improving operational efficiency and effectiveness, improving services to Bank customers, and providing a safe, high-quality work environment. In support of these goals, the 2001 budget includes five major categories of capital outlays: building and facility improvements, automation-related initiatives, payment system improvements, Reserve Bank security initiatives, and cash services initiatives (chart 3.2).

Buildings and Facilities

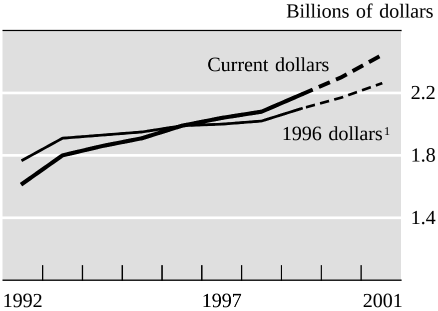
The 2001 capital budget includes $197.9 million for the renovation, modernization, or replacement of physical facilities and the replacement or upgrading of critical systems. Of the total building-related capital, $101.1 million (51.1 percent) is attributable to seven initiatives with budgets greater than $4.0 million: the New York District's floor-by-floor head office modernization program, the Atlanta District's new head office building project, relocation of the Chicago District's Detroit Branch and the Chicago check-processing function, major floor renovations at the Chicago Bank, the Houston Branch building project, and the check department renovation at the St. Louis head office. In addition to these larger projects, funding is also provided for the routine replacement of building-related equipment, as well as furniture and fixtures.

Automation

The capital budget includes $82.0 million for major automation initiatives. These initiatives do not include the automation components of building, payment systems (including check modernization), or cash services initiatives that are discussed separately. The strategic directions outlined in the individual Reserve Bank budgets include enhanced technological capabilities, the continued implementation of LAN technology, the development of common office environments and web-based applications, and several Treasury-related initiatives.

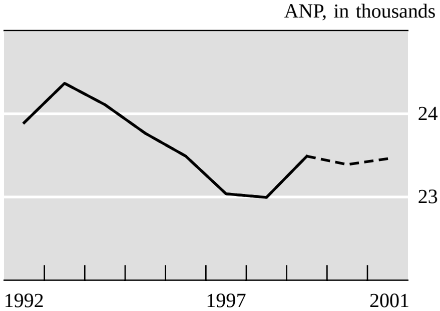
Of the total automation-related outlays, FRIT projects and acquisitions account for $26.7 million. FRIT's 2001 capital plan includes outlays for Fednet modernization ($8.7 million), virtual tape server implementation ($1.8 million), and various software and hardware upgrades and enhancements. Aside from FRIT, major automation-related projects include $2.3 million for continued development of New York's Transaction Processing System; $1.9 million for enhancements to the Statistics and Reserves (STAR) system; $1.3 million

Chart 3.3
Operating Expenses of the
Federal Reserve Banks, 1992–2001



NOTE. For 2000, estimated; for 2001, budgeted.
1. Calculated with the GDP price deflator.

Chart 3.4
Employment at the
Federal Reserve Banks, 1992–2001



NOTE. Includes Federal Reserve Automation Services. For 2000, estimated; for 2001, budgeted. See text note 4 for definition of ANP.

for development of the Account Management Information (AMI) gateway; $1.3 million for upgrades to the System's Internet and directory services (IDS) competency center; and $1.1 million for the Atlanta District's ethernet conversion project.

The automation total also includes $4.2 million in capital for software development for, and equipment enhancements to, several reimbursable Treasury-related initiatives, including the Treasury Automated Auction Processing System (TAAPS), the Intra-governmental Payment and Collection (IPAC) system, the Savings Bond Architecture Project (SnAP), the Automated Standard Application for Payments (ASAP) system, and the Treasury Check Operations Re-engineering Effort (TCORE). The largest share of the remaining funds supports the Districts' distributed technology strategies.

Payment System

The 2001 capital budget includes $57.4 million for initiatives related to payment system improvements. These initiatives include $11.6 million in FRIT's budget for hardware, software, and network components for the ISS and check standardization projects. The remaining funds support other national and local initiatives associated with the check modernization projects, the acquisition and installation of high-speed check imaging equipment and software, and check reader–sorter and endorser replacements. Many aspects of these initiatives are under way in a majority of the Districts.

Reserve Bank Security

The 2001 capital budget includes $11.6 million in spending for enhanced Bank security. Over half of this funding ($5.8 million) is for the Richmond Bank's security enhancement project.

Cash Services

Outlays of $12.4 million have been included in the capital budget for cash services initiatives. The Atlanta District's initiatives account for $5.9 million of the total, including the Atlanta Bank's cash vault automation and currency disposal systems ($4.2 million) and new currency processing machines for the Atlanta and Jacksonville offices ($1.7 million). ■

Chapter 3

Federal Reserve Banks

The 2002 operating budgets of the twelve Reserve Banks total $2,580.2 million.[1] The 2002 total is $118.4 million, or 4.8 percent, above estimated 2001 expenses (table 3.1).[2] Approximately 37 percent of Reserve Bank expenses in the 2002 budget are offset by priced service revenues, and an additional 12 percent are reimbursable claims for services provided to the U.S. Treasury and other government agencies.

Revenues from priced services are budgeted to increase 0.3 percent in 2002 as a result of projected price increases and modest volume growth in the check service. The increase in revenues is moderated, however, by declining revenue in other services, namely automated clearinghouse (ACH), Fedwire, and book-entry securities. ACH revenue reductions reflect some erosion of commercial origination volume, due to increased competition, as well as price reductions. Declining revenue in the Fedwire funds transfer and book-entry securities services is also attributed to price reductions. Reimbursable claims for Treasury-related services are expected to increase 5.4 percent.

1. These expenses include those budgeted by Federal Reserve Information Technology (FRIT) and the Office of Employee Benefits (OEB). Expenses from these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets.

2. Unless otherwise noted, expenses also include costs associated with the check standardization special project. Special projects are major efforts having Systemwide significance that are outside the budgets of the individual Reserve Banks.

Table 3.1

Expenses of the Federal Reserve Banks, Net of Receipts and Claims for Reimbursement, 2001 and 2002

Millions of dollars except as noted

Item	2001 (estimated)	2002 (budgeted)	Change	
			Amount	Percent
Operations	2,461.8	2,580.2	118.4	4.8
LESS				
Revenue from priced services	951.8	954.4	2.6	.3
Other income	1.1	1.0	–.1	−10.0
Claims for reimbursement[1]	292.2	307.9	15.7	5.4
EQUALS				
Net expenses	**1,216.7**	**1,316.9**	**100.2**	**8.2**

NOTE. Excludes capital outlays. Includes expenses budgeted by Federal Reserve Information Technology (FRIT) and the System's Office of Employee Benefits (OEB). Expenses from these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets. Components may not sum to totals and may not yield percentages shown because of rounding.

Operating expenses reflect all redistributions for support and allocations for overhead.

1. Costs of fiscal agency and depository services provided to the U.S. Treasury and other government agencies that are billed to these agencies.

At each Reserve Bank, budgeted 2002 expenses are increasing from estimated 2001 expenses by amounts ranging from 0.3 percent to 8.7 percent (see table D.1, appendix D). The Reserve Bank budget increase of $118.4 million provides funding for each District's salary administration and benefits program, local initiatives, nationally provided support service (NPSS) initiatives, and consolidated operations.

The average number of personnel (ANP) projected to be employed at the Reserve Banks, Federal Reserve Information Technology (FRIT), and the Office of Employee Benefits (OEB) during 2002 is 23,550, an increase of 282 ANP, or 1.2 percent, from estimated 2001 staff levels (table 3.2).[3] Reserve Bank employment is expected to increase 228 ANP or 1.0 percent in 2002; this increase is largely a result of plans to increase the number of security staff (for more detail on expenses and ANP by District and operational area, see tables D.1 through D.4, appendix D).

2001 Budget Performance

The Reserve Banks estimate 2001 expenses to have been $2,461.8 million, an increase of $19.6 million, or 0.8 percent, from the approved 2001 budget of $2,442.2 million (table 3.3). The Reserve Banks estimate employment, including FRIT and OEB, to have been 23,268 ANP, a decrease of 218 ANP from approved 2001 levels.

Eight Reserve Banks had cost overruns in 2001 ranging from 0.1 percent (Dallas) to 6.8 percent (Kansas City). The remaining four Banks estimated their 2001 expenses to have been below their approved 2001 budgets by amounts ranging from 0.7 percent (Philadelphia) to 4.5 percent (Atlanta). In appendix D, tables D.5 through D.8 detail 2001 expense and ANP estimates by District and operational area.

About $9.5 million of the Reserve Banks' 2001 overrun is attributable to higher-than-budgeted contract staff expenses. The largest share of these expenses ($3.8 million) reflect fees for consultants involved in national project management and development support

3. The term *average number of personnel* describes levels and changes in employment at the Reserve Banks. ANP is the average number of employees in terms of full-time positions for the period. For instance, a full-time employee who starts work on July 1 counts as 0.5 ANP for that calendar year; two half-time employees who start on January 1 count as 1 ANP.

Table 3.2

Employment at the Federal Reserve Banks, FRIT, and OEB, 2001 and 2002

Average number of personnel except as noted

Item	2001 (estimated)	2002 (budgeted)	Change	
			Number	Percent
Reserve Banks	22,525	22,753	228	1.0
Federal Reserve Information Technology	712	763	51	7.2
Office of Employee Benefits	31	34	3	9.7
Total	**23,268**	**23,550**	**282**	**1.2**

NOTE. Components may not sum to totals and may not yield percentages shown because of rounding. See text note 3 for definition of average number of personnel.

Table 3.3
Budget Performance of the Federal Reserve Banks, Operating Expenses and Employment, 2001

Item	2001 (budgeted)	2001 (estimated)	Change	
			Amount	Percent
Operating expenses (millions of dollars)	2,442.2	2,461.8	19.6	.8
Employment (average number of personnel)	23,486	23,268	–218	–.9

NOTE. See note to table 3.1. See text note 3 for definition of average number of personnel.

for the check standardization project. The remainder of these expenses ($5.7 million) reflect the hiring of technical personnel to support local information technology (IT) initiatives, the hiring of temporary staff in New York's check-processing operation, and several major Systemwide initiatives to convert to standardized software applications.

Estimated expenses for 2001 also include $6.8 million in unbudgeted costs related to the September 11 terrorist acts.[4] These costs are primarily for an increase in overtime for protection staff, alternative check shipping arrangements, and the shipping of currency to alternative storage locations. Offsetting a portion of these expenses are lower-than-planned travel expenses ($1.0 million).

Estimated 2001 expenses include a net increase of $4.7 million and 14 ANP associated with the System's revamped financial services product office structure. The Reserve Banks created the product office structure in the early 1990s to centralize leadership of the System's major financial services business lines. The structure is designed to draw on leadership from Reserve Bank offices that possess specialized expertise in a particular business area. As business requirements change and Reserve Banks develop new projects and initiatives, leadership of a product office may shift from one Reserve Bank to another, and responsibilities may be redefined. In 2001, the Reserve Banks redefined several areas of responsibility and shifted leadership among several Banks. Because final plans for these changes had not been approved when the Banks developed their 2001 budgets, the associated costs were unbudgeted. Most of the increase is the result of expanded product office responsibilities.

Higher costs associated with fully reimbursable Treasury projects account for $2.9 million of the 2001 overrun. This increase reflects higher communications costs for Treasury Direct consolidation, additional enhancements requested by the Treasury for continued development of the ASAP.gov application, and the new Pay.gov and Government Point-of-Sale Check Conversion (GPCC) projects.

In addition to the broader trends discussed above, specific factors at a few Reserve Banks contributed to the overrun in 2001. The Retail Payments Office in the Atlanta District reported

4. These costs are not included in the 2001 overrun discussed in subsequent paragraphs.

higher-than-budgeted costs for the Check Relay air transportation function ($2.1 million) because of higher fuel costs. Several Banks incurred higher-than-planned medical costs ($5.9 million) and one-time transition costs associated with the Systemwide consolidation of ACH operations ($1.5 million); in addition, Chicago increased its supervision staff by seventeen ANP to enhance the quality of that function ($1.2 million). In Richmond and Dallas, severance payments associated with restructuring, centralization, and efficiency initiatives also added to the overrun ($4.2 million).

Partially offsetting these increases were lower costs related to the check imaging project as a result of delays in its implementation schedule ($3.6 million); lower-than-expected spending in San Francisco ($3.0 million); and cost reductions in Atlanta ($8.1 million and 157 ANP) and Richmond ($1.1 million and 72 ANP).

The 2002 Budget

The discussion of the 2002 budget covers salary administration and System and Reserve Bank initiatives.

2002 Salary Administration

The budgets for the Reserve Banks, FRIT, and OEB include $108.9 million to fund salary administration programs for officers and employees (table D.9).[5] Average merit increases of 4.5 percent for officers and 4.3 percent for employees account for $52.0 million, or 48 percent, of the total salary administration budget. Variable pay programs, which include cash awards and incentive payments for officers and employees, represent $33.2 million of the total budget.[6] Promotions, reclassifications, and market adjustments represent $16.4 million; retention payments represent $4.1 million; and severance payments represent $3.2 million. Merit and other salary-related expenses are in line with public and private sector trends.

Officer incentive payments and cash awards total $10.2 million, or 7.0 percent of officer salary liability. Officer variable pay continues to show increased funding for incentive-type awards, with one District using the entire variable pay pool for incentive awards.

Employee incentive payments and cash award funds total $22.8 million, or 2.2 percent of employee salary liability. Three Banks opted to apportion a higher percentage of the award funds to the top three grades, with a commensurate reduction in other grade pools; these actions are consistent with the variable pay guidelines. The mix between incentive and cash awards in the employee category continues to be heavily weighted toward cash awards.

Officer turnover in 2002, including retirements, is projected to decrease from an estimated 5.9 percent in 2001 to 4.0 percent in 2002; Boston and Kansas City expect no turnover in 2002, while San Francisco expects 12.3 percent, the high end of the projections. Employee turnover is projected to increase slightly

5. Salary administration represents the budgeted funds that are available to increase compensation to officers and employees in the coming year. It does not include adjustments for changes in staffing levels, turnover and lags in hiring, and overtime.

6. Cash awards are payments for exceptional achievements during the year. Incentive payments represent awards for the accomplishment of pre-defined objectives related to specific projects and initiatives.

from 10.9 percent in 2001 to 11.1 percent in 2002, ranging from 8.1 percent (Richmond) to 15.0 percent (Kansas City). Reserve Banks are reporting relatively higher turnover in check operations and some professional and technical areas compared with other areas. To assist in retaining employees with critical skills, Reserve Banks plan to maximize variable pay, retention incentives, and other monetary and nonmonetary rewards for key officers and employees.

Retirement and other benefit expenses, which account for 15 percent of Reserve Bank budgets, are anticipated to increase $31.0 million, or 8.9 percent, in 2002. Salary-related benefits, such as social security and Thrift Plan contributions, will increase 9.7 percent. The increase is primarily related to the combined effect of higher salaries and a change in 2002 in the employer-matching component of the System's Thrift Plan (increasing the employer match from 80 percent to 100 percent for employees with at least five years of service). Other factors include projections of higher postretirement and postemployment benefit expenses, which are directly related to changes in actuarial assumptions. Nonsalary-related benefits will increase 10.7 percent, primarily because of increases in employer contributions for health benefits (10.2 percent for non-HMO plans, 14.0 percent for HMO plans, and 6.2 percent for dental plans). These increases are partially offset by projected savings from the new System prescription drug program.

Initiatives Affecting the 2002 Budget

The 2002 budget provides funding for several System and Reserve Bank initiatives. The budgetary requirements for these initiatives are described below.

Fee-Based Services to Financial Institutions

Initiatives for fee-based services in 2002 include check modernization and the wholesale payments and automated clearinghouse consolidations.

Check Modernization

In 1999, the Federal Reserve Banks, under the leadership of the Retail Payments Office, initiated four major projects, collectively referred to as check modernization. The four projects—check standardization, enterprisewide adjustments, image services system, and electronic access and delivery—will standardize the check-processing infrastructure, enable new products to be introduced into the market more quickly, reduce operational costs, and facilitate the move to electronic payments. The 2002 budget for the check modernization projects consists of $82.4 million in System costs and $23.8 million in local Reserve Bank costs. The budgetary effect of each of the check modernization projects is described below. (For a discussion of the operational details of the check modernization projects, see chapter 4 of *Budget Review 2001*.)

Check Standardization. For the check standardization project, the Reserve Banks and FRIT have identified nationally provided support service (NPSS) costs of $39.7 million, local Reserve Bank implementation costs of $22.5 million, and special project costs of $12.4 million.[7] Reserve Bank implementation costs vary significantly by District

7. The check standardization special project includes only the portion of the check standardization project that relates to redundant operational costs and severance and retention payments for staff affected by each Bank's transition to the new check operating environment.

and are determined by the timing of each office's conversion in the forty-five-month implementation schedule.

Enterprisewide Adjustments. The 2002 budget for the enterprisewide adjustments (EWA) project consists of $7.7 million for NPSS costs and $0.5 million for costs at individual Reserve Banks. The San Francisco District is responsible for the development and Systemwide implementation of EWA. Twenty-five offices had converted to EWA by the end of 2000, and by late 2001, thirty-seven adjustment offices were relying on EWA for check adjustments processing. The remaining offices are scheduled to convert during 2002. In late 2002 and early 2003, the servers that support EWA are scheduled to migrate to FRIT.

Image Services System. The 2002 budget for the image services system (ISS) consists of $15.5 million in NPSS costs and $0.4 million in individual Reserve Bank costs. The Boston District is managing the ISS project, which will convert the Federal Reserve's diverse and decentralized commercial image archive systems to a standardized, centrally managed national image archive. As the project management site, the Boston Reserve Bank began staffing an ISS centralized business administration function in 2001 that will support ongoing operations after ISS implementation. Three Reserve Banks will serve as regional archive sites for the System. The first archive was not ready for production until early 2002, almost a year later than originally planned, because of software vendor delays.

Electronic Access and Delivery. The 2002 budget for electronic access and delivery (EAD) consists of $7.0 million in NPSS costs and $0.4 million in individual Reserve Bank costs. The Dallas Reserve Bank is responsible for developing this application. The System began converting customers to EAD under a controlled rollout in July 2001.

Wholesale Payment Consolidations

The 2002 budget includes net cost reductions as a result of the continued consolidation efforts of the Wholesale Payment Product Office (WPPO). In 2002, consolidation is expected to yield savings of $4.9 million in the funds transfer service and nearly $1.4 million in the book-entry securities service and a reduction in staff of sixteen ANP.

Off-line transfer services were consolidated into two Reserve Banks. In the fourth quarter of 2001, the WPPO began consolidating the on-line support and related administrative functions for the funds transfer and book-entry securities transfer services to these two sites. Customer testing is being consolidated into one Reserve Bank. These consolidations, scheduled for completion in the third quarter of 2002, will reduce costs across the System by standardizing the provision of the service while improving service quality.

Automated Clearinghouse Consolidation

Early in 2001, the RPO announced the consolidation of ACH operations into two processing sites, resulting in 2002 budget savings of $8.8 million and thirty-seven ANP.

Services Provided to the Treasury and Other Government Agencies

Five Districts identified projects for the Treasury that in the aggregate are projected to add $9.1 million and five ANP to 2002 expenses. The Treasury will reimburse the Reserve Banks for project development costs. These projects include the Treasury Check Information System, Pay.gov, Government Point-of-Sale Check Conversion, the Intragovernment Payment and Collection System, the Automated Standard Application for Payment, and the Treasury Web Application Infrastructure.

Central Bank Services

Initiatives for 2002 in the central bank services area consist of projects in the cash and the supervision and regulation areas.[8]

Cash Initiatives

Three Districts have identified cash initiatives that will result in an aggregate increase of $5.7 million and ten ANP. The increased costs are primarily the result of the full-year effect of opening the new Phoenix operations center in September 2001. To a lesser degree, costs related to additional currency processing shifts at the Atlanta and Dallas Banks and currency volume increases in the Atlanta and San Francisco Districts are contributing to growth in this area.

Supervision and Regulation

Initiatives affecting bank supervision and regulation are projected to add $5.1 million and thirty-seven ANP in 2002. Additional resources are needed to address the growth in the number of state member banks, increased supervisory responsibilities related to large complex banking organizations, and the full-year effect of 2001 staff increases. These initiatives are concentrated in the Richmond, Chicago, Kansas City, and San Francisco Districts.

Cross-Functional Areas

Cross-functional initiatives for 2002 involve staff reductions and security enhancements.

Targeted Staff Reductions

Ten Districts identified savings totaling $66.0 million and staff reductions of 392 ANP resulting from initiatives to improve productivity, streamline operations, and reduce discretionary expenditures. The majority of the staff reductions are in Reserve Bank support and overhead areas, including information technology, financial management, administrative services, personnel services, and business development. Targeted reductions in discretionary expenditures include areas such as equipment, travel, training and education, and food service operations.

Security Enhancements

The budgets include $50.3 million to enhance security at the Reserve Banks, an increase of $11.4 million from estimated 2001 expenses. About half of the increase is associated with salary-related expenses for additional staff. Also included in this increase are expenses for security screening equipment and depreciation of various security-related building projects.

Risks in the 2002 Budget

The Reserve Banks have noted several common risks associated with the 2002 budgets. A number of Banks believe that some cost-reduction initiatives,

8. Central Bank Services is composed of monetary and economic policy, services to financial institutions and the public, and supervision and regulation.

necessary to meet System budget guidance, may be difficult to achieve. Many of the efficiency initiatives include staff reductions through attrition. If attrition is not sufficient to achieve needed staff reductions, a limited amount of unbudgeted severance may be required.

The check modernization projects continue to present budget risks. Delays with the ISS project have shifted some resources and costs from 2001 to 2002. Similar pressures exist with the check standardization project. In addition to potential resource diversions, delays in project schedules could result in higher-than-projected costs for staffing, equipment, and software. The amount of expense associated with this risk varies by Bank and is dependent upon each Bank's position in the transition schedule. Following conversion, unforeseen problems, such as the inability to stabilize operations, could present additional risk.

Some risk also exists in bank supervision and regulation. Most prevalent are concerns that additional staff could be needed if examination requirements exceed those already factored into the budgets. In the past, filling additional positions has presented challenges for Reserve Banks because of tight labor markets. However, with the exception of highly specialized positions, Banks recently have reported greater success in hiring examiners, a fact attributable primarily to softening labor markets. In addition, the supervision function is sharing more resources and specialized skills across Districts.

The Reserve Banks are conducting a post–September 11 assessment, with a focus on further improving the robustness and resiliency of critical Federal Reserve functions. Funding needed to implement recommendations that may arise from this assessment has not been included in the budgets. In addition, the Reserve Banks' 2002 budgets include early estimates of the expense and capital funding that will be required to enhance the overall physical security of the Banks. As Reserve Banks finalize these plans, additional resources may be required.

2002 Capital Plan

The 2002 capital budget submitted by the Reserve Banks, FRIT, and OEB totals $375.1 million—$338.3 million for the Reserve Banks, $33.5 million for FRIT, and $3.3 million for OEB. Tables D.10 and D.11, in appendix D, detail capital expenditures by District and asset classification.

As in previous years, the 2002 capital budgets include funding for projects that support the strategic direction outlined in the plans of the Reserve Banks, FRIT, and OEB. These strategic goals include improving operational efficiency and effectiveness, improving services to Bank customers, and providing a safe, high-quality work environment. In support of these goals, the 2002 budget contains four major categories of capital outlays: building and facility improvements, including security enhancements; automation and communications-related initiatives; payment service improvements; and cash services initiatives.

Buildings and Facilities

The proposed capital budget includes an estimated $220.7 million for building-related projects and facility improvements. These projects are geared toward renovation, modernization, or replacement of physical facilities, and replacement or upgrading of critical systems. Building initiatives include several projects in New York, including the continuation of the multiyear modernization of the head office building, and various other building and leasehold improvements. Budgets also include funding for the new building project at the Eleventh District's Houston Branch, the Detroit building project, renovations at the Chicago Bank, and remodeling of the San Francisco Bank's lobby. In addition to these larger projects, funding is provided for security enhancements and for routine replacement of furniture, fixtures, and building-related equipment.

Automation

The proposed capital budget includes $75.9 million in funding for major automation and communications initiatives. These initiatives do not include the automation components of building, payment systems, or cash services initiatives that are discussed separately. The strategic directions outlined in the individual Bank budgets include enhanced technological capabilities, the continued implementation of LAN technology, and the development of common office environments and web-based applications.

FRIT projects and acquisitions account for $27.8 million of total automation-related outlays. FRIT's 2002 capital plan includes outlays for FEDNET modernization, a mainframe processer replacement project, and various software and hardware upgrades and enhancements. Aside from FRIT, major automation-related projects include $10.3 million for server equipment (primarily in the New York and Atlanta Districts), $5.1 million for additional phases of the Transaction Processing System and the Foreign Processing System projects in New York, $2.1 million for telecommunication equipment upgrades and Internet gateway-directory services in Boston, and $1.5 million for local area network upgrades in Philadelphia.

The automation total also includes $11.9 million in capital expenditures for reimbursable Treasury initiatives, including the Treasury Web Application Infrastructure project, the Treasury Check Information System, and the Savings Bond Architecture Project. The largest share of the remaining funds supports the Districts' distributed technology strategies.

Payment System

The 2002 capital budget includes $43.8 million for initiatives to improve the payment system. These initiatives include $5.7 million in FRIT's budget for hardware, software, and network components for the ISS and check standardization projects. The remaining funds support other national and local initiatives associated with the check modernization projects, the acquisition and installation of high-speed check imaging equipment and software, and check reader-sorter and endorser replacements. Many aspects of these initiatives are under way in a majority of the Districts.

Cash Services

Outlays of $34.7 million have been included in the capital budget for cash services initiatives. For 2002, Bank budgets include $27.1 million for the Board-approved cash project to install new sensors and scanners on all currency-processing machines. In addition, San Francisco has included $4.1 million for an inventory-management system. ■

Chapter 3

Federal Reserve Banks

The 2003 operating budgets of the twelve Reserve Banks total $2,629.9 million.[1] The 2003 total is $54.5 million, or 2.1 percent, above estimated 2002 expenses (table 3.1).[2] Reserve Banks developed their 2003 budgets by incorporating spending guidance provided by System business leaders. In large part because of poor cost recovery in the check service, business leaders have set aggressive spending targets for most functions. The Monetary Control Act provides that "the Board shall require reductions in the operating budgets of the Federal Reserve banks commensurate with any actual or projected decline in the volume of services to be provided by such banks." The Banks' 2002 estimate and 2003 budget plans reflect, in part, the spending restraint necessary to improve cost /revenue performance in the check service.

Because of Reserve Banks' adherence to specific targets for direct costs in the check service and to guidance from business leaders concerning most of the related support and overhead functions, the 2003 budget reflects lower check-service costs. Targets established for the 2003 budget, however, were not limited to areas affecting the check service. The supervision and regulation and cash functions also established budget targets.

Approximately 48 percent of Reserve Bank expenses in the 2003 budget are

1. These expenses include those budgeted by Federal Reserve Information Technology (FRIT) and the Office of Employee Benefits (OEB). Expenses from these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets.

2. Unless otherwise noted, expenses also include costs associated with the check-standardization special project. Special projects are major efforts having Systemwide significance that are outside the budgets of the individual Reserve Banks.

Table 3.1

Expenses of the Federal Reserve Banks, Net of Receipts and Claims for Reimbursement, 2002 and 2003

Millions of dollars except as noted

Item	2002 (estimated)	2003 (budgeted)	Change	
			Amount	Percent
Operations	2,575.4	2,629.9	54.5	2.1
LESS				
Revenue from priced services	909.6	925.8	16.2	1.8
Other income	1.0	0.8	–0.2	–20.0
Claims for reimbursement[1]	316.3	328.9	12.6	4.0
EQUALS				
Net expenses	**1,348.5**	**1,374.4**	**25.9**	**1.9**

NOTE. Excludes capital outlays. Includes expenses budgeted by Federal Reserve Information Technology (FRIT) and the System's Office of Employee Benefits (OEB). Expenses from these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets. Componenets may not sum to totals and may not yield percentages shown because of rounding.

Operating expenses reflect all redistributions for support and allocations for overhead.

1. Costs of fiscal agency and depository services provided ot the U.S. Treasury and other government agencies that are billed to these agencies.

offset by priced-service revenues (35 percent) and reimbursable claims for services provided to the U.S. Treasury and other agencies (13 percent). Although budgeted 2003 revenue is up slightly from estimated 2002 levels, it is still significantly below the 2002 budgeted level, reflecting declines in check volume. Reimbursable claims are expected to increase 4.0 percent, reflecting higher costs for Treasury-requested projects partially offset by efficiency measures and lower allocated costs from support and overhead functions.

The Reserve Banks' 2003 budgeted net operating expenses are $1,374.4 million, 1.9 percent higher than the 2002 estimate. The moderate increase reflects efforts by all Banks to reduce costs, to improve priced-services performance, and to meet System targets established by national business leaders. Banks have been able to limit overall cost increases through plans to self-fund many new initiatives, implement productivity and efficiency measures, and continue consolidating functions at a regional or national level.

The average number of personnel (ANP) projected to be employed at the Reserve Banks, Federal Reserve Information Technology (FRIT), and the Office of Employee Benefits (OEB) during 2003 is 22,422, a decrease of 743 ANP, or 3.2 percent, from 2002 estimated staff levels (table 3.2).[3] Although all Districts are planning to reduce staffing in 2003, three Banks—New York, Atlanta, and San Francisco—account for slightly more than half of the overall reductions. As a result of declining volumes and efforts to improve productivity, all Banks are reducing staff in the check service. Several Banks will also reduce check staff after making the transition to the standardized check-processing platform. The remainder of the reduction is the net effect of several System and District efforts to meet System cost-reduction initiatives and improve operational efficiencies. For more detail on expenses and ANP by District and operational area, see appendix E, tables E.1 through E.4.

2002 Budget Performance

The Reserve Banks estimate 2002 expenses have been $2,575.4 million, a decrease of $4.8 million, or 0.2 percent, from the approved 2002 budget of $2,580.2. The 2002 estimate is $116.1

3. The term *average number of personnel* describes levels and changes in employment at the Reserve Banks. ANP is the average number of employees in terms of full-time positions for the period. For instance, a full-time employee who starts work on July 1 counts as 0.5 ANP for that calendar year; two half-time employees who start on January 1 count as 1 ANP.

Table 3.2

Employment at the Federal Reserve Banks, FRIT, and OEB, 2002 and 2003

Average number of personnel except as noted

Item	2002 (estimated)	2003 (budgeted)	Change	
			Amount	Percent
Reserve Banks	22,359	21,607	–752	–3.4
Federal Reserve Information Technology	774	779	5	0.6
Office of Employee Benefits	32	36	4	12.5
Total	**23,165**	**22,422**	**–743**	**–3.2**

NOTE. Components may not sum to totals and may not yield percentages shown because of rounding. See text note 3 for definition of *average number of personnel*.

Table 3.3

Budget Performance of the Federal Reserve Banks, Operating Expenses and Employment, 2002

Item	2002 (budgeted)	2002 (estimated)	Change	
			Amount	Percent
Operating Expenses (millions of dollars)	2,580.2	2,575.4	–4.8	–0.2
Employment (average number of personnel)	23,550	23,165	–385	–1.6

NOTE. Excludes capital outlays. Includes expenses budgeted by Federal Reserve Information Technology (FRIT) and the System's Office of Employee Benefits (OEB). Expenses from these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets. Componenets may not sum to totals and may not yield percentages shown because of rounding.

Operating expenses reflect all redistributions for support and allocations for overhead.

See text note 3 for definition of *average number of personnel*.

million above the 2001 actual expense of $2,459.3 million. The Banks estimate ANP at 23,165, a decrease of 385 ANP, or 1.6 percent, from approved 2002 budget levels and 54 ANP below 2001 actual levels.

Most Bank estimates include targeted staff reductions and realignment of resources due to volume declines in the check service. Check expenses and staffing are declining at nine Banks as resources are aligned to the lower volume projections, resulting in an underrun of $10.0 million and 241 ANP from the 2002 budget. Support and overhead costs, primarily in Information Technology (IT), are declining by a total of $9.3 million, largely as a result of staff reductions and lower depreciation expense. The 2002 estimate also reflects reductions in cash operations totaling $6.5 million from the 2002 budget, resulting primarily from lower staffing-related costs due to less-than-anticipated volume growth in several Districts, productivity improvements, and delayed implementation of equipment upgrades.

Offsetting some of the decreases are increasing expenses in other areas, including two large, one-time expenses. The Customer Relations and Support Office in Chicago incurred an $8.6 million expense as a result of canceling the FedLine for Windows project. Also, estimated 2002 severance payments are $16.9 million, $13.7 million higher than budgeted. Excluding these expenses, the 2002 estimate would be approximately $27 million lower than the approved 2002 budget.[4] In addition to these one-time expenses, the estimate includes slightly-higher-than-anticipated costs in several Districts for check-standardization implementation and fully reimbursable Treasury projects.[5]

The 2003 Budget

Efforts to reduce spending in 2002 have positioned the Banks to develop 2003 budgets consistent with guidance provided by the System business leaders during the budget outlook process. This guidance has not only assisted Reserve Banks in developing their 2003 budgets

4. Excluding these one-time costs, the 2003 budget would reflect an increase of about $77 million, or 3.0 percent, from the adjusted 2002 estimate.

5. Although projected to be over budget in 2002, overall costs for the check-standardization project are still expected to be under budget for the life of the project.

and multiyear business plans but has also provided them with a management tool to better monitor direct-spending plans. Overall, Reserve Banks have met or exceeded the aggressive-business-leader guidance established earlier this year. Adherence to the guidance, in conjunction with other cost-reduction initiatives, helps the System address the cost-recovery pressures in the check service while enabling the Banks to fund other high-priority initiatives.

Initiatives Affecting the 2003 Budget

The 2003 budget provides funding for several System and Reserve Bank initiatives. The budgetary requirements for these initiatives are described below.

Check Modernization

Perhaps the single biggest factor influencing 2003 expense and staffing levels is the Banks' effort to address the shortfalls in check-cost recovery while managing the completion of the check-modernization projects. Check modernization encompasses four projects: check standardization, enterprisewide adjustments (EWA), FedImage, and check electronic access and delivery. Check standardization involves standardizing Reserve Bank item processing on a single platform and software suite, and centralized application software support. EWA provides a common, standard platform for check-adjustments processing throughout the System, which in the long term will improve efficiency and eliminate duplicate support. FedImage (formerly know as Image Services System) integrates current image production from nonstandard hardware and software platforms into a consistent production environment for the capture and archiving of check images. Check electronic access and delivery migrates the check service to the new web-based platform for accessing check products.

In the 2003 budgets, these projects account for a $16.6 million increase over estimated 2002 expenses. According to the transition schedule, all Banks should be using the standard check-processing platform by year-end 2003. This standardization will allow Banks to gain efficiencies and reduce expenses associated with additional staff retained through conversions to ensure a smooth transition. These savings alone, however, are not enough to address the challenges presented by lower volume projections, changes in deposit mix, and corresponding revenue shortfalls.

The Banks are taking steps to address these cost and revenue challenges. Banks that have completed the transition to check standardization and EWA have begun to capitalize on the efficiencies gained in the forward and adjustment processing environments. These savings are reflected in the check-service costs, which are $17.2 million, or 2.2 percent, less than 2002 estimated expenses. In the 2003 budget, staffing for check service is 568 ANP below 2001 actual levels.

The overall reduction in check costs is the result of Reserve Banks' efforts to reduce direct costs and restrain support and overhead spending. Because charges from support and overhead account for about 30 percent of check-service costs, cost reductions in these areas are a necessary, though alone not sufficient, factor in achieving check spending targets. Much as the accounting area was provided with cost-reduction guidance over the last five years, each of the major support and overhead areas was given specific spending guidance for 2003. In aggregate, these areas have reduced expenses by $18.5 million and 504 ANP. For most support services, expense growth is projected to be 2 percent or less, with the majority achieving budgeted expenses below the estimated 2002 levels.

Information Technology

The most significant cost reductions are in the area of information technology (IT). These reductions reflect the multiyear targeted-reduction initiative established by the Reserve Banks to reduce local IT costs from the 2001 budget by $65 million.[6] Several efficiency initiatives are underway, including the e-mail server administration and management centralization project, standardization of desktop PC software application and hardware configurations, and implementation of Active Directory.[7] FRIT also has efforts underway to use its resources more effectively, for example, by improving the efficiency of its mainframe processing environment. Budgeted IT costs for 2003 are $30.1 million below the 2001 budgeted levels.

The IT cost-reduction target was designed to be an ambitious goal supporting the reengineering of Reserve Banks' provision of IT services. Reserve Banks recently have recognized that it is unlikely that the multiyear target will be achieved, in part because of delays in the desktop-standardization initiative and further study of a server-management initiative. They do believe, however, that the target has fostered opportunities to streamline and consolidate operations. In the 2003 budget, local IT staffing has decreased 154 ANP from the 2002 estimate. About half of the local IT staff reductions have been redirected to support initiatives in several of the nationally provided support services.

6. The IT multiyear target excludes support for Treasury initiatives, check-modernization projects, and economic research.

7. The Active Directory project is a centralized and standardized system that automates network management of user data, security, and distributed resources, enabling interoperability with other directories.

Electronic Access Customer Support

The Customer Relations and Support Office plans to consolidate the electronic access customer support function at two offices. Although project costs are expected to total $8.6 million in the 2003 budget, these costs are expected to be more than offset by savings at the other ten Banks over the next three years.

Treasury-Related Functions

The growth of 5.6 percent in Treasury-related functions is due to higher FRIT costs for Treasury Web Applications Infrastructure (TWAI) and Treasury Account Management Information (TAMI) system ($15.8 million). TWAI involves developing a network to support the Treasury applications that will connect customers and other businesses through the web. TAMI will also use web-based technology to improve reporting and reconcilement of Treasury account information. This increase is partially offset by reduced costs from the support and overhead areas, along with the savings that have been achieved through efficiency measures, such as the consolidation of Treasury check processing sites, from eight to four during 2002.

Supervision and Regulation

Total expenses for the supervision and regulation function increase $31.8 million, or 6.7 percent, in the 2003 budget, primarily because of the growth in the number and asset size of state member banks and an increased need to closely monitor large regional institutions in several Districts. The Reserve Banks have achieved efficiencies through increased use of risk-focused examinations and resource sharing among Reserve Banks, and have reduced travel costs through greater use of video conferencing. Systemwide, staffing levels remain flat, with a shift of personnel from foreign and community bank work to multistate banking organizations. As with Treasury costs, growth in the supervision and regulation function would have been higher if not for the reductions in support and overhead costs.

Cash Services

The Cash Product Office also established budget guidance for the cash function as part of the budget process. Most Banks have budgeted to meet the guidance primarily by increasing efficiencies and adjusting staffing levels to meet volume projections, which appear to be more stable after several years of substantial growth.

Research

During the budget guidance-setting process, growth in the research area was estimated to be 4.7 percent based on a trend forecast. The research functions have budgeted an aggregate increase of 4.7 percent, with staffing expected to be seven ANP higher than the 2002 estimate.

2003 Salary Administration

The budgets for the Reserve Banks, FRIT, and OEB include $117.1 million to fund salary administration programs for officers and employees (appendix E, table E.5).[8] The largest component of the salary programs is merit.[9] The average merit increase is budgeted at 3.6 percent for officers and 3.5 percent for employees, totaling $43.2 million, or 41 percent of the total salary administration budget. The other programs that affect base salaries—promotions, reclassifications, and market adjustments—total $13.5 million.

Officer and employee cash awards and incentive payments represent about $36.6 million, or 34 percent, of salary program costs. Cash award and incentive payment programs are increasing $3.2 million compared with 2002 estimated spending. Retention and severance payments (programs designed to deliver one-time payments most often associated with reengineering and efficiency initiatives) total $2.1 million and $10.3 million, respectively. The 2003 budget reflects a decrease in funding from the 2002 estimate for retention payments ($0.6 million) and for severance payments ($6.7 million).

Officer incentive payments and cash awards total $11.3 million, or 7.1 percent of officer salary liability. Although the officer variable-pay threshold was set at 8.0 percent of salary liability for 2003, half of the Banks and FRIT did not fully fund officer incentive payments and cash awards. In 2003, ten Banks, FRIT, and OEB targeted more than half the officer variable-pay pool toward incentives. Employee incentive payments and cash awards total $25.3 million, or 2.3 percent of employee salary liability. The mix between incentive and cash awards in the employee category continues to be weighted toward cash awards (cash awards represent 1.3 percent of salary liability; incentives represent 1.0 percent).

Officer turnover, including retirements, is projected to decrease from an estimated 5.3 percent in 2002 to 3.9 percent in 2003.[10] Reserve Banks estimate, however, that approximately one-third of all officers will be eligible to retire by second quarter 2004. Average employee turnover is projected to remain flat at 11 percent. Reserve Banks believe that continuing

8. Salary administration represents the budgeted funds that are available to increase compensation to officers and employees in the coming year. It does not include adjustments for changes in staffing levels, turnover and lags in hiring, and overtime.

9. Salary program costs described in this section include program expenses budgeted at the Reserve Banks, FRIT, and OEB.

10. Turnover rates include voluntary and involuntary departures.

market pressures for critical skill sets will increase the risk of losing key employees. The Banks therefore plan to use variable pay, retention incentives, and other monetary and nonmonetary rewards for key officers and employees.

Retirement and other benefit expenses, which account for 14 percent of Reserve Bank budgets, are anticipated to increase by $21.8 million, or 6.1 percent, in 2003. The primary factors driving the high costs include increases in salary-related benefits, such as Social Security and Thrift Plan contributions, which are directly related to an increase in salaries, and higher health care costs. The increases in employer contributions for health benefits average 19 percent for non-HMO plans, 8.9 percent for HMOs, and 11 percent for dental plans. The Reserve Banks' new consolidated health care program has helped to moderate the increase in employer contributions.

2003 Capital Budget

The 2003 capital budget submitted by the Reserve Banks and FRIT totals $491.4 million, a $160.6 million increase over the 2002 estimated levels. The budget includes $430.5 million for the Banks and $60.9 million for FRIT. The increase in 2003 outlays from the 2002 estimate is due largely to planned new building programs and various other building-renovation projects. Tables E.6 and E.7 in appendix E detail capital expenditures by District and by category.

As in previous years, the 2003 capital budgets include funding for projects that support the strategic direction outlined in the Banks' plans. These strategic goals include improving operational efficiency and effectiveness, improving services to Bank customers, and providing a safe, quality work environment. In support of these strategies, the 2003 budget identifies four major categories of capital outlays: building projects, payment system improvements, information technology initiatives, and security enhancements.

Building Projects

The proposed capital budget includes an estimated $268.7 million for building projects. Of this total, 58 percent, or $156.8 million, is related to the planned new building projects in Detroit, Houston, Kansas City, and Seattle. The remaining outlays in this category will fund various other major building renovations, as well as miscellaneous facility-improvement and energy-efficiency projects and acquisitions of contingency equipment.

Payment System Projects

The proposed capital budget includes $109.0 million for initiatives related to payment system improvement. Over 40 percent of these funds ($45.4 million) support reimbursable initiatives, including the Treasury Web Applications Infrastructure, Pay.gov, and Savings Bond Architecture projects. Outlays for the cash services area account for about one-third of the outlays. The 2003 budgets include funds for upgraded currency-processing equipment sensors ($19.0 million), cash inventory management systems, and Standard Cash Automation initiatives. Other outlays are associated with equipment and software needed in Districts migrating to the standard check-processing software platform in 2003 ($15.9 million) and for FRIT's Web Applications Infrastructure initiative ($3.3 million), which includes outlays for the Secure IP (Internet Protocol) project.

Information Technology Projects

The proposed capital budget includes $55.0 million in funding for major information technology initiatives. These initiatives do not include the automation components of building or payment systems initiatives that are discussed separately. The strategic objectives outlined in the individual Bank budgets are directed toward achieving the System's goal to increase the business value of System IT investments and to reduce technology costs. Of the total automation-related outlays, FRIT projects and acquisitions account for over half, or $30.9 million. The FRIT budget includes capital for the distributed processing, network, and mainframe environments, including a CPU replacement project and various software and hardware upgrades and enhancements. Aside from FRIT, the Districts have budgeted to begin replacing aging servers in compliance with the System's server-management initiative ($6.9 million). Bank budgets also include outlays for various other local initiatives and for systems operated or developed on behalf of the System.

Security Enhancements

The proposed capital budget includes $49.2 million in funding for security enhancements. Almost all Districts have included capital spending for security measures necessary to enhance security at Reserve Bank facilities. ▪

Chapter 3

Federal Reserve Banks

The 2004 operating budgets of the twelve Reserve Banks total $2,666.4 million.[1] The 2004 total is $39.1 million, or 1.5 percent, above estimated 2003 expenses (table 3.1).[2]

The modest increase in the 2004 Reserve Banks' budgets reflects continued initiatives to streamline operations and improve operational efficiency. The Banks' budgets reflect reductions in several areas, primarily in support services and check functions. Banks have been able to limit overall cost increases through the consolidation of selected operations and through continued efforts to realize efficiencies in workflow and service delivery. Lower costs in the check operation reflect efficiencies as the Reserve Banks near completion of a multiyear effort to modernize the check operating environment, as well as the effect of a check-restructuring initiative, which reduces the number of check-processing sites and consolidates check-adjustment and administrative functions. Spending restraint has been facilitated in part by voluntary retirement programs at the majority of Reserve Banks.

After considering the effect of revenue and reimbursements, the Reserve Banks' 2004 budgeted net operating expenses are $1,368.0 million, 3.1 percent lower than the 2003 estimate. The decrease reflects a 6.9 percent increase in revenue and

1. These expenses include those budgeted by Federal Reserve Information Technology (FRIT) and the Office of Employee Benefits (OEB). Expenses for these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets.

2. Unless otherwise noted, 2003 expenses also include costs associated with the check-standardization special project. Special projects are major efforts having Systemwide significance that are outside the budgets of the individual Reserve Banks. There are no special projects in 2004.

Table 3.1

Expenses of the Federal Reserve Banks, Net of Receipts and Claims for Reimbursement, 2003 and 2004

Millions of dollars except as noted

Item	2003 (estimated)	2004 (budgeted)	Change	
			Amount	Percent
Operations	2,627.3	2,666.4	39.1	1.5
LESS				
Revenue from priced services	888.0	929.2	41.2	4.6
Other income	0.8	0.8	0.0	0.0
Claims for reimbursement[1]	326.8	368.4	41.6	12.7
EQUALS				
Net expenses	**1,411.7**	**1,368.0**	**–43.7**	**–3.1**

NOTE. Excludes capital outlays. Includes expenses budgeted by Federal Reserve Information Technology (FRIT) and the System's Office of Employee Benefits (OEB). Expenses from these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets. Components may not sum to totals and may not yield percentages shown because of rounding.

Operating expenses reflect all redistributions for support and allocations for overhead.

1. Costs of fiscal agency and depository services provided to the U.S. Treasury, other government agencies, and other fiscal principals that are billed to these agencies.

reimbursements and stringent spending targets established by System business leaders as the Reserve Banks strive to improve priced-service cost-recovery performance. Approximately 49 percent of Reserve Bank expenses in the 2004 budget are offset by priced-service revenues (35 percent) and reimbursable claims for services provided to the Treasury and other agencies (14 percent). The budgeted 2004 service revenue is higher than the 2003 estimated level, largely because of higher imputed net income on clearing balances (NICB) and, to a lesser extent, price increases.[3] Reimbursable claims will increase 12.7 percent in 2004, reflecting additional efforts by the Reserve Banks on behalf of the Treasury.

Total 2004 projected employment for the Reserve Banks, FRIT, and OEB is 21,300 average number of employees (ANP), a decrease of 860 ANP, or 3.9 percent, from 2003 estimated staff levels (table 3.2).[4] If the Reserve Banks realize this staffing decrease, it will be their largest annual workforce reduction since the System began collecting automated cost-accounting information in 1977. Most Banks are reducing staff in the check service as a result of the successful transition to the standardized check platform, the check-restructuring effort, declining volumes, and efforts to improve priced-service performance through additional efficiencies. The remainder of the reduction is the net effect of several System and District efforts to meet System cost-reduction initiatives and improve operational efficiencies. Voluntary retirement incentive programs announced at nine Reserve Banks and FRIT help achieve these reductions.

2003 Budget Performance

Total 2003 expenses are estimated to be \$2,627.3 million, which represents a decrease of \$2.6 million or 0.1 percent from the approved 2003 budget of \$2,629.9 million. The Banks, FRIT, and OEB estimate ANP at 22,160, a decrease of 262 ANP from approved 2003 levels.

The decrease in the estimate reflects reductions in support and overhead areas

3. The increase in NICB is associated with a change in methodology to calculate imputed investment income and a change in the rate at which earnings credits are paid to depository institution holders of clearing balances. Both changes were approved by the Board in October 2003.

4. ANP is the average number of employees in terms of full-time positions for the period. For instance, a full-time employee who starts work on July 1 counts as 0.5 ANP for that calendar year; two half-time employees who start on January 1 count as 1 ANP.

Table 3.2

Employment at the Federal Reserve Banks, FRIT, and OEB, 2003 and 2004

Average number of personnel except as noted

Item	2003 (estimated)	2004 (budgeted)	Change	
			Amount	Percent
Reserve Banks	21,366	20,551	–815	–3.8
Federal Reserve Information Technology	759	713	–46	–6.1
Office of Employee Benefits	36	37	1	2.8
Total	**22,160**	**21,300**	**–860**	**–3.9**

NOTE. Components may not sum to totals and may not yield percentages shown because of rounding. See text note 4 for definition of *average number of personnel*.

totaling $18.0 million. Reserve Banks noted cost savings from major staff reductions in general administrative services (89 ANP), information technology (IT) services (40 ANP), human resource functions (30 ANP), business development (19 ANP), and accounting functions (13 ANP). These reductions were achieved through consolidation of operations, operational efficiencies, and a change in service levels as areas better align resources with business activity. In addition, operational efficiencies and lower-than-expected volumes in the cash area result in a $9.9 million and 25 ANP decrease, and the cancellation by the Treasury of a project to integrate sites that process savings bonds by having a single customer service contact number will save $3.7 million.

These savings are partially offset by higher-than-budgeted costs in the check area related to initiatives to improve cost-recovery performance in the long term. Check-related projects were estimated to be $33.2 million over budget in 2003. Three major projects account for this cost overrun:

1. The System's decision to restructure the provision of check services will result in nonrecurring expenses of approximately $26.2 million, which were accounted for in 2003, for separation payments, lease buyouts, retirement of impaired assets, and facilities expenses associated with closing selected check-processing operations that were not included in the original budget.
2. Conversion to the national, standardized check-processing platform is estimated to be $5.0 million over budget because of the use of unbudgeted staff support, additional overtime, and travel.
3. The conversion of the legacy check-image files to the new FedImage system required an additional $4.0 million for additional staff, software costs, and fees, because of an unplanned software upgrade and the three-month extension of consultant services.[5]

The check-project overruns are partially offset by a decrease in costs of the check-standardization special project ($2.9 million) resulting from earlier Reserve Bank conversions and from severance payments for this project having been budgeted but not paid.

Factors Affecting the 2004 Budget

Check Service

The Reserve Banks continue to be challenged by shortfalls in check-cost recovery. In 2004, the System will continue to see cost reductions with the completion of two major initiatives in the check service: (1) check modernization, which includes four projects—check standardization, enterprise-wide adjustments, FedImage, and check electronic access and delivery—and (2) the current check-restructuring effort. With the completion of the check-modernization initiative, the 2004 costs for supporting and implementing further enhancements to the check-modernization systems will be $32.6 million less than estimated for 2003.

Check restructuring, which was announced early in 2003, will better align the Federal Reserve check-processing infrastructure with the evolving market environment, provide greater flexibility in managing check operations, and improve resource allocation. The 2003 estimate and 2004 budget reflect plans to reduce the number of check-processing locations from 45 to 32 and to consolidate the number of check-adjustment functions from 43 locations to 12 regional sites. Although the planned restructuring efforts will be completed by the end of

5. Staff includes outside-agency and hourly help.

2004, many costs associated with this initiative, such as one-time separation pay and asset-impairment expenses, were accrued in 2003. The 2004 budget includes $29.0 million to fund additional efforts to streamline check operations and to support resource needs anticipated as the Banks prepare for changes associated with the Check Clearing for the 21st Century Act (Check 21 Act).

Support Services

As in 2003, the 2004 budget reflects cost savings from staff reductions in the support service areas. These reductions are the result of consolidations and efficiency measures as well as a shrinking base of internal customers demanding support services. Savings in support services are driven in large part by aggressive multiyear savings targets established by the IT, human resources, and business development areas.

Local IT costs are budgeted to decrease $14.3 million from the 2003 estimate and $37.8 million from the 2001 budget. This reduction is part of a multiyear initiative to reduce IT costs.[6] These savings are being realized through several cost-reduction initiatives, such as e-mail server administration and management, standardization of desktop PC configurations, implementation of active directory, and server standardization and management.[7] The human resources area also has a multiyear cost-reduction initiative. These costs are budgeted to decrease $3.1 million from the 2003 estimate and $8.3 million, or 13 percent, from 2001 actual expenses. The savings are a result of the consolidation of benefits and payroll functions, and other workflow efficiencies.

Local customer support and marketing costs are budgeted to decrease as well. The $5.4 million reduction from the 2003 estimate is due in large part to the consolidation of electronic access customer support at two sites, which will be completed by April 2004. Total business development costs have declined $11.8 million, or 14 percent, from 2001 actual expenses. In addition to the reductions in IT, HR, and customer support and marketing, costs for administrative services are budgeted to be slightly below the 2003 estimate, reflecting overall staff reductions, lower printing costs, use of digital technology, and a decline in printing volume. The savings in support services are exclusive of security-enhancement efforts, which are budgeted to increase $6.7 million.

Treasury-Related Functions

The Treasury continues to request services from the Reserve Banks on its behalf. The Banks are fully reimbursed by the Treasury for these services. All projects are reviewed by the Reserve Banks' Treasury Relations and Support Office (TRSO), along with Board staff, to ensure that Federal Reserve resources are used effectively. A majority of the projects involve converting from paper-based to electronic payments and using web technology for increased efficiency. Treasury initiatives that account for the largest cost increases are the Treasury Web Application Infrastructure ($11.5 million), the Pay.gov/paper check conversion ($9.3 million), the Treasury Check Information System ($1.2 million), and the Treasury Web Central Reporting System ($0.9 million). In addition, at the request of the Financial Management Service (FMS), the TRSO will manage two market research projects and a market-

6. The IT multiyear target excludes support for Treasury initiatives, check-modernization projects, and economic research.

7. The active directory project is a centralized and standardized system that automates network management of user data, security, and distributed resources, enabling interoperability with other directories.

ing campaign to support the FMS goal of increasing electronic payments of federal benefits payments ($8.5 million). Slightly offsetting these increases are savings from lower support and overhead costs charged to the Treasury, and staff reductions and lower associated expenses in TreasuryDirect and saving bonds operations due to declining volumes.

Supervision and Regulation

Supervision and regulation expenses are increasing 5.2 percent from the 2003 estimate. The increase is driven largely by annual salary merit increases, higher salary costs related to hiring more experienced staff, and resource needs at two Reserve Banks.

2004 Personnel Expenses

Personnel expenses, which include both salaries and benefits, represent 62 percent of the budget. The budgets include $88.8 million to fund salary administration programs for officers and employees.[8] Expenses associated with merit programs and with cash awards and incentives account for about 85 percent of salary administration. A total of $38.5 million has been included for merit programs. The average merit increase is budgeted at 3.4 percent for officers and 3.2 percent for employees, lower than the 2003 average merit increases of 3.6 percent for officers and 3.5 percent for employees.

Officer incentive payments and cash awards total $11.7 million.[9] Employee incentive payments and cash award funds total $25.6 million.[10]

Officer turnover, including retirements, is projected to increase from an estimated 5.4 percent in 2003 to 7.3 percent in 2004.[11] Average employee turnover is projected to increase from an estimated 9.8 percent in 2003 to 12.9 percent in 2004. The rise in turnover is in large part due to the voluntary retirement programs and the check-restructuring efforts. Approximately 80 officers and 900 employees are projected to leave the System under the voluntary retirement programs, with the majority of departures occurring in 2004. The average cost-recovery period is estimated at 1.4 years, with the expected replacement rates for these programs varying by Reserve Bank and ranging from 34 percent to 80 percent.

Retirement and other benefit expenses, which account for 14 percent of Reserve Bank budgets, are anticipated to increase by $20.2 million, or 5.4 percent, in 2004. The primary factors driving the high cost increases in non-salary-related benefits are increases in health care and group life insurance costs. The increases in employer contributions for health benefits average 13.8 percent for non-HMO plans and less than 1 percent for HMOs. An estimated $4.2 million in savings from the System's new consolidated health care program has helped to offset some of the increase in employer contributions.

Areas of Risk in the 2004 Budget

The effects of check restructuring, volume declines, and revenue loss pose a

8. Salary administration represents the budgeted funds that are available to increase compensation to officers and employees in the upcoming year. It does not include adjustments for changes in staffing levels, turnover and lag in hiring, and overtime.

9. For 2004, the officer variable-pay threshold remained at 8.0 percent of salary liability.

10. The 2004 employee variable-pay threshold remains at 2003 levels: 8.0 percent for the special professional grades, 4.0 percent for the top three grades, and 1.7 percent for all other grades.

11. Turnover rates include full-time, part-time, and hourly voluntary and involuntary departures, regardless of whether the positions will be refilled.

higher-than-usual risk to the check service in 2004. Delays in the check-restructuring project, as check operations are consolidated, could result in higher-than-budgeted staffing, overtime, and facility costs. The budget would also be affected by higher overtime costs for resolving reconcilement issues or unanticipated write-offs. The budget reflects a projected 8.9 percent decrease in processed-check volume. Budgeted check revenues would be affected adversely by further volume declines.

Reserve Banks also noted some risk associated with unanticipated requests to perform work on behalf of the Treasury, the loss of key staff, and possible structural changes in the business development and marketing areas. As in the past, changes to the services the Reserve Banks provide as fiscal agent may result in differences between budgeted and actual costs for 2004. In addition, the voluntary retirement programs offered in nine Reserve Banks and FRIT present the risk of losing key staff. Although many Banks have noted that they have developed succession plans, there is the risk that the loss of experienced staff and difficulty filling key positions could adversely affect some Bank operations.

2004 Capital Budget

The 2004 capital budget submitted by the Reserve Banks, FRIT, and OEB totals $467.4 million, a $60.9 million increase from the 2003 estimated levels. The increase in 2004 outlays from the 2003 estimate is due largely to planned new building programs.

As in previous years, the 2004 capital budget includes funding for projects that support the strategic direction outlined in the individual Reserve Banks' and the System's plans. These strategic goals focus on investments that improve operational efficiencies and services to Bank customers, and on providing a safe, quality work environment. In support of these strategies, the 2004 budget identifies five major categories of capital outlays: building projects and facility improvements, payment system improvements, automation and communication initiatives, security enhancements, and miscellaneous acquisitions.

Building Projects

The proposed capital budget includes an estimated $249.9 million for building-related projects and facility improvements. Over half of this total ($143.3 million) is related to the new building projects in Detroit, Houston, Kansas City, and Seattle. The remaining outlays in this category ($55.6 million) will fund various other building renovation and refurbishment projects, as well as miscellaneous facility-improvement and energy-efficiency projects.

Payment System Projects

The budget includes $97.1 million for initiatives related to payment system improvements. Almost half of these funds ($41.6 million) are for reimbursable expenses for Treasury initiatives. Although the majority of the System's investment in the standard software platform for check standardization is complete, the 2004 capital budget includes outlays to prepare for check restructuring, changes authorized by the Check 21 Act, and customer demand for image services ($14.8 million). The 2004 capital budget also includes funding, mainly at FRIT, to support the growth in processing capacity ($7.3 million). Other outlays are for improvements in the cash services area ($9.8 million) and to support FRIT's web applications infrastructure initiative ($11.9 million).

Information Technology Projects

Banks have included $61.6 million in funding for major information technology initiatives. These initiatives do not include the automation components of building or payment systems initiatives that are discussed separately. Of the total automation-related outlays, FRIT projects and acquisitions account for over 40 percent, or $27.0 million. Aside from FRIT, the District budgets include the replacement of aging servers, in compliance with the System's Server Management Initiative ($7.2 million), and telecommunications projects at several Reserve Banks ($4.2 million). The remainder of the budget is for various equipment and software to support local and System initiatives.

Security Enhancements and Miscellaneous Items

Finally, the proposed capital budget includes $53.9 million in funding for security enhancements and $4.9 million for miscellaneous capital items. Miscellaneous capital includes funding for other equipment and software not falling into the other defined categories. ■