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Statement by

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and

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before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

of the

U.S. House of Representatives

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It is a pleasure for Governor Kelley and me to visit with this Subcommittee today. This is the fourth time that I have had the opportunity to discuss and review the Federal Reserve System's expenses and budget with you. Today as we look at the Federal Reserve System's budget for 1990, Governor Kelley will discuss the Board's budget and major initiatives, and my comments will focus on the Reserve Bank budgets, as well as major System initiatives.

The Board has recently made available to the public and to this Subcommittee copies of our publication entitled Annual Report: Budget Review, 1989-90 presenting detailed information about spending plans for 1990. The attached tables have been updated for 1989 actual experience and, therefore, some variations exist from data in that document.

In January 1990 the Board decided to reduce the approved budgets of the Federal Reserve System by $4.4 million in order to achieve a degree of restraint in the Federal Reserve comparable to the restraint imposed on the Federal government by Gramm-Rudman-Hollings. Because the budgets were approved prior to making the Gramm-Rudman-Hollings cuts, the Board and the Reserve Banks have the responsibility of meeting this overall target, but were not asked to detail the reductions.

While the Federal Reserve has historically been concerned about controlling costs, the Monetary Control Act of 1980 has provided additional motivation to control costs. As a matter of law, services provided to depository institutions must meet a clear market test. Specifically, all expenses (including overhead and the imputed cost of capital and taxes) involved in providing "priced" services are covered by charges to users. The markets for these correspondent banking services, in which we operate in providing those services, are highly competitive, thereby providing a strong and direct incentive to maintain our efficiency. Given these internal and external restraints on costs, the Federal Reserve System's expenses are projected to increase by an average annual rate of 5.1 percent from 1986 through 1990. This increase includes expenses for Supervision and Regulation initiatives, Expedited Funds Availability legislation requirements, contingency planning initiatives, and several major initiatives for the U.S. Treasury. I would add that it is difficult to judge the degree of restraint in an organization's budget based solely on the growth rate of expenses. Our objective is to provide services at prices that promote efficiency and to perform those responsibilities given to us by Congress in an effective manner.

For 1990, the Federal Reserve System has budgeted operating expenses of $1.5 billion, an increase of 5.0 percent over 1989 actual expenses. Before getting to the substance of our 1990 budget, I would remind the Subcommittee of two aspects of Federal Reserve System operations that affect our budget in unusual ways. First, 41 percent of System expenses arise from services provided to depository institutions for which, by law, we charge fees adequate to cover all costs. Since additional costs of these services are more than recovered by additional revenues, any increases in costs result in increased earnings returned to the U.S. Treasury. Second, many fiscal agency operations are provided to the Treasury Department and other agencies on a reimbursable basis. Altogether, 59 percent of our total expenses are either recovered through pricing or are reimbursable (see Table 1). On a net basis the cost to the public of operating the Federal Reserve System is $621 million of the total $1.5 billion budget (see Table 1).

Historical Overview

It may be helpful to put the budget for 1990 in perspective by sketching the most recent 10-year history of System expenses. Between 1979 and 1989, Federal Reserve System expenses increased at an average annual rate of 6.8 percent (see Table 2 and Chart 1); System employment increased at an average annual rate of 0.2 percent (see Table 2); and volume increased by 32 percent over the 10-year period (see Chart 2). Unit cost did increase in the early eighties as Federal Reserve Bank volumes adjusted to pricing following implementation of the Monetary Control Act. However, after the transition to pricing was completed in 1983, the composite unit cost for all functions has actually declined by 0.2 percent on an annual rate, even while improvements have been made in the quality of services.

For priced services, a decline in unit cost has been particularly noticeable in the electronic payments areas. Volume growth has averaged over 6 percent per year for funds transfers and over 25 percent for automated clearinghouse (ACH) transactions. In commercial check processing, on the other hand, where there has been a significant effort to improve the quality of service through increased availability and improved deposit deadlines, there has been an increase in unit cost of 2.5 percent per year since 1983. In the most recent year-over-year comparison (1989 over 1988) check processing unit cost rose 6.6 percent due primarily to implementing provisions of the Expedited Funds Availability legislation (EFA).

For nonpriced cash operations--involving the distribution of currency and coin--the decline in unit cost has also been noticeable; since 1983 the average decline has been 3.0 percent per year. Currency paying and receiving volume has increased by an average rate of 6.7 percent annually since 1979. In fiscal agency operations, also nonpriced, there has been an increase in unit cost of 2.1 percent per year since 1983 reflecting new operations. Also in the nonpriced area, the Federal Reserve System has managed a number of initiatives for the Treasury to improve long term efficiency in Treasury securities and savings bonds. Through 1989 the Federal Reserve has added 175 staff and spent $42 million on these Treasury initiatives.

As for the impact of EFA on our cost structure, in 1989 we have seen an overall unit cost increase of 2.3 percent compared to 1988. This increase was primarily due to the implementation of the Expedited Funds Availability legislation. This legislation required banks to provide prompt availability for check deposits and gave the Federal Reserve the authority to make improvements in the payments system to speed the collection and return of checks. Thus, the Board's Regulation CC mandated expeditious return of unpaid checks to reduce banks' risks in providing the prompt availability required by the Act. To facilitate banks' compliance, the Federal Reserve Banks implemented new returned checks services for which they had to add about 600 employees throughout 1988 and 1989 and spend over $60 million.

It is difficult to measure productivity improvements in the Supervision and Regulation area, but these activities have required significant increases in resources over the last 10 years. Supervision and Regulation has added 786 staff and increased expenditures by $127.2 million since 1979. These resources have been employed to strengthen the ability of the

Reserve Banks to identify and address problems in the banking organizations under their jurisdiction. Obviously, the problems the Reserve Banks have had to deal with in the last several years have increased greatly, as reflected in the record number of bank failures and problem banks, as well as in the increasingly complex issues they have had to face in reviewing and processing of regulatory applications and in developing supervisory policies to deal with new and changing banking risks.

In presenting our spending plans for 1990, I would like to mention that both the Reserve Bank budgets and the Board's budget must be approved by the Board of Governors. Reserve Bank budgets are first approved by the Banks' Boards of Directors and then reviewed by the Committee on Federal Reserve Bank Activities prior to submission to the Board of Governors. Governor Kelley oversees the Board's budget and I will turn to him for that discussion.

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Introduction

I am pleased to appear before this Subcommittee again this year. In the past we have discussed our budget process and the comprehensive planning process the Board has in place to ensure that we identify and accomplish key objectives in an effective and efficient manner. The Annual Report: Budget Review 1989-90 describes these processes, discusses the Board's record of sound budget management, and provides trend data. Therefore, I will confine my testimony to the 1990 budget unless the Committee has questions.

The 1990 budget posed difficult challenges. Problems in the thrift industry, which culminated in passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), placed substantial new pressures on our supervision and regulation program. As a result, the banking supervision program had a large increase in terms of funding. Staff increases in supervision, however, were offset by decreases elsewhere throughout the Board. Full implementation of our new compensation system also contributed to the rate of increase in the budget being above normal levels. Finally, there was a major increase in the level of resources devoted to our Inspector General Program.

The Board Operating Budget

The 1990 Board operating budget is composed of two components: regular operations and the Office of the Inspector General (OIG). The regular operations budget of $102.9 million represented an increase of 7.9 percent. The OIG budget of $1.7 million represented an increase $0.8 million, or 114 percent, for operations and $0.2 million for facilities.

The initial regular operations budget submissions totaled $105,550,300. During the budget reviews, reductions of $2,380,400 lowered the approved budget to $103,169,900. Voluntary implementation of Gramm-Rudman-Hollings reductions paralleling those of other agencies further reduced the budget to $102,865,200, an increase of 7.9 percent over 1989 expenses. This is a larger increase than in recent years. Growing supervisory responsibilities, including the changes brought about by the FIRREA, and the implementation of our new compensation program contributed to the increase in the 1990 budget level.

Division budget submissions minimized expenses, reallocated resources to higher priority work, and included new initiatives only as necessary to meet Board objectives. The approved budget contained sufficient funding to meet the major Board objectives in each program area, including: funding and positions to support major workload increases tied to the supervision and regulation area discussed earlier; resources for the continued development of the National Information Center; continued investments in productivity enhancements including office automation and an electronic Records Management initiative; and funds to maintain a safe and effective working environment.

In terms of people employed, 10 new positions were created to support the new and additional work requirements associated with the supervision and regulation function. This was offset by a reduction of 11 positions elsewhere in the budget.

Budget Highlights

Supervision and Regulation

This budget supports necessary enhancements in our ability to effectively respond to the continuing regulatory and supervisory issues caused by problems in the financial industry and to meet new obligations posed by the FIRREA legislation aimed at correcting those problems. The budget addressed these requirements in a number of ways.

The enactment of the Financial Institutions Reform, Recovery and Enforcement Act and the underlying problems that required that legislation, caused additional expense of $550,000. The added expense was for 10 new positions, offset elsewhere in the budget, and accelerated hiring to meet the expanded workload in the areas of policy, financial analysis and enforcement. We are also working with other agencies, through the Federal Financial Institutions Examination Council, to implement new Home Mortgage Disclosure Act reporting requirements and, among other things, to expand the coverage of the Act to include mortgage lenders not affiliated with lending institutions. The number of records maintained will grow tenfold from 600,000 to 6,000,000 as a result of this expanded coverage.

In addition to the resources added in supervision and regulation, Board resources were reallocated in the other operational areas to meet requirements of the FIRREA legislation. Our research divisions anticipated substantial work on issues relating to deposit insurance, monitoring the savings and loan industry, and support to the Chairman in his responsibilities as a member of the Oversight Board. This incremental staff effort is estimated at six work-years for 1990. To repeat, the work is being accomplished by reallocating resources; no new positions were added.

Our legal staff is encountering a major workload increase in litigation and enforcement. Two of three new attorney positions added in 1989 support FIRREA-related work. Again, no new positions were added in the 1990 budget.

Other Board program areas are also feeling the effects of the FIRREA legislation. For instance, senior staff in a number of areas are providing substantial start-up assistance to the Real Estate Appraisal Subcommittee of the FFIEC.

The National Information Center (NIC) is a major System-wide standard automation project providing important support to the supervision and regulation operational area. It was established in 1988 to provide the Board and Reserve Banks with a single-source, high-quality database from which information about financial institutions will be drawn to monitor safety and soundness, process applications, and maintain accuracy of published data series. The growth of interstate banking, the acquisitions of financial institutions tied to the resolution of bank and savings and loan failures, and the growing complexity of the inter-relationships between financial institutions makes the establishment of a central database critical to the System's supervision and regulation function.

A significant commitment of existing resources continues in a number of the Board's divisions in support of this project. The 1990 budget requirement for data processing resources (at the Board only) is $1.6 million. This is slightly higher than the level of data processing resources committed in 1989. The NIC project is now scheduled to be implemented in mid-1991.

Compensation

In earlier testimony and letters to this Committee, Chairmen Volcker and Greenspan indicated concerns over the adequacy of our compensation system to attract and retain the type of staff required for the Board to fulfill its mission. Last year I testified that our compensation system was being revised and there would be some significant costs as we tried to reduce the gap which had developed between staff salaries and those in the market. In 1990, the first full year of the Board's new compensation program, the budget provided approximately $3.5 million for the full, one-time, cost of transition to the new salary schedule. We had anticipated phasing the increase to lessen its impact on any one budget year; however, events in the marketplace, including substantial increases at the other financial regulatory agencies, caused us to accelerate our schedule. The budget also provided $4.2 million to fund the increase in salary rates caused by increases in salaries in the marketplace during the previous year.

Inspector General

The Office of the Inspector General was created by the Board in July 1987. Its reporting relationships, duties and responsibilities were formalized by the Inspector General Act Amendments of 1988.

A review by the Inspector General of how his Office is carrying out those duties and responsibilities led to the development of a five-year strategic plan. The plan proposes a phase-in of broader audit and investigation coverage of the Board's mission areas as well as attention to the legal requirement to review new and existing laws and regulations for their impact on the economy and efficiency of Board programs and operations.

To implement the findings of the review, a significant increase was approved for the budget of the Office of the Inspector General. The approved 1990 OIG budget is $1.7 million, an increment of $0.8 million for the mission activities of the office and $0.2 million for office space. The mission increment provides $0.4 million for six new positions. It also covers a substantial increase in travel for the IG staff and shifts the burden of travel costs for staff borrowed for reviews of Board operations to the Board from the Reserve Banks. The increment also provides for a higher level of contract support.

Contingency Processing Center (CPC)

In 1989 the Board transferred the management of the CPC, the System's backup data processing facility, to the Federal Reserve Bank of Richmond. This was done to recognize a substantial increase in the Reserve Banks' utilization of the CPC for operational requirements, with corresponding requirements for equipment upgrades, while the Board's requirements for a backup capability and relocation site remained stable. The change in requirements substantially reduced the Board's share of the overall cost of the CPC. Positions added when the Board established the CPC in 1985 were deleted from the Board's budget concurrent with the transfer of management to Richmond. Although this action was not implemented as part of the 1990 budget, since it occurred in the middle of 1989, it resulted in a reduction in Board expenses in both 1989 and 1990. The total change was a reduction of approximately $1.7 million in the Board's expenses.

Budget By Operational Area

The Board's activities fall into four broadly defined operational areas: monetary and economic policy, supervision and regulation of financial institutions, services to financial institutions and the public, and System policy direction and oversight. I would like to take a minute to discuss the budget for each of these operational areas. Since each area was affected by general factors, such as the compensation program and the higher costs for health insurance, I will focus only on the unique factors affecting each. You might wish to turn to Table 4 during this discussion.

Monetary and Economic Policy

This function is expected to cost $53.6 million in 1990, an increase of 6.9 percent from 1989 expenses. In addition to maintaining the quality of economic forecasts and analysis, the budget reallocates resources to support FIRREA, continue development of the National Information Center, and process the data from the Survey of Consumer Finances conducted in 1989.

Supervision and Regulation

This function is expected to cost $26.8 million in 1990, an increase of 14.1 percent. This is the largest increase by operational area and reflects the seriousness of the issues facing the financial regulators. The main causes of the increase are new positions and the NIC.

Services to Financial Institutions and the Public

This is the smallest operational area of the Board. It is composed entirely of the System's payments functions. The 1990 budget of $2.7 million is an increase of approximately $250,000 or 10.2 percent over 1989 expenses. An important factor in the increase is the establishment of a payments risk program in mid-1989. The program coordinates the analysis of risks associated with national and international payment and settlement systems.

System Policy Direction and Oversight

This function will cost $19.7 million, an increase of 3.0 percent. Resources in lower priority areas of this category were reallocated to higher priority work in the other operational areas, thus this was the lowest rate of increase at the Board.

Budget By Object Class

Excluding the budget of the Office of the Inspector General, the 1990 budget was \$7.6 million or 7.9 percent more than 1989 expenses. The increase for salaries, \$7.8 million or 12.8 percent, was the major factor in the increase. The net effect of all object classes other than salaries was a decline of \$0.2 million. Table 5 presents a summary of Board expenses by object class.

Personnel Costs

The increase in salaries was closely related to the new compensation program. As mentioned earlier, \$3.5 million was for the accelerated transition into the new system while an additional \$4.2 million was to make up for the changes that occurred in the market during 1989. The remaining \$0.1 million increase in salaries was caused by technical factors such as promotions.

Insurance and retirement costs rose by \$0.6 million and \$0.2 million respectively. The former rose because of increases in health insurance rates while the latter rose because of the higher salary levels and increases in the tax rate and taxable wage base for Social Security.

Goods and Services

The overall cost of goods and services declined by \$1.0 million in 1990. The main reasons were the change in the cost sharing formula for the CPC and the completion of the Survey of Consumer Finances.

Positions

The 1990 budget authorizes 1,555 positions, a reduction of one position from 1989.

Ten new positions were added in the budget while 11 were abolished. The 10 new positions support the supervision and regulation function, eight of which are related to work stemming from FIRREA, while two will support implementation of the National Information Center. The 11 positions that have been abolished include eight positions at the CPC. Three additional positions will be eliminated during the 1990 budget year. Table 6 presents the number of positions by operational area.

Trends

The 1990 regular operations budget increase of 7.9 percent is larger than the 5.7 percent compound annual rate of increase from 1980 to 1990. The pressures in the supervision and regulation area and unique 1990 costs of the new compensation program account for the size of the increase. Without the reduced expense associated with the change in utilization and cost-sharing for the Contingency Processing Center, the 1990 increase would have been larger.

The 1,555 positions approved in the 1990 regular operations budget is 48 less than the number of positions at the end of 1980. Implementation of the provisions of the Monetary Control Act and other significant legislation had increased the number of positions to 1,653 in 1984. Automation and other efforts to control expenses and improve productivity have assisted us in reducing to the current level which did not increase over 1989 in spite of FIRREA and other pressures associated with the supervision and regulation area.

Capital Budget

The approved capital budget was $4.0 million which is comparable to the $3.9 million 1989 expenditures. The largest category of expenditure is $1.6 million for important workstation, network, office automation, and records management investments. Facilities investments of $1.3 million provide funds for a new roof for the Martin Building, a replacement fire intrusion and detection system, and miscellaneous energy conservation investments. Central automation initiatives costing $0.7 million provide a system to connect distributed workstations to the mainframe, additional disk space to support the NIC and growth on the research departmental computers, and mainframe software. The remainder of the capital budget provides $0.4 million for miscellaneous small capital expenditures.

Conclusion

The 1990 budget was 7.9 percent higher than 1989 expenses and is the largest increment since 1982; it is also larger than the 5.7 percent average annual rate of increase over the last 10 years. The large increase stems from the convergence of two unrelated actions: full implementation of our compensation program and passage of FIRREA.

This budget added positions in critical areas but eliminated them elsewhere. Excluding the Office of the Inspector General, the number of positions is 126 below the peak reached in 1984 when the Board was still reacting to the changes brought about by the Monetary Control Act, International Banking Act, and Financial Institutions Deregulation and Interest Rate Control Acts, and to a deteriorating situation at that time in the banking industry.

I would be happy to address any questions you may have after Governor Angell concludes our joint testimony.

Reserve Bank Budgets

The Reserve Bank expense increase--both priced and non-priced--was budgeted at 5.8 percent which fell well below the 1990 budget objective of 6.1 percent. Again, the Banks' approved 1990 budget was further reduced by $4.1 million in January 1990 with the restraint imposed on the Federal government by Gramm-Rudman-Hollings. With this cut in place and using actual 1989 expenses instead of estimated 1989 expenses as the base, the anticipated expense increase for 1990 is now only 4.8 percent. Seven major initiatives account for almost half of the budgeted increase in Reserve Bank expenses (see Table 7).

A particularly noteworthy initiative in 1990 is the enhancement of fiscal agency services for the U.S. Treasury and the U.S. Department of Agriculture's Food and Nutrition Service ($5.7 million). The U.S. Treasury effort involves a $4.1 million expenditure for the nationwide expansion of a Regional Delivery System, which consolidates issuance of over-the-counter savings bonds. System-wide implementation of the project, which began as a pilot program at the Federal Reserve Bank of Cleveland, will continue through 1993. A staff increase of 116 is expected in 1990 and a total staff increase of 350 is projected by the time the project is fully implemented. Although this initiative results in additional short-term expenses for the Federal Reserve Banks, the costs are more than offset by savings at government agencies and commercial banks.

The second 1990 fiscal agency initiative is implementation of changes requested by the Food and Nutrition Service in processing food coupons. These changes, first tested at the Memphis and Dallas offices, will add $0.6 million and increase staff by 22 in 1990. Expenses for both savings bond and food coupon initiatives are fully reimbursable.

Other initiatives include improvements to facilities, many of which are aging and no longer have efficient support systems or the space to allow an efficient flow of work. Each year steady progress is made toward achieving the type of space needed for modern central bank operations.

Reserve Bank operations in today's environment require more reliable and secure computer systems, more use of office automation, extended communication networks, and the most efficient high-speed sorters and counters for checks and currency. The initiatives identified in Table 7 as Automation, Check operations, Currency processing, and Contingency back-up all result from this requirement.

Also, the Reserve Banks require added resources for Supervision and Regulation due to current conditions in the banking industry and the greater complexity of examinations generally.

In addition to these major initiatives, it may be helpful to look at 1990 budgeted expenses on the basis of our four service lines (see Table 8).

Expenses for Services to Financial Institutions and the Public, which include both priced and nonpriced services, are budgeted at $947.0 million and account for two-thirds of total expenses. Expenses are increasing by $30.7 million, or 3.3 percent, over 1989. Staffing is budgeted at 9,335, down 87, or 0.9 percent, primarily because of reductions of 52 in commercial check, and 30 in services rendered others. The reduction in services rendered others is associated with an anticipated reduction in staff assistance provided to other agencies to address problems in the savings and loan industry. Expenses of priced services are budgeted at $622.1 million, an increase of 2.3 percent. Expenses of the nonpriced services are budgeted to increase 5.4 percent.

Commercial check processing is by far the largest service ($477.8 million), comprising half the budgeted expenses of this operational area and employing 5,814. The anticipated increase in expenses is $7.6 million, or 1.6 percent over 1989. Staffing levels for 1990 include a reduction of 52 resulting from the stabilization of workloads in the commercial check, check adjustment, and check return item areas. Commercial check volume is budgeted to increase by 1.5 percent; the volume of return items is expected to be stable during 1990.

Expenses for the currency service are expected to increase $9.9 million, or 7.9 percent. Unit cost is expected to increase by 2.6 percent. The net staffing levels will decrease by 13 primarily because of a staff reduction of 10 in Boston resulting from a change in operating controls and a staff reduction of 13 in New York related to a shift from medium-speed to high-speed currency processing. Volume will continue to increase in the currency areas. Other initiatives affecting this service are automation efforts in various Districts and a project to develop a second generation of high-speed currency processing equipment.

Expenses for the automated clearinghouse (ACH) service are budgeted to increase $3.8 million, or 5.1 percent, with a minimal change in staffing. There is a shift in expense growth from government ACH to commercial ACH that corresponds to the faster growth of the latter. Total ACH volume is projected to increase 14 percent in 1990. The major initiative affecting this service is Fedline II, which is the standard intelligent terminal software for access to Federal Reserve services.

Expenses associated with public programs are budgeted to increase by $3.7 million, or 8.7 percent. The staff level will increase by 17. The increases result from a greater involvement in regional and public forums, provision of outreach programs, and additional efforts in the automation of mailing and subscription lists.

Expenses for Supervision and Regulation, budgeted at $214.5 million for 1990, are expected to increase by $19.4 million, or 9.9 percent, over 1989. This service line now constitutes 15.1 percent of total System expenses, compared with 13.6 percent in 1985. The budgeted staff level is 2,258, an increase of 61, or 2.8 percent, over 1989.

The expense increase reflects the additional staff and increases in compensation, travel, training, and automation. Most Districts project an increase in the number and complexity of examinations in 1990. Also, the number of supervised institutions is increasing in some Districts. Examinations deferred during 1989 because of the reallocation of resources to assist other agencies with the savings and loan crisis will be rescheduled for 1990. Another factor contributing to the expense increase is the program on daylight overdraft pricing.

Expenses for Services to the U.S. Treasury and Other Government Agencies are budgeted at $158.6 million, an increase of $13.1 million. or 9.0 percent, from 1989, and represent approximately 11 percent of the Reserve Banks' total operating costs. Staffing levels are budgeted to increase by 119, or 6.7 percent. The major initiatives (as discussed earlier) driving the increases in both expenses and staff levels are the nationwide expansion of the Regional Delivery System, which consolidates issuance of over-the-counter savings bonds at one office within each District, and the nationwide expansion of changes in the requirements for processing food coupons.

By the end of 1993, the Regional Delivery System is scheduled to replace the existing network of issuing agents. Under the system, applications for savings bonds are accepted at various financial institutions and forwarded to the Federal Reserve, where the inscription data for the bond are entered into a computer data base, transmittals are balanced, accounting entries made, and the bonds are printed and mailed to the customers. During 1990 the program will expand to cover all or parts of eight Districts.

The changes in the processing of food coupons requested by the Food and Nutrition Service of the U.S. Department of Agriculture, requires Federal Reserve Banks to verify that the value of redemption certificates and the value of food coupons match in each deposit. Financial institutions are also required to encode the redemption certificates to allow their processing on check equipment and the transmittal of the data to the Minneapolis data center of the Food and Nutrition Service via FRCS-80, the Federal Reserve's data communications system. These procedures were successfully tested in the Dallas and Memphis territories for the six months ending March 1989.

Expenses in 1990 for the conduct of Monetary and Economic Policy at the Federal Reserve Banks total $98.9 million and account for 7.0 percent of their budgets. The increase of $5.3 million, or 5.7 percent, from 1989 expenses reflects staff increases, salary administration actions, and additional equipment and data processing costs associated with automation initiatives. Employment at 786 is an increase of 3 over 1989. The 1989 employment is below the approved budget for 1989 because of the Banks' inability to fill all positions authorized. The number of authorized positions is the same for both 1989 and 1990.

A brief review of Reserve Bank expenses on an object of expense basis also might be useful to the Subcommittee.

Operating expenses for personnel comprise officer and employee salaries, other compensation to personnel, and retirement and other benefits. Total personnel costs account for 63.8 percent of Reserve Bank expenses and are expected to increase by 6.3 percent in 1990 (Table 10).

Salaries and other personnel expenses account for nearly 52 percent of 1990 budgeted expenses and are expected to be $36.5 million, or 5.2 percent, above 1989 expenses. Salaries are budgeted to increase $41.3 million, or 6.1 percent, and will be partially offset by a decline in other personnel expenses of $4.8 million, or 32.2 percent. The decrease in other personnel expenses results from a declining use of personnel agencies. Merit pay increases of $34.7 million, or 5.0 percent, are the primary reasons for salary expense growth. Also contributing to additional salary expenses are promotions, reclassifications, structure adjustments, and staffing level increases. These increases are partially offset by short-term position vacancies and reduced overtime.

Expenses for retirement and other benefits, which account for 11.8 percent of Reserve Bank budgets, are anticipated to increase by $17.0 million, or 11.3 percent, in 1990. This increase is the result of continued escalation in hospital and medical costs and a rise in the social security tax.

Non-personnel expenses account for 36.2 percent of Reserve Bank expenses and are projected to increase by 3.0 percent in 1990. Equipment expenses are expected to increase by 9.2 percent and to account for 12.2 percent of total costs in 1990. Most of the increase is for depreciation, resulting from acquisitions to expand data processing and data communications capability to handle increased workloads, and the full-year effect of equipment purchased in 1989.

Shipping costs (primarily for checks) account for 6.0 percent of the 1990 budget and are projected to increase by 2.8 percent in 1990. The increase is primarily the result of rate increases by contract carriers and carriers supporting the Interdistrict Transportation System. Partially offsetting the 1990 increase is the reduction in postage expense due to a lower projected volume in the fiscal area.

Building expenses, which account for 9.2 percent of total expenses, are expected to increase by 8.8 percent in 1990. The newly renovated Chicago office, an Atlanta addition and renovation, and the full-year effects of the new Charlotte Branch contribute to higher costs for property depreciation and utilities. These projects along with a Dallas building project, are expected to increase real estate taxes by $5.5 million, or 23.6 percent. The $1.2 million decline in other building expenses is the result of the completion of renovations at the New York Bank.

Recoveries are expected to increase by $2.9 million, or 8.4 percent, in 1990, primarily because of new leases with outside organizations in the New York and Chicago offices.

Table 11 depicts the plans of the Reserve Banks for capital spending in 1989. By their nature, capital outlays vary greatly from year to year. Outlays for buildings and for data processing and communications equipment continue to dominate Reserve Bank capital budgets.

Special Budget Emphasis

I would like to mention briefly several initiatives intended to provide long-range benefits to the Federal Reserve, the banking industry, and the public at large. Because spending on such projects is relatively high and short-term, the Federal Reserve accounts for it separately from its operating expenses but includes it in its total budget. The budget for "Special Projects" in 1990 is $6.7 million, or $.8 million less than expenses in 1989. About 35 percent of the $6.7 million will be recovered through prices.

A major inefficiency of the present check system is that settlement depends on presentment of physical checks. The process could be made more efficient by a transition to collection based on transmission of an electronic image. We expect, that in the future, checks will undergo a transition from paper delivery to electronic delivery. In mid-1985 the System began testing of digital image technologies to produce high quality images of check documents in a sustained high-speed check processing environment. The primary applications chosen for the testing were truncation of government checks and the processing of return items. Both these check processes provide rigorous tests for image technology in that they require the storage of large amounts of data and require a high level of quality in the retrieved image. Total 1990 expenses associated with this project are estimated to be $1.6 million.

In 1990, the project will complete the testing of a prototype system integrated with existing high-speed check processors at two Federal Reserve Bank sites. Given the positive results to date, the project will continue to focus on government checks and return items. A request for proposal will be issued in late 1990 for a pilot test involving government check processing.

In 1988, the Federal Reserve initiated a special project for the development of an optical counterfeit-detection system (OCDS). During 1989 and continuing in 1990 the project will be expanded to include other means of authentication. The 1990 special project budget includes $3.2 million in support of these developmental efforts.

In 1990, the Federal Reserve will request proposals from vendors to share the costs of continued development and testing of a prototype OCDS. This and several other efforts, both long-term and short-term, are designed to produce counterfeit detection devices to be placed on the Federal Reserve's high-speed currency processing equipment.

A study by the Federal Reserve has indicated that the System will need to extend the number of hours and improve the reliability of electronic payments services to better control risk in the payments system. The study also indicated that users of electronic payments will need more flexibility in the range of services offered as well as cost-effectiveness.

The Federal Reserve is evaluating the use of nonstop, fault-tolerant equipment, known as the Electronic Payments Processor (EPP), for processing electronic payments including funds and securities transfers and ACH transactions. This approach is of the type frequently used by commercial banks for transaction processing. The Federal Reserve should complete its evaluation of this approach by September 1990 at a 1990 cost of $1.9 million.

The Federal Reserve knows that a rigorous budget process is only one part of financial management. We are equally concerned about other areas of financial integrity.

The structure of the Federal Reserve System provides for appropriate segregation of responsibilities; a reasonable accounting control over assets, liabilities, revenues and expenses; and an organizational structure that establishes responsibilities for audit and oversight of the objectives and goals of the Federal Reserve System.

It is the policy of the Federal Reserve that the Board and each Reserve Bank maintain a system of internal controls which is designed to ensure that objectives of each are achieved and that they each operate in compliance with all prescribed rules, regulations, and policies. The management of each is responsible for maintaining adequate internal financial, custody, and data security controls over all aspects of their respective operations.

To ensure that these controls are operating in an effective manner at the Federal Reserve Banks, the following procedures have been set in place: (1) an internal audit function at each Reserve Bank is responsible for assessing practices and procedures for soundness and conformity with regulations in accordance with professional auditing standards; (2) the Board of Governors' examiners conduct financial, operational, and procedural reviews at each of the Banks; (3) a CPA firm reviews the procedures and practices of the Board's examination program; and (4) the Board specialists review the effectiveness of each Reserve Bank's internal audit function. We believe that these measures, although not fail-safe, offer excellent protection against financial impropriety.

We thank you for this opportunity to address the Subcommittee on the Federal Reserve System budget. The existing budget processes are working well in controlling costs, while at the same time encouraging quality improvements. We welcome your comments and would be pleased to address any questions you may have on our budget.

Table 1

Operating Expenses of the Federal Reserve System, Net of Receipts 1988-90
Millions of dollars, except as noted

Item	1988	1989	1990 Budget	Change 1988-89 Amount	%	Change 1989-90 Amount	%
Total System operating expenses	1,353	1,446	1,519 1/	93.0	6.9	73.0	5.0
Less:							
Revenue from priced services	667	719	757	52.0	7.8	38.0	5.3
Other income	16	19	18	3.0	18.8	-1.0	-5.3
Reimbursements	116	127	123	11.0	9.5	-4.0	-3.1
EQUALS							
Net System operating expense	554	581	621	27.0	4.9	40.0	6.9

1/ Includes a reduction of $4.4 million consistent with Gramm-Rudman-Hollings cuts in the Federal government.

Table 2

Federal Reserve System Expense and Employment, 1978-90 Budget[1]
Millions of dollars

	Expenses		Personnel	
	Amount	Percent Change	Amount	Percent Change
1979	747	6.2	24,551	(1.6)
1980	852	14.1	25,198	2.6
1981	948	11.3	25,480	1.1
1982	1,041	9.8	24,755	(2.8)
1983	1,100	5.7	24,466	(1.2)
1984	1,145	4.0	24,257	(0.9)
1985	1,199	4.8	24,609	1.5
1986	1,245	3.8	24,721	0.5
1987	1,278	2.7	24,483	(1.0)
1988	1,353	5.9	24,832	1.4
1989	1,446	6.9	25,157	1.3
Growth Rate 1979-89		6.8		0.2
1990 Budget	1,519	5.0	25,383	0.9

1/ Includes expenses and personnel of both the Reserve Banks and the Board of Governors. Budgeted expenses for 1990 exclude $4.4 million for Gramm-Rudman-Hollings.

Table 3

Federal Reserve Bank Employment by Service Line

Year	Monetary and Economic Policy	Services to the U.S. Treasury and Gov't Agencies	Services to Financial Institutions	Supervision and Regulation	Support	Overhead	Total	Percent Change
1979	597	1,883	9,790	1,411	4,055	5,367	23,104	
1980	618	1,946	9,614	1,589	4,238	5,680	23,682	2.5%
1981	717	1,881	9,480	1,733	4,434	5,745	23,989	1.3%
1982	743	1,851	8,566	1,796	4,599	5,676	23,230	-3.2%
1983	804	1,838	8,424	1,862	4,367	5,589	22,883	-1.5%
1984	826	1,798	8,395	1,885	4,340	5,424	22,669	-0.9%
1985	816	1,781	8,754	1,912	4,398	5,323	22,984	1.4%
1986	791	1,819	8,799	2,087	4,469	5,274	23,239	1.1%
1987	775	1,836	8,775	2,147	4,452	5,024	23,010	-1.0%
1988	766	1,818	9,032	2,208	4,562	4,951	23,337	1.4%
1989	782	1,771	9,422	2,197	4,551	4,947	23,670	1.4%
1990 Budget	786	1,890	9,335	2,258	4,636	4,985	23,890	0.9%
Long Term Growth Rate 1979-89	2.7%	-0.6	-0.4%	4.5%	1.2%	-0.8%	0.2%	
Recent Year 1988-89	2.2%	-2.6%	4.3%	-0.5%	-0.2%	-0.1%	1.4%	
Budget Year 1989-90	0.4%	6.7%	-0.9%	2.8%	1.9%	0.8%	0.9%	

Table 4

BOARD OPERATING EXPENSES
BY OPERATIONAL AREA
($000s)

Functional Area	1988 Actual	1989 Actual	1990 Budget	Change 1988-89 Amount	%	Change 1989-90 Amount	%
Monetary & Economic Policy	$47,620	$50,200	$53,640	2,580	5.4%	3,440	6.9%
Supervision & Regulation	$21,743	$23,532	$26,845	1,789	8.2%	3,313	14.1%
Services to Financial Institutions & the Public	$2,574	$2,462	$2,712	(112)	-4.4%	250	10.2%
System Policy Direction & Oversight	$17,988	$19,099	$19,668	1,111	6.2%	569	3.0%
TOTAL	$89,925	$95,293	$102,865	$5,368	6.0%	$7,572	7.9%
Inspector General	$580	$718	$1,737	138	23.8%	1,019	141.9%

NOTE: Includes allocation for support & overhead costs.

Table 5

BOARD OPERATING BUDGET
BY OBJECT OF EXPENSE

Object of Expense	1989 Actual Expense	1990 Operating Plan 1/	1990 Operating Plan vs 1989 Actual Expenses Amount	Percent
Salaries	$61,282,747	$69,109,031	$7,826,284	12.8%
Retirement	3,895,063	4,123,521	$228,458	5.9%
Insurance	4,412,059	4,969,566	$557,507	12.6%
Pers. Costs Subtotal	$69,589,869	$78,202,118	$8,612,249	12.4%
Travel	$3,328,569	$3,341,922	$13,353	0.4%
Postage	1,070,114	1,149,263	$79,149	7.4%
Telephone & Telegraph	1,543,082	1,680,526	$137,444	8.9%
Software	2,505,712	2,221,723	($283,989)	-11.3%
Utilities	1,570,807	1,515,000	($55,807)	-3.6%
Cont. Prof. Svcs.	3,353,702	2,645,588	($708,114)	-21.1%
Printing & Binding	746,364	708,574	($37,790)	-5.1%
Repairs, Maint., & Altns	2,753,869	3,145,114	$391,245	14.2%
Depreciation/Disp of Asset	7,326,104	5,840,413	($1,485,691)	-20.3%
All Other	1,504,972	2,936,560	$1,431,588	95.1%
Goods & Srvs Subtotal	$25,703,295	$25,184,683	($518,612)	-2.0%
Savings Target	0	(521,622)	($521,622)	-
BOARD OPERATING BUDGET	$95,293,166	$102,865,179	$7,572,013	7.9%
Inspector General Costs	$718,224	$1,737,299	$1,019,075	141.9%

1/ Adjusted to reflect GRH reductions.

Table 6

BOARD AUTHORIZED POSITIONS
BY OPERATIONAL AREA

Functional Area	1988 Actual	1989 Actual	1990 Budget	Change 1988-89 Amount	%	Change 1989-90 Amount	%
Monetary & Economic Policy	397	398	398	1	0.3%	0	0.0%
Supervision & Regulation	264	264	277	0	0.0%	13	4.9%
Services to Financial Institutions & the Public	22	20	20	(2)	-9.1%	0	0.0%
System Policy Direction & Oversight	148	152	151	4	2.7%	(1)	-0.7%
Overhead & Support	734	722	709	(12)	-1.6%	(13)	-1.8%
TOTAL	1565	1556	1555	(9)	-0.6%	(1)	-0.1%
Inspector General	8	9	15	1	12.5%	6	66.7%

NOTE: Does not allocate support & overhead positions to functional service lines.

Operating Expenses Budgeted
for Major Initiatives of the Federal
Reserve Banks in 1990 1/

Area of initiative	Millions of dollars	Percent of 1990 operating budget
Facilities......................	4.9	.4
Fiscal activities..............	5.7	.4
Contingency Back-up............	4.1	.3
Automation.....................	8.4	.6
Supervision and regulation......	1.5	.1
Check operations................	4.3	.3
Currency processing............	1.7	.1
Total..........................	30.6	2.2
MEMO		
Increase in total operating expenses, 1989 to 1990 budget.............	68.5	5.1

1/ Does not reflect a reduction of $4.1 million for Gramm-Rudman-Hollings which was applied to the overall target after the 1990 Budget was approved.

Table 8

Operating Expense of the Federal Reserve Banks, by Operational Area 1988-90
Millions of dollars, except as noted

Service Line 1/	1988	1989	1990 2/ Budget	Change 1988-89 Amount	%	Change 1989-90 Amount	%
Monetary and Economic Policy.................	87.1	93.6	98.9	6.3	7.2	5.3	5.7
Supervision and Regulation............	185.1	195.1	214.5	10.0	5.4	19.4	9.9
Service to Financial Institutions and the Public............	848.5	916.3	947.0	67.8	8.0	30.7	3.3
Services to the U.S. Treasury and Other Government Agencies....	141.5	145.5	158.6	4.0	2.8	13.1	9.0
TOTAL	1,262.4	1,350.5	1,419.0	88.1	7.0	68.5	5.1

1/ Includes the cost of support and overhead services.
2/ Does not reflect a reduction of $4.1 million for Gramm-Rudman-Hollings which was applied to the overall target after the 1990 Budget was approved.

Table 9

Employment at the Federal Reserve Banks, by Activity, 1988-90
Average number of personnel, except as noted

Service Line	1988	1989	1990 Budget	Change 1988-89 Amount	%	Change 1989-90 Amount	%
Monetary and Economic Policy.................	766	782	786	17	2.2	3	0.4
Supervision and Regulation............	2,208	2,197	2,258	-11	-0.5	61	2.8
Service to Financial Institutions and the Public............	9,032	9,422	9,335	391	4.3	-87	-0.9
Services to the U.S. Treasury and Other Government Agencies....	1,818	1,771	1,890	-47	-2.6	119	6.7
Support and overhead:							
Support..................	4,562	4,551	4,636	-10	-0.2	84	1.9
Overhead.................	4,951	4,947	4,985	-5	-0.1	38	0.8
TOTAL	23,337	23,670	23,890	334	1.4	219	0.9

Table 10

Operating Expenses of the Federal Reserve Banks, by Object, 1988-90
Millions of dollars, except as noted

Object	1988	1989	1990 1/ Budget	Change 1988-89 Amount	Change 1988-89 %	Change 1989-90 Amount	Change 1989-90 %
Personnel							
Officers' salaries	64.0	68.1	72.6	4.1	6.4%	4.5	6.6%
Employees' salaries	581.9	618.1	654.9	36.2	6.2%	36.8	6.0%
Other personnel	15.3	14.9	10.1	-0.4	-2.6%	-4.8	-32.2%
Retirement and benefits	133.2	150.2	167.2	17.0	12.8%	17.0	11.3%
Total Personnel	794.5	851.3	904.8	56.8	7.1%	53.5	6.3%
Nonpersonnel							
Forms and supplies	51.0	54.4	54.8	3.4	6.7%	0.4	0.7%
Equipment	153.8	158.1	172.6	4.3	2.8%	14.5	9.2%
Software	--	--	28.8	--	--	28.8	--
Shipping	82.0	82.2	84.5	0.2	0.2%	2.3	2.8%
Travel	25.3	27.2	28.2	1.9	7.5%	1	3.7%
Buildings:							
Insurance	0.8	0.7	0.7	-0.1	-12.5%	0	0.0%
Taxes on real estate	24.0	23.3	28.8	-0.7	-2.9%	5.5	23.6%
Depreciation	28.4	30.7	35.0	2.3	8.1%	4.3	14.0%
Utilities	23.0	24.8	26.1	1.8	7.8%	1.3	5.2%
Rent	21.7	21.2	22.1	-0.5	-2.3%	0.9	4.2%
Other building	18.1	19.7	18.5	1.6	8.8%	-1.2	-6.1%
Total building	115.9	120.5	131.1	4.6	4.0%	10.6	8.8%
All Other	74.2	91.4	51.5	17.2	23.2%	-39.9	-43.7%
Recoveries	(34.3)	(34.6)	(37.5)	-0.3	0.9%	-2.9	8.4%
Total Nonpersonnel	467.9	499.2	514.1	31.3	6.7%	14.9	3.0%
Total	1,262.4	1,350.5	1,419.0	88.1	7.0%	68.5	5.1%

1/ Does not reflect a reduction of $4.1 million for Gramm-Rudman-Hollings which was applied to the overall target after the 1990 Budget was approved.

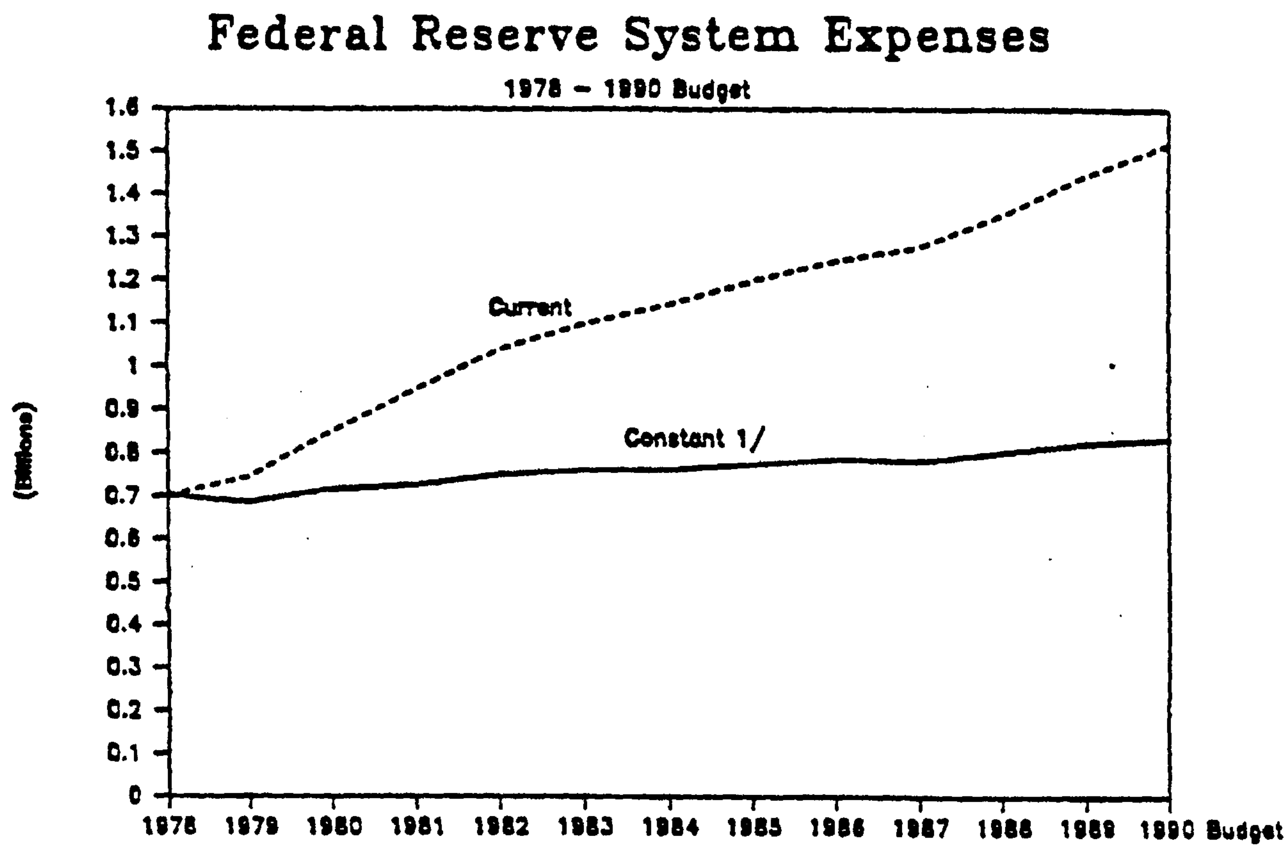
2/ Software was made a separate item in 1990; previously costs were included in all other ($24.0 million in 1988 and $29.0 million in 1989).

Table 11

Capital Outlays of the Federal Reserve Banks, by Class of Outlay, 1988-90
Millions of dollars, except as noted

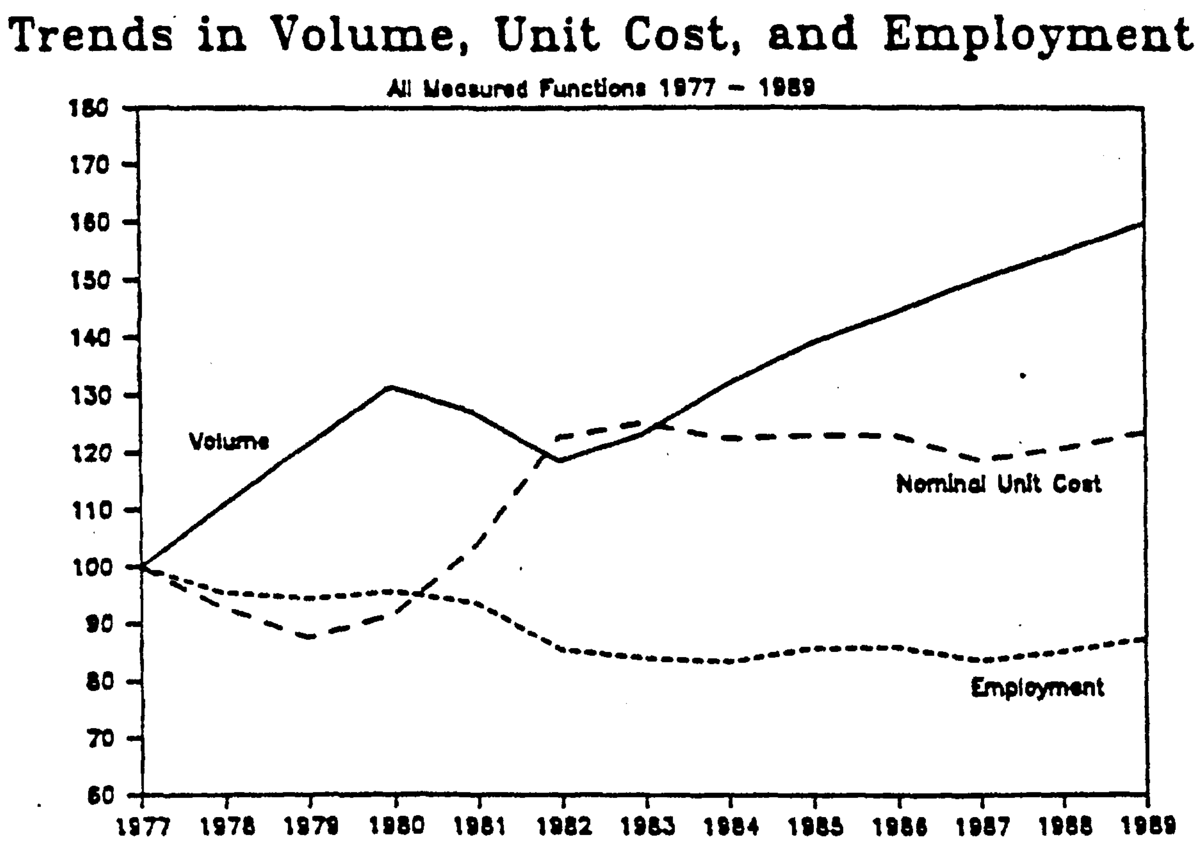
Capital class	1988	1989	1990 Budget	Change 1988-89 Amount	Change 1988-89 %	Change 1989-90 Amount	Change 1989-90 %
Data processing and data communications equipment	78.0	62.2	133.2	15.8	-20.3	71.0	114.1
Furniture and other equipment	23.7	25.6	40.9	1.9	8.0	15.3	59.8
Land and other real estate	.4	25.3	5.1	24.9	...	-20.2	-79.8
Buildings	55.2	36.6	80.4	-18.6	-33.7	43.8	119.7
Building machinery and equipment	7.6	8.5	14.2	.9	11.8	5.7	67.1
Leasehold improvements	2.3	1.7	1.2	-.6	-26.1	-.5	-29.4
Total	167.1	159.8	274.9	-7.3	-4.4	115.1	72.0

Chart 1



1/ Deflated by GNP Deflator (1978 = 100)

Chart 2


Trends in Volume, Unit Cost, and Employment
All Measured Functions 1977 – 1989
180
170
160
150
140
130
120
110
100
90
80
70
60
Volume
Nominal Unit Cost
Employment
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989