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Statement of

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and

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Members, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

of the

U.S. House of Representative

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It is a pleasure for Governor Kelley and me to visit with this Subcommittee today to discuss and review the Federal Reserve System's expenses and budget. Today, as we look at the Federal Reserve System's budget for 1992, 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, Annual Report: Budget Review, 1991-92, presenting detailed information about spending plans for 1992. The attached tables have been updated for 1991 actual experience and, therefore, some variations exist from data in that document.

The actual increase in Federal Reserve System expenses from 1986 to 1991 has been 5.2 percent. This increase is not a cost increase for a constant basket of services but reflects our response to Supervision and Regulation initiatives, Expedited Funds Availability (EFA) legislation requirements, contingency planning initiatives, and several major initiatives for the U.S. Treasury.

For 1992, the Federal Reserve System has budgeted operating expenses of \$1.7 billion, an increase of 6.9 percent over the 1991 budget and 7.4 percent above 1991 actual expenses. From 1990 to 1991 expenses were up 6.3 percent, reflecting a 0.5 percent underspending of the 1991 budget. Before getting to the details of our 1992 plans, I would remind the Subcommittee of two aspects of Federal Reserve System operations that affect our budget in unusual ways. First, 45 percent of System expenses (\$786 million) was recovered through priced service revenues. All increases in priced services costs result in increased earnings returned to the U.S. Treasury. Second, 9 percent of our expenses (\$158 million) is for fiscal agency operations provided to the Treasury Department and other agencies on a reimbursable basis. About 40 percent of total reimbursable expenses was actually reimbursed in 1991. Altogether, about 55 percent of our total expenses is either recovered through pricing or are reimbursable (see Table 1, page 32). On a net basis the cost to the public of the Federal Reserve System's operations is \$776 million of the total \$1.7 billion budgeted for 1992 (see Table 1, page 32). In addition to priced service revenues the System has very large earnings on the System's portfolio of assets which are derived directly from required bank reserves, currency issuance activities, and foreign exchange activities which enabled the Federal Reserve Banks to pay \$21 billion to the Treasury in 1991.

Historical Overview

It might be helpful to put the budget for 1992 in perspective by sketching the most recent 10-year history of System expenses. Between 1981 and 1991, Federal Reserve System expenses increased at an average annual rate of 5.4 percent (see Table 2 and Chart 1, pages 33 and 39); System employment decreased at an average annual rate of 0.1 percent (see Table 2, page 33); and volume in measured operations increased by 30 percent over the 10-year period (see Chart 2, page 40). Unit cost did increase in some services in the early eighties as Federal Reserve Bank volumes fell following the implementation of pricing under the Monetary Control Act. However, after the transition to pricing was completed in 1983, the composite unit cost for all functions has increased only by 0.3 percent on an annual basis, 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 payment areas. Automated Clearinghouse (ACH) unit cost has decreased by 7.7 percent per year (1981-91) and Funds Transfer unit cost has decreased by 1.4 percent per year during this same time period; since 1986, the decreases per year have been 11.4 percent for ACH, and 1.9 percent for Funds. Volume growth has averaged almost 8 percent per year for Funds Transfer and 23 percent per year for

ACH transactions (1981-91). In our large check processing operation, 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 average increase in unit cost of 1.9 percent per year since 1983. It should also be pointed out that many of these initiatives have resulted in reducing Federal Reserve float. Since 1983 Federal Reserve float has been reduced from a daily average of \$1.5 billion to a daily average of \$348 million in 1991.

For our nonpriced cash operations--involving the distribution of currency and coin--unit costs have also been declining. Since 1983 the decline has averaged about 1.2 percent per year with volumes increasing 4.4 percent per year. However, in our fiscal agency operations, also nonpriced, there has been an increase in unit costs of 4.8 percent per year since 1983, reflecting new operations and services for the Treasury. In this 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 and to improve the quality of service to the public. Through 1991 the Federal Reserve has added 468 staff and spent a cumulative \$96 million on these Treasury initiatives.

It is difficult to measure productivity improvements in the Supervision and Regulation area, and these activities have

required significant increases in resources over the last 10 years. We do not have good data regarding the benefit to the banking system and the insurance fund regarding the efficiency of additional Supervision and Regulation expenditures. Between 1981 and 1991 staff for Supervision and Regulation increased by 610 and annual expenditures increased by \$137.5 million. 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 Reserve Banks have had to deal with greatly increasing workloads in the last several years 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 1992, 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.

* * * * *

Introduction

The 1992 budget of the Board of Governors comprises three parts: a Board operations budget of \$123.6 million, an extraordinary items budget of \$3.2 million for special projects of a unique or one-time nature, and an Office of Inspector General budget of \$2.0 million. The operations budget of \$123.6 million is 12.5 percent greater than 1991 expenses. Increases in salaries and benefits for current personnel and in the price of goods and services, account for 51 percent of the rise. Initiatives to increase staffing and improve automation, largely in the supervision and regulation and monetary and economic policy operational areas, account for the remaining 49 percent.

The Board authorized 1,608 positions for the operational areas and 21 for the Office of Inspector General; no positions were required for the extraordinary items budget. The budget added a total of thirty-nine positions for the operational areas; of this total, twenty-five were for the supervision and regulation function. Coupled with positions added during 1991 and fewer vacancies, the new positions will enhance the Board's ability to manage a growing workload in international supervision, enforcement, and litigation. The remaining fourteen positions were added for the monetary and economic policy function to strengthen and expand long-term research, to help in a nationwide effort to improve the quality of government economic

statistics, and to enhance analytical capabilities through additional automation.

The budget did not fund any requirements that might result from a proposed special investigative unit, pending further review of the requirements and estimates of necessary resources.

Operations Budget by Operational Area

Monetary and Economic Policy

The budget for the monetary and economic policy area is \$59.5 million which is \$4.5 million or 8.2 percent more than 1991 expenses. The budget provided an increased level of funding for the divisions that support this function to meet an increasing workload, expand long-term research, and improve the quality of economic data. Automation initiatives, including continuation of the phased development of the research computing system, were key elements of the divisions' plans to manage the workload. Because productivity improvements alone were not sufficient to support these initiatives, fourteen new positions were added.

Investments in research automation have produced productivity gains that, combined with adjustments in priorities and reductions in long-term research, have limited expenses and

the degree of staff growth for the monetary policy function over the last five years. The greater 1992 personnel authorizations, in large measure driven by an effort to meet analytical requirements at the Board, also reflect increased requirements for support from the supervision and regulation operational area. Questions on such topics as the farm credit system, insurance companies, interest-rate risk, capital standards, and regulation of government-sponsored enterprises have added to the workload. Studies on banking legislation, deposit insurance, and consolidation in the banking industry are typical of areas requiring increased attention. The additional staff resources will slow continued growth in the volume of uncompensated staff overtime and will allow for a moderate increase in long-term research.

Supervision and Regulation

The budget for the supervision and regulation area is \$38.5 million; this amount is \$6.4 million, or 19.9 percent over 1991 expenses. As noted earlier, twenty-five positions were added which, in conjunction with positions added during 1991, cause the majority of the increase. The additional positions were required to meet continued growth in workload, particularly in international supervision, policy analysis, applications, and litigation and enforcement.

In addition to costs associated directly with new initiatives, the budget funded the Board's share of the automation costs for development of the National Information Center (NIC). The NIC is the sole source of consolidated banking structure and financial data for bank holding companies. When the entire NIC is established, complete with national structure, supervisory, and certain financial data for financial and other related institutions, it will be of major benefit to the supervision and regulation operational area. The 1992 funding was approved to continue the scheduled transition from existing software to software which can access the NIC database. The completed NIC will reduce Systemwide costs, improve data integrity, and lead to more timely and more meaningful analysis of applications, merger requests, and other actions.

Substantial resources were also approved for the rewrite of the programming which produces the Bank Holding Company Performance Report (BHCPR), an analytical tool used by all Reserve Banks and Board staff. This report is utilized for determining the financial condition of Bank Holding Companies in connection with off-site analysis, on-site inspections and reviews of proposed mergers and acquisitions.

Finally, resources were approved for enhanced software to access the Home Mortgage Disclosure Act (HMDA) database to provide improved analysis of the data used in the examination,

applications, and research areas. On an annual basis, the HMDA Act requires lending institutions that have more than \$10 million in assets, and offices in Metropolitan Statistical Areas (MSA), to compile data regarding applications for origination and purchases of mortgage and home improvement loans. These data are then submitted to the supervisory agencies and processed by the FFIEC to produce a disclosure statement that the FFIEC must make available to the public.

Automation enhancements were approved to replace obsolete equipment with equipment capable of greater interaction with the NIC, BHCPR, HMDA, and other critical databases. The upgraded equipment improves the staff's ability to meet tight deadlines with high-quality analyses and finished products.

Services to Financial Institutions and the Public

Services to financial institutions and the public, which includes the payments function, has a budget of \$3.3 million, an increase of \$0.5 million, or 15.8 percent over 1991 expenses. The increase was necessary to fund both improvement of cash tracking for the System and a lower level of staff vacancies.

System Policy Direction and Oversight

The budget for System policy direction and oversight is \$22.2 million, a \$2.4 million or 12.0 percent increase over 1991 expenses.

The increase in this budget was tied to a lower level of vacancies, a new position, and the development of mainframe software to provide improved financial information. This budget also funded continued upgrading of office automation systems and the expansion of network facilities.

Operations Budget by Object of Expense

The most significant expense item in the Board's budget is for personnel, which accounts for about 75 percent of operating expenses. The 1992 increase in the salary budget, \$6.4 million or 8.7 percent, includes not only annual salary increases for current personnel (4.9 percentage points) but also salaries for new positions (3.8 percentage points), both those added in late 1991 and the thirty-nine positions added for 1992. A lower vacancy rate also contributed to the increase.

Retirement costs for 1992 are \$0.8 million, or 16.3 percent greater than 1991 expenses, primarily because of increases in the Board's matching contribution to the thrift plan

and in the wage base subject to social security and medicare taxes.

Insurance costs are \$0.3 million, or 4.8 percent greater than 1991 expenses. The rate increase for the health insurance plans, combined with a higher level of staffing for new positions and fewer vacancies, produced \$0.5 million of increase. Partially offsetting these increases was a \$0.2 million decrease in workers compensation, reflecting a large one-time payout in 1991.

The cost of goods and services accounted for 25 percent of the budget. To keep permanent staff increases to a minimum, the budget funded increased use of contractual professional services to provide software development support for important projects as well as expert advice for data improvement and examiner training initiatives. The travel budget increased due to higher airfares, a greater volume of travel to resolve supervisory issues, and relocation costs for new staff. Software expenses are higher as a result of rate increases for mainframe software and the changing technological needs of the Board.

Capital Budget

The capital budget for 1992 is \$5.0 million, or \$54,600 greater than 1991 expenditures. The budget provided for

requirements in the areas of automation and telecommunications and improvements to facilities.

Continued investment by all the Board's divisions in workstation, network, and office automation systems amounted to \$3.3 million. The budget includes funds for a premise-wide network, a document management system, and a network for the administrative systems using off-the-shelf software.

Facilities improvements include a multiyear effort to repair concrete slabs in the parking garage and a new air handler, to improve heating, ventilation, and air conditioning in the data center. Capital funds will also be required for the reconfiguration of office space.

Trends

The increase in the 1992 operations budget of the Board over 1991 expenses, 12.5 percent, was significantly greater than the 7.8 percent average annual rate of increase for the last five years and the 7.1 percent increase for the last ten years. The larger increase reflects the surge in workload that has exceeded the ability of managers to absorb through improved productivity.

The average annual increase in Board costs since 1982 has been 6.3 percent. Although this figure is low relative to

the substantial growth in workload, the annual rate of increase has been rising. For example, in the ten years ending in 1990 the average annual increase was 6.0 percent. The recent rise is attributable to a higher level of staffing, adjustments of salaries resulting from a revised employee compensation program, and sharp increases in benefit costs, particularly for health insurance. The salary and benefit changes have had a particularly noticeable impact, as 75 percent of the Board's budget is for staffing. For the first time since 1988, the goods and services budget increased at a faster pace than the personnel budget. The shift is a result of depreciation expenses on a larger stock of capitalized automation equipment, costs of maintaining the Board's facilities and providing additional office space, and a decision to satisfy software requirements through temporary contractual arrangements rather than hiring additional permanent staff. The latter decision was made in recognition of the temporary nature of the increased requirement for software development for major projects such as the NIC and HMDA.

Personnel costs have been affected by the increase in the total number of positions and the decline in the number of position vacancies. The 1992 increase in positions, to a total of 1,608, returns the Board to the same number as in 1985. In recent years, increases in the supervision and regulation operational area were offset by decreases elsewhere. Between

1985 and 1991, the number of positions directly supporting the supervision and regulation function increased from 242 to 293 while the overall number of positions at the Board declined. The 1992 budget provided an additional 25 positions in this area to a new total of 318.

The combined effects of the revised employee compensation program and the slowdown in the economy have resulted in a reduced rate of staff turnover and a lower level of vacancies. Turnover in 1991 was the lowest in many years, and a low rate was projected in the 1992 budget. This is proving extremely important to the Board in meeting key requirements without further increases in the number of positions.

The 1992 rate increase for the Board's health insurance plan, 6.3 percent, is significantly below the 22 percent average annual rate of increase in the previous five years. The lower rate of increase reflects some reductions in the plan's benefits, necessary in light of the large and continuing increases that were projected to continue indefinitely without management action.

Extraordinary Items

Three projects are covered by the extraordinary items budget. The first was the 1992 Survey of Consumer Finances,

which will collect important financial data used for a wide variety of policy analysis and monetary policy purposes. The project reflects the Board's interest in enhancing the quality of economic data by obtaining information on income, assets, debts, pensions, employment, use of financial services, savings behavior, and other characteristics of U.S. households. Cross-categorization of the data will allow important statistical observations useful in a wide variety of economic studies.

The second project is an audit of the Federal Reserve Bank of Kansas City by a public accounting firm, which was originally scheduled to be performed in 1991. Because more lead time was needed for procurement, the project was rescheduled for 1992. The Financial Examinations Program in the Division of Reserve Bank Operations and Payment Systems will audit the other Reserve Banks as usual. The objective of the outside audit is to provide assurance that internal audits at the Reserve Banks achieve desired controls and standards consistent with those applied by the accounting profession.

The third project covered by the extraordinary items budget was a study by an outside consultant to ensure the security of the transfer of funds and securities via Fedwire. The study will focus on additional security enhancements that should be incorporated into the Federal Reserve System

information security architecture to ensure the reliability and security of the Fedwire system.

Office of Inspector General

The 1992 Office of Inspector General (OIG) budget of \$2.0 million was \$0.4 million, or 28.0 percent higher than 1991 expenses. The increase was due largely to the addition of two new audit manager positions and related expenses. The office's goods and services expenses decreased slightly, primarily because of a one-time software purchase in 1991 and reduced use of external legal services.

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

Reserve Bank Budgets

The Reserve Bank 1992 expense increase--both priced and nonpriced--was budgeted at 6.4 percent above the 1991 budget as compared to the actual increase in expenses between 1990 and 1991 of 6.2 percent. Eight major initiatives account for almost a third of the budgeted increase in Reserve Bank expenses (see Table 4, page 35).

The initiative with the largest expense impact is Facility improvements, which will add \$18.7 million to operating expenses in 1992, 1.2 percent of the operating budget. Expenses associated with two building projects account for nearly all of the increase: New York's East Rutherford Operations Center (EROC) (\$9.2 million) and Dallas' new building (\$7.9 million).

Initiatives in Supervision and Regulation are expected to increase expenses by \$8.5 million and employment by 108. A majority of the Reserve Banks see a need for additional staff due to increased workloads, increased examination of foreign banks, and more problem institutions. Additional pressures result from the passage of the FDIC Improvement Act. Travel and automation costs add to the salary expense burden for the additional staff.

Nine Banks collectively have budgeted \$2.8 million to improve the efficiency of check collection systems. Most of these projects are continuing efforts and are contributing to a reduction in check-staff levels.

Expenses for Fiscal initiatives, which are reimbursable, are expected to add \$2.4 million. Most of this increase is for the final phase of the Regional Delivery System (RDS), which involves centralized issuance of over-the-counter savings bonds. Another Savings Bond initiative known as Masterfile, which provides for centralized processing of payroll

deductions, will also add expenses. These projects are being implemented at the request of the Treasury Department in order to bring operating efficiencies to the Savings Bond program.

Reserve Bank operations in today's environment require more reliable and secure computer systems, more office automation, and more communication networks. These needs are met partly through the initiative for Automation and Contingency Projects (\$2.0 Million).

The remaining initiatives included \$4.6 million for the last year of the plan to increase the employer's share of the matching contribution to the thrift plan: in 1992 the employer's share will increase from 70 cents to 80 cents on the dollar up to 6 percent of salary. An additional \$1.0 million is budgeted for currency processing equipment and personnel to handle currency volume growth on the west coast.

Partially offsetting the above increases are initiatives that will result in savings of \$3.4 million. These savings are being achieved by increased productivity and consolidation of certain operations in four Districts.

In addition to these major initiatives, it may be helpful to look at 1992 budgeted expenses on the basis of our four service lines (see Table 5, page 36).

Expenses for Services to Financial Institutions and the Public, which include all of the priced and some of the nonpriced services, are budgeted at \$1,042.1 million and account for two-thirds of total expenses. These expenses are increasing by \$61.7 million, or 6.3 percent over 1991. Staffing for Service to Financial Institutions and the Public is budgeted at 8,974, a decrease of 70 or 0.8 percent. Expenses of priced services (all of which are within this Service Line) are budgeted at \$672.3 million, an increase of 4.0 percent; these services, incidentally, are expected to generate revenues of about \$786 million. Non priced services within this Service Line are budgeted at \$369.8 million, an increase of 7.5 percent.

Commercial Check Processing is by far the largest component in the Financial Institutions and the Public service line (\$504.9 million); it accounts for 48.5 percent of these expenses and employs 5,480 people. The anticipated increase in expenses is \$22.2 million or 4.6 percent, while employment is expected to decline by 60 or 1.1 percent. The staff reduction results from continued automation in adjustments, conversion to optical disk storage systems, and improvements in return item processing. Commercial check volume is budgeted to decrease 0.2 percent, while unit costs are budgeted to increase 4.2 percent. Continuing efforts to increase automation in the commercial check service should continue to lower unit costs in the future.

Our other large operations in the Financial Institutions and the Public service line are Currency (\$157.2 million and 1,524 people), Automated Clearinghouse (\$89.5 million and 361 people), and Funds Transfer (\$75.7 million and 158 people). Currency expenses are expected to increase by 10.8 percent over 1991 due to rising volumes and implementation of new high speed equipment. In Automated Clearinghouse a 10.9 percent increase in expenses reflects an anticipated volume increase of 15.9 percent. Funds Transfer is expecting stable growth and a decrease of 2 ANP; expenses will be up 8.8 percent primarily due to increased data processing costs.

Expenses for Supervision and Regulation, budgeted at \$261.2 million for 1992, are expected to increase by \$23.9 million, or 10.1 percent over 1991. The Supervision and Regulation service line has been the fastest growing of the service lines and now constitutes 16.4 percent of total System expenses, compared with 14.3 percent in 1987. The budgeted staff level is 2,477, an increase of 135 or 5.8 percent over 1991.

The expense increase for Supervision and Regulation is concentrated in the salary and benefit object for new and on-going staff as well as travel, training and automation (primarily laptop computers). Demands on the Federal Reserve Banks' Examination staffs include more examinations of broader scope, increased emphasis on Bank Secrecy Act issues, and the need to

monitor compliance with and pursue enhancements to international risk-based capital standards. Also, our examination staff must handle a large number of organizations that continue to require special attention in the form of extended examinations. The expense increase is also affected by initiatives for payment system risk and daylight overdraft pricing. In addition, the passage of the FDIC Improvement Act of 1991 will require additional resources in 1992 mainly for the examination of branches of foreign Banks operating in this country.

Expenses for Services to the U.S. Treasury and Other Government Agencies are budgeted at \$180.1 million, an increase of \$10.6 million or 6.2 percent over 1991. These expenses continue at about 11 percent of total expenses in 1992. Staffing levels are budgeted to increase by 32 or 1.7 percent. Operationally, the most significant development in this area is the continuing conversion of over-the-counter savings bonds to the Savings Bond Regional Delivery System, which is the main reason for the net staff increase. Savings bond volume is expected to increase by 9.0 percent and unit costs are budgeted to decrease by 0.4 percent.

Expenses in 1991 for the conduct of Monetary and Economic Policy at the Federal Reserve Banks total \$113.0 million and account for about 7 percent of the total budget. An increase of \$6.3 million and 5.9 percent is anticipated in 1992.

Employment, budgeted at 794, reflects an employment increase of 11 over actual 1991. In addition to providing for the staff additions, the expense increase represents salary administration actions and increased equipment and data-processing costs associated with automation initiatives.

Reserve Bank expenses on an object of expense basis also might be useful to the Subcommittee and are shown in Table 7.

Operating expenses for Personnel comprise officer and employee salaries, other compensation to personnel, and retirement and other benefits. Total personnel costs account for 65.0 percent of Reserve Bank expenses and are expected to increase by 7.2 percent in 1992.

Salaries and Other Personnel expenses account for about 52 percent of 1992 Reserve Bank budgeted expenses and are expected to be \$47.5 million or 6.1 percent above 1991 expenses. Salaries alone are budgeted to increase by \$50.3 million or 6.5 percent and will be partially offset by a decline in Other Personnel expense of \$2.8 million or 22.2 percent. The decrease in Other Personnel expenses results from a declining use of temporary help. Merit pay increases of \$37.1 million, or 4.8 percent account for about 74 percent of salary expense growth. Staffing level increases, promotions, reclassifications, and

structure adjustments account for about 26 percent of salary expense growth. These increases are partially offset by position vacancies and reduced overtime.

Expenses for Retirement and Other Benefits, which account for 13.0 percent of Reserve Bank budgets, are anticipated to increase by \$22.3 million, or 12.1 percent, in 1992. This increase is the result of continued escalation in hospital and medical costs, a rise in Social Security, and an increase in the thrift plan match in 1992.

Nonpersonnel expenses account for 35.0 percent of Reserve Bank expenses and are projected to increase by 6.2 percent in 1992.

Equipment expenses are expected to increase by 8.1 percent and to account for 11.3 percent of total expenses in 1992. Most of the increase is in depreciation expenses resulting from acquisitions to expand data-processing and data-communications capabilities because of increased workloads.

Shipping costs (primarily for check operations) account for 5.7 percent of the 1992 budget and are projected to increase by 3.5 percent in 1992. This relatively small increase is due primarily to savings in postage costs as a result of the implementation of the Regional Delivery System for savings bonds.

Building expenses, which account for 9.2 percent of total expenses, are expected to increase by 10.3 percent in 1992 because of higher real estate taxes in several Districts and the full year effect of recently completed capital projects. The New York, East Rutherford Operations Center and the Dallas building projects contribute heavily to the large increase in Building expenses.

Table 8, page 38 depicts the plans of the Reserve Banks for Capital spending in 1992. By their nature capital outlays vary greatly from year to year. These expenditures are greatly affected by the near completion of the Dallas building and the New York East Rutherford Operations Center -- and by outlays for data-processing and data-communications equipment.

Special Budget Emphasis

The Board of Governors has continued to approve two research and development projects and has added a third project in the 1992 budget. These projects will provide long-range benefits to the Federal Reserve and the banking industry and ultimately the American public. Because spending on such projects is relatively high and short-term, the Federal Reserve accounts for them separately from its operating expenses. The budget for these "Special Projects" in 1992 is \$20.1 million. This amount includes \$4.3 million for "Check Image Processing",

\$9.3 million for "Currency Authentication Systems", and \$6.5 million for the new project in 1992 - "Automation Consolidation."

The "Check Image Processing" project will continue to build on prior year's research -- the central concept is to test digital technologies to record images for use in processing checks. The focus in 1992 will be in three areas: (1) preparing for sustained tests of high-speed image capture systems for the government check application; (2) developing low-speed personal computer-based systems for the return item application; and (3) leading efforts to develop industry standards for interchange of check images between banks.

The primary concept of the second project, "Currency Authentication Systems," is to improve capabilities for detection of counterfeit notes in the processing of incoming currency deposits at the Reserve Banks -- and, thereby, promote the integrity of United States currency in circulation. These efforts should lead to effective counterfeit detector devices which will be attached to the Federal Reserve's high-speed currency processing equipment.

In 1992, the System will incur its first expenditures for "Automation Consolidation." This project involves the consolidation of all mainframe computer operations at three sites within the System -- Richmond, Dallas, and New York. The 1992

project budget covers staffing of the project team and development of a detailed plan for achieving a consolidated automation environment within the Federal Reserve System.

Governor Kelley and I 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.

Testimony on H.R. 4398

Mr. Chairman you have also asked for our assessment of H.R. 4398, the "Federal Reserve Bank Branch Modernization Act", a bill introduced by Mr. Erdreich on March 5, 1992. This is a much needed action which would remove outdated limitations on the acquisition or construction of branch buildings and should result in the least costly provision of space for Federal Reserve operations.

The construction, expansion, or modernization of Branch Federal Reserve Bank Buildings is authorized in Section 10 of the Federal Reserve Act. Statutory limitations included in the Act place an accumulative ceiling on branch construction. As most recently amended in 1974, the Act places an aggregate cumulative limitation of \$140 million on funds that may be expended on

branch construction. Recently completed branch buildings have exhausted the fund, and as a result, the Federal Reserve is unable to pursue needed branch construction projects.

A few of our Branch buildings need attention not just because they are in excess of thirty years old but more important they do not provide adequate types or amounts of space for check and cash or provide efficient building support systems. The Federal Reserve has experienced significant changes in facility requirements in recent years, primarily related to automation of check and cash, that have further exacerbated the situation. Because many of the affected areas do not lend themselves to renovation--vaults and delivery courts, for instance-- efforts by Branch management to obtain needed space through leasing and renovating have only provided temporary relief. While the Federal Reserve does lease space, experience has indicated that the long term costs of leasing are higher than the costs of ownership. Prior to making any decisions related to the provision of space, I want to assure you that we thoroughly analyze the discounted life cycle costs of several alternatives.

The latest analysis of projected building needs from the Reserve Banks suggests that either renovations, additions, or new facilities may be required in Birmingham, Nashville, Houston, San Antonio, and El Paso in the next 5 to 10 years. The remaining balance in the Branch Fund prohibits us from addressing

these needs. A brief description of each Branch's needs follows.

Birmingham Branch

It is projected that the current facility, constructed in 1927 with an addition constructed in 1959, will soon be unable to accommodate the anticipated facility demands and occupancy levels. The most significant deficiencies are related to inadequate and inefficient operations facilities that include the vault, cash and check processing areas, and secure and general delivery areas. Also, in recent years the basement has been damaged from a continuous influx of subsurface ground water that necessitates continuous operation of a sump pump.

Nashville Branch

The existing 1958 building will soon be inadequate to accommodate facility and occupancy demands. Specifically, the vaults and secure delivery court are either currently or will soon be inadequate to accommodate volume levels.

Houston Branch

The existing 1958 building is presently considered inadequately sized for the long term requirements. Specifically,

the vault, cash processing, and delivery court areas are not adequate to allow efficient operations. In addition, should the Houston economy rebound to near previous levels, the Branch's activities and subsequent facility demands will further increase the pressure on the building.

San Antonio Branch

While the present building, constructed in 1956, has been well maintained, the facility does not provide adequate vault, cash processing, and delivery court areas. A significant upturn in the Texas economy will require that additional space be provided.

El Paso

The present 1957 building exhibits deficiencies similar to those identified in the other branch buildings. Those deficiencies are related to vault, operations areas, and delivery courts.

Branches, even more so than head offices, are primarily engaged in providing services to financial institutions and the U.S. Treasury. These services include check collection, currency and coin processing and distribution, funds transfer services, processing of government payments, and other services. All costs

to provide these services (including building costs) are recovered either as reimbursable expenses (in the case of U.S. Treasury services) or by pricing the services.

To continue providing quality financial services in the most efficient manner, it is important that our facilities remain efficient. The provisions in the proposed amendment to Section 10 would enable us to provide facilities for delivering services efficiently to the nation's financial institutions and the Treasury.

Therefore, we encourage passage of H.R. 4398 and will be glad to respond to questions you may have in this area.

Table 1

Operating Expense of the Federal Reserve System, Net of Receipts 1990-92
(Dollars in millions)

Item	1990	1991	1992 Budget	Change 1990-91		Change 1991-92	
				Amount	Percent	Amount	Percent
Total System Operating expenses	1,511	1,606	1,725	95	6.3	119	7.4
Less:							
Revenue from priced services	746	750	786	4	0.5	36	4.8
Other income	19	18	5	-1	-5.3	-13	-72.2
Reimbursables	140	152	158	12	8.6	6	3.9
Memo:							
Actual Reimbursements	38	62	n/a				
Un-reimbursements	102	90	n/a				
EQUALS -- Net System Operating Expense	606	686	776	80	13.2	90	13.1

Table 2

Federal Reserve System Expense and Employment, 1981-1992 Budget 1/
(Dollars in Millions)

Year	Expenses		Personnel	
	Amount	Percent Change	Amount	Percent Change
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	25,140	1.2
1990	1,511	4.5	24,990	-0.6
1991	1,606	6.3	25,114	0.5
Growth rate 1981-1991		5.4		-0.1
1992 Budget	1,725	7.4	25,445	1.3

1/ Includes expenses and personnel of the Reserve Banks and the Board of Governors.

Table 3

Federal Reserve Bank Employment by Service Line, 1981-92 Budget

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
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	773	1,816	9,214	2,217	4,533	4,940	23,492	-0.8%
1991	784	1,870	9,044	2,343	4,629	4,924	23,594	0.4%
1992 Budget	794	1,902	8,974	2,477	4,730	4,995	23,871	1.2%
Long Term Growth Rate 1981-91	0.9%	-0.1%	-0.5%	3.1%	0.4%	-1.5%	-0.2%	
Recent Year 1990-91	1.4%	3.0%	-1.8%	5.7%	2.1%	-0.3%	0.4%	
Budget Year 1991-92	1.3%	1.7%	-0.8%	5.7%	2.2	1.4%	1.2%	

Table 4

Operating Expenses Budgeted for Major Initiatives
of the Federal Reserve Banks in 1992
(Dollars in Millions)

Area of Initiative	Amount	Percent of 1992 Operating Budget
Facility Improvements	18.7	1.2
Supervision and Regulation	8.5	0.6
Enhanced Check Operations	2.8	0.2
Currency Initiatives	1.0	0.1
Automation and Contingency Projects	2.0	0.1
Fiscal Initiatives	2.4	0.2
Thrift Plan	4.6	0.3
Productivity and Operational Improvements	-3.4	-0.2
Total	36.6	2.5
Memo: Increase in Total Operating Expenses 1991 to 1992 Budget	102.5	6.9

Table 5

Operating Expense of the Federal Reserve Banks, by Operational Area 1990-92
(Dollars in Millions)

Service Line	1990	1991	1992 Budget	Change 1990-1991		Change 1991-1992	
				Amount	Percent	Amount	Percent
Monetary and Economic Policy	99.0	106.7	113.0	7.7	7.8	6.3	5.9
Supervision and Regulation	211.9	237.4	261.2	25.4	12.0	23.9	10.1
Service to Financial Institutions and the Public	938.9	980.4	1,042.1	41.5	4.4	61.7	6.3
Services to the U.S. Treasury and Other Gov't Agencies	156.9	169.5	180.1	12.5	8.0	10.6	6.2
Total	1,406.7	1,493.9	1,596.4	87.3	6.2	102.5	6.9

Table 6

Employment at the Federal Reserve Banks, by Operational Area 1990-92
(Average Number of Personnel, except as noted)

Service Line	1990	1991	1992 Budget	Change 1990-1991		Change 1991-1992	
				Amount	Percent	Amount	Percent
Monetary and Economic Policy	773	784	794	11	1.5	11	1.3
Supervision and Regulation	2,217	2,343	2,477	126	5.7	135	5.8
Service to Financial Institutions and the Public	9,214	9,044	8,974	-170	-1.8	-70	-0.8
Services to the U.S. Treasury and Other Gov't Agencies	1,816	1,870	1,902	54	3.0	32	1.7
Support and Overhead							
Support	4,553	4,629	4,730	96	2.1	100	2.2
Overhead	4,940	4,924	4,995	-16	-0.3	70	1.4
Total	23,492	23,594	23,871	102	0.4	277	1.2

Table 7

Operating Expense of the Federal Reserve Banks, by Object 1990-92
(Dollars in Millions)

Object	1990	1991	1992 Budget	Change 1990-1991		Change 1991-1992	
				Amount	Percent	Amount	Percent
Officers salaries	74.0	80.6	85.0	6.6	8.9	4.4	5.5
Employees salaries	647.0	690.0	735.9	43.0	6.6	45.9	6.7
Other Personnel	12.9	12.6	9.8	-0.3	-2.3	-2.8	-22.2
Retirement and other benefits	163.8	184.7	207.0	20.9	12.8	22.3	12.1
TOTAL PERSONNEL	897.6	967.8	1,037.6	70.2	7.8	69.8	7.2
Forms and Supplies	53.4	54.6	56.0	1.2	2.2	1.4	2.6
Equipment	162.8	166.1	179.6	3.3	2.0	13.5	8.1
Software	32.2	32.7	34.4	0.5	1.6	1.7	5.2
Shipping	83.5	88.2	91.3	4.7	5.6	3.1	3.5
Travel	28.9	32.8	34.0	3.9	13.5	1.2	3.7
Insurance	0.8	0.9	1.1	0.1	12.5	0.2	22.2
Taxes on real estate	22.4	26.5	30.8	4.1	18.3	4.3	16.2
Depreciation	33.5	35.6	40.2	2.1	6.3	4.6	12.9
Utilities	25.5	26.7	29.5	1.2	4.7	2.8	10.5
Rent	22.0	23.6	24.8	1.6	7.3	1.2	5.1
Other Building	19.2	19.6	20.3	0.4	2.1	0.7	3.6
TOTAL BUILDING	123.5	133.0	146.7	9.5	7.7	13.7	10.3
All Other	60.0	55.8	54.9	-4.2	-7.0	-0.9	-1.6
Recoveries	-35.2	-36.9	-38.0	-1.7	4.8	-1.1	3.0
TOTAL NONPERSONNEL	509.0	526.1	558.8	17.1	3.4	32.7	6.2
TOTAL	1,406.7	1,493.9	1,596.4	87.2	6.2	102.5	6.9

Table 8

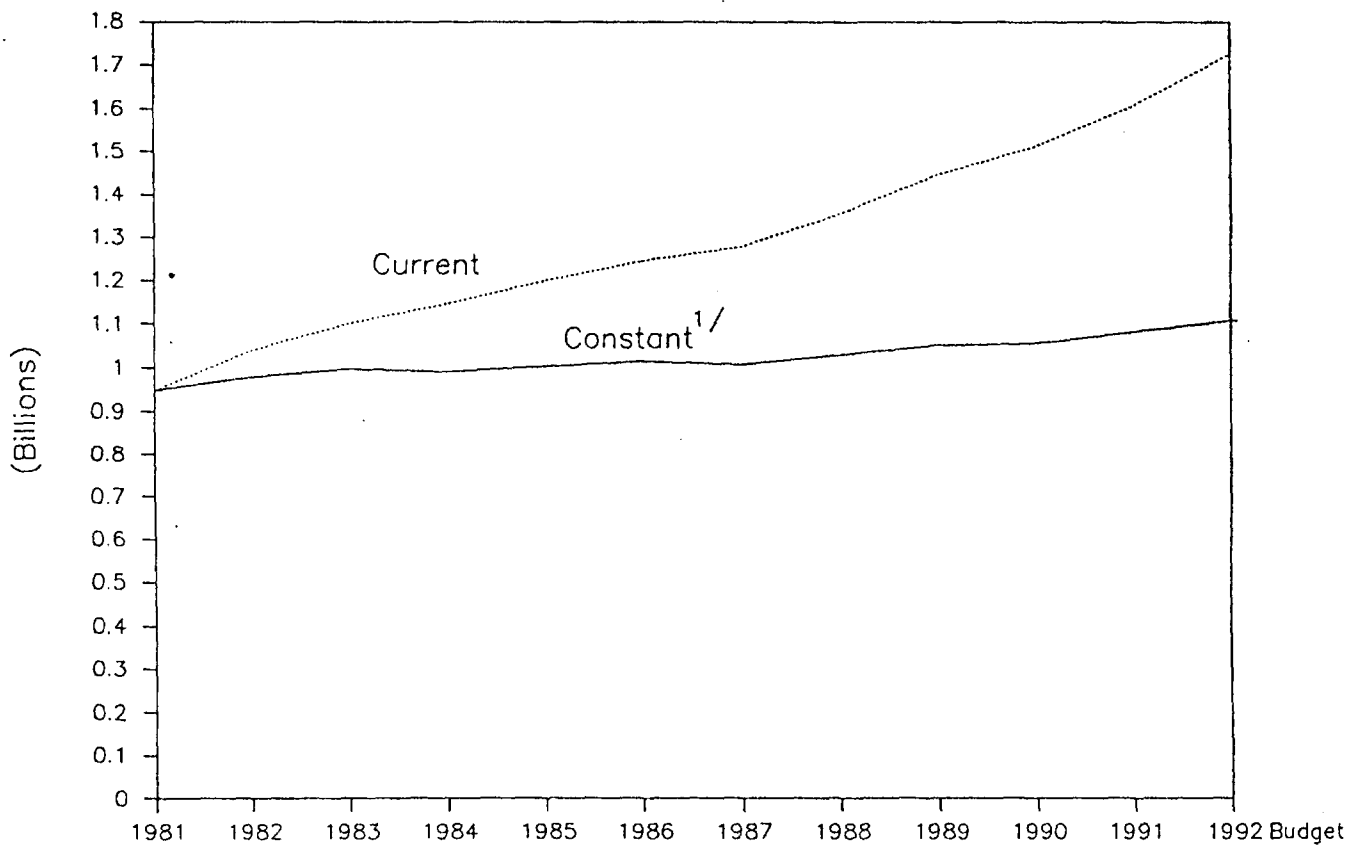
Capital Outlays of the Federal Reserve Banks, by Class of Outlay, 1990-92
(Dollars in Millions)

Capital Class	1990	1991	1992 Budget	Change 1990-1991		Change 1991-1992	
				Amount	Percent	Amount	Percent
Data processing and Data Communications Equipment	94.7	64.8	112.5	-29.9	-31.6	47.7	73.6
Furniture and Other Equipment	26.9	31.4	62.8	4.5	16.7	31.4	100.0
Land and Other Real Estate	35.1	3.3	8.6	-31.8	-90.6	5.3	160.6
Buildings	76.3	134.3	51.3	58.0	76.0	-83.0	-61.8
Building Machinery and Equipment	8.9	4.9	18.7	-4.0	-44.9	13.8	281.6
Leasehold Improvements	1.0	1.2	2.8	0.2	20.0	1.6	133.3
Software	---	---	2.5	---	---	---	---
Total	243.0	240.0	259.1	-3.0	-1.2	19.1	8.0

Chart 1

Federal Reserve System Expenses

1981 - 1992 Budget



1/ Deflated by GDP Deflator (1981 = 100)

Chart 2

Trends in Volume, Unit Cost, and Employment

For Volume Measured Functions 1981-91
(1981 = 100)

