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Report to Congressional Requesters

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FEDERAL RESERVE SYSTEM

Current and Future Challenges Require Systemwide Attention

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The Honorable Harry Reid
The Honorable Byron L. Dorgan
United States Senate

This report responds to your request asking us to review the operations of the Federal Reserve System (Federal Reserve). The report discusses the Federal Reserve's finances, including levels of spending and factors that could affect its finances. We also reviewed the Federal Reserve's major expenditures and discussed areas where spending may possibly be reduced. Additionally, the report discusses how the Federal Reserve's unique structure presents challenges in systemwide management. The report contains matters for congressional consideration and recommendations to the Board of Governors of the Federal Reserve System for reducing Federal Reserve spending and improving operations.

We are sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System, the other Governors, and the Presidents of the Federal Reserve Banks. We are also sending copies to members of the banking committees and other interested parties.

Major contributors to this report are listed in appendix VI.

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Executive Summary

Purpose

The Federal Reserve System (Federal Reserve or System), our nation's central bank, is unique among governmental entities in its mission, structure, and especially its finances. Unlike federal agencies funded through congressional appropriations, the Federal Reserve is a self-financing entity that deducts its expenses from its revenue and transfers the remaining amount to the U.S. Department of the Treasury. Although the Federal Reserve's primary mission is to support a stable economy, not to maximize the amount transferred to Treasury, System revenues contribute to total U.S. revenues and deductions from System revenues thus represent a cost to U.S. taxpayers. In view of today's constrained budget environment, Senators Reid and Dorgan requested GAO's assistance in analyzing Federal Reserve finances, including levels of spending; factors that could affect Federal Reserve finances in the future; and mechanisms used to control the cost of the Federal Reserve to taxpayers.

Specifically, GAO sought to (1) analyze trends in the cost of Federal Reserve operations during 1988 to 1994 and the System's management processes for controlling spending and overseeing operations, (2) identify opportunities to increase the System's efficiency without adversely affecting its effectiveness, (3) identify ongoing and future developments that could significantly affect the Federal Reserve's mission and finances, and (4) assess the System's strategic management processes and identify actions the Federal Reserve could take to successfully meet future challenges and ensure the efficiency and effectiveness of its operations.

Background

The Federal Reserve's Mission and Structure

The Federal Reserve is responsible for conducting monetary policy, maintaining the stability of financial markets, providing services to financial institutions and government agencies, and supervising and regulating banks and bank-holding companies. The Federal Reserve Act of 1913 established the Federal Reserve as an independent, decentralized central bank to better ensure that monetary policy was based on a broad economic perspective from all regions of the country and was not unduly influenced by political pressures.

One major component of the System's structure is a federal agency in Washington, D.C.—the Board of Governors of the Federal Reserve System.

The top officials of the Board are seven Board members who are appointed by the president and confirmed by the U.S. Senate. Although the Federal Reserve is required to report to Congress on its activities, its decisions do not have to be approved by either the president or Congress.

The other major components are 12 federally chartered corporations located throughout the United States, which are known as the Federal Reserve Banks. The Reserve Banks, with a total of 25 branches, are not federal agencies and are structured to function with a measure of autonomy. The stock of the Reserve Banks is held by those commercial banks that are members of the Federal Reserve, but that stock does not carry all of the usual incidents of stock ownership. Each Reserve Bank has its own management structure and board of directors. The Board of Governors appoints three of the nine directors of each Reserve Bank, including the Chairman, and approves the appointments and salaries of each Reserve Bank president and first vice president.

The Reserve Banks are also subject to the "general supervision" of the Board. With certain exceptions, such as a requirement that the Board order an annual financial examination of each Reserve Bank, the Federal Reserve Act does not specifically define this general supervisory authority. The Federal Reserve Act also limits this authority in certain ways. For example, the Board cannot close a Reserve Bank or establish a new one without congressional approval. Generally, the Board exercises its supervisory role through operations reviews, financial examinations, budget reviews and approvals, and year-end evaluations.

The Federal Reserve's Finances

Over the 1988 to 1994 period, the Federal Reserve's annual revenue averaged $22.0 billion and greatly exceeded its average annual expenses and other deductions of $2.5 billion. Consequently, the annual amount returned to Treasury during this period ranged from about $16 billion to $24 billion. The return of these remaining revenues to Treasury is in accordance with a policy established by the Board of Governors, and is not required by statute.

The most significant source of Federal Reserve revenue each year is the interest earned on U.S. securities held by the Reserve Banks as backing or "collateral" for the Federal Reserve notes that circulate as paper money. It is this revenue, which accounted for almost 90 percent of the total Federal Reserve revenue in 1994, that virtually guarantees a substantial annual "profit" for the System. The second largest source of revenue is the fees that the Federal Reserve charges banks and other financial institutions for providing "priced services," such as check-clearing and electronic funds transfers. As required by the Monetary Control Act of 1980, the Reserve Banks are to assess fees on the basis of, among other things, all direct and indirect costs incurred in providing such services. The Federal Reserve is reimbursed, in part, by Treasury and in full by other agencies for the services the System provides to them.

The most significant deduction from its revenue that the Federal Reserve makes each year is for the operating expenses of the Reserve Banks and the Board. The amount of this deduction, which is the major focus of this report, totaled $2.0 billion in 1994. About 70 percent of these operating expenses is for payment system and other financial services provided to banks and agencies, about 20 percent is for supervision and regulation, and about 10 percent is for monetary policy activities. Pay and benefits for the Federal Reserve's workforce of over 25,000 employees accounted for almost 70 percent of its total operating expenses in 1994.

Results in Brief

The Federal Reserve has unquestionably played a major role in promoting the nation's economic well-being. Although the Federal Reserve's cost of operations has rarely emerged as a visible public issue because of its self-financing nature, increasing constraints on the federal budget require increased scrutiny of this cost, just as all costs that affect U.S. taxpayers. Over the 7-year period of 1988 to 1994, the cost of Federal Reserve operations increased steadily and substantially. Specifically, operating expenses for the Board and Reserve Banks increased by about 50 percent, with the greatest increases occurring in the areas of bank supervision, personnel costs, and data-processing modernization. The costs of providing priced services have been rising faster than the corresponding revenues received. Overall, these cost increases exceeded the 25-percent inflation that occurred during this period.

With the current budgetary climate, the Federal Reserve could do more to increase its cost consciousness and ensure that it is operating as efficiently as possible in its day-to-day operations. GAO's review identified several inefficiencies in the Federal Reserve's policies and practices that have increased the cost of providing its current services, including its costs for travel, personnel benefits, building acquisition, and contracting and procurement. Many of these inefficiencies relate to the decentralized nature of the Federal Reserve, which allows each Reserve Bank to set many of its own policies, and to the absence of traditional cost-minimizing forces that are commonplace in entities that are either purely private or public sector in nature. The Federal Reserve also retains a $3.7 billion surplus account that GAO believes could be safely reduced or returned to the Treasury. While many of these areas have some potential for reducing its costs, GAO believes that achieving major cost reductions ultimately depends on the Federal Reserve's carefully reexamining its mission, structure, and work processes.

The need for such a reexamination is underscored by a number of major legislative, technological, and marketplace developments that could profoundly affect the nature, size, and distribution of the Federal Reserve's activities and resources. For example, the Reserve Banks are facing a major challenge in the form of increasing competition from private sector suppliers of financial services. In addition, a continuing switch from paper-based to electronic payment services and the rapid consolidation that is currently occurring in the banking industry could significantly affect both the magnitude and distribution of the Reserve Banks' workloads and resources. Since almost 90 percent of the Reserve Banks' costs is currently associated with the delivery of payment system and other financial services and bank supervision, these developments raise important questions regarding the future role of the Reserve Banks, their management structures, and their locations.

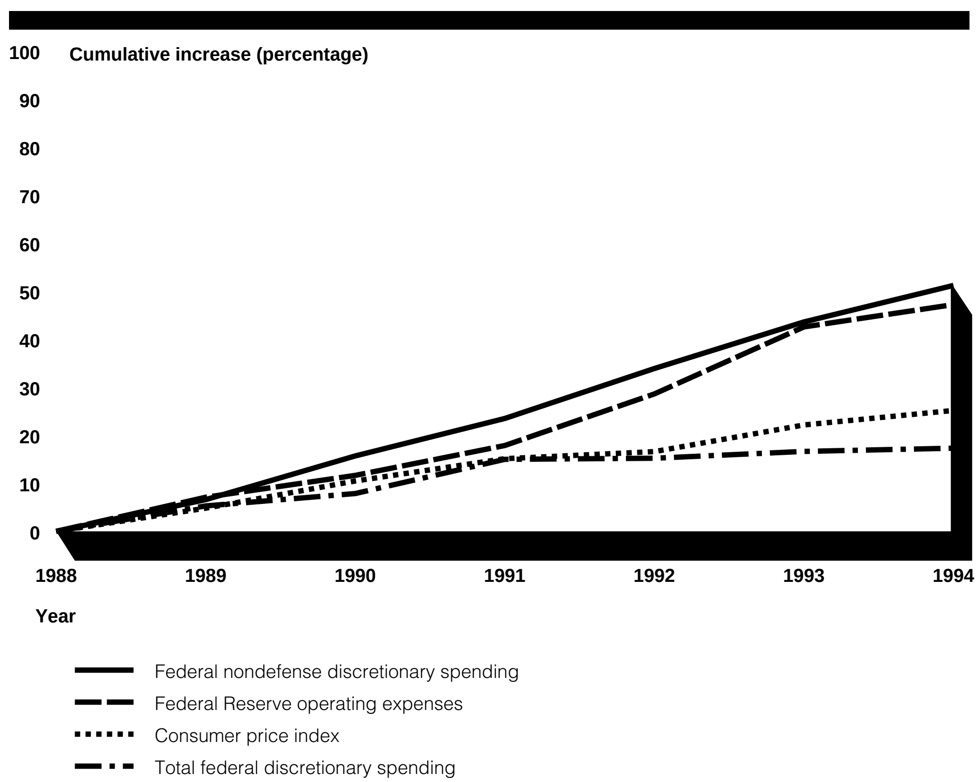
For the Federal Reserve to most effectively meet these challenges and streamline its operations, the Board and Reserve Banks must work together to strategically plan for the future. Prior GAO reviews of public and private sector organizations, which have successfully faced similar challenges, indicated that these organizations effectively implemented initiatives to focus on their primary missions and business lines, realign their structures to fit their missions, and apply technology to streamline their work processes. If the Federal Reserve is to effectively follow this strategy, it will need the Board's sustained leadership and the Reserve Banks' commitment. The Federal Reserve will also need to address certain weaknesses that GAO identified in its existing oversight and budgetary processes. Such weaknesses include a budgetary process that assumed continued incremental growth and oversight mechanisms that appeared fragmented, inefficient, or lacking in independence. The Federal Reserve has begun to show that it can address operational issues strategically and work in a systemwide manner when necessary. As the Federal Reserve enters the next century, it is vital that it continues such efforts so that it can accomplish its mission as efficiently and effectively as possible.

Principal Findings

Federal Reserve Operating Costs Have Increased Rapidly

Federal Reserve operating expenses increased from $1.36 billion in 1988 to $2.00 billion in 1994, or 48 percent. This represents a significant increase in the real cost of Federal Reserve operations as it exceeded the 25-percent inflation that occurred during this period. In addition, as shown in figure 1, the 48-percent increase in the Federal Reserve's operating costs from 1988 to 1994 was also greater than the 17-percent increase in overall federal discretionary spending and somewhat less than the 51-percent increase in federal discretionary spending adjusted to exclude the effects of the "peace dividend."

Figure 1: Cumulative Increases in Federal Reserve Expenses, 1988-1994



Sources: Federal Reserve Board and the budget of the United States.

The most significant increases occurred in expenses for bank supervision and regulation, personnel costs, and an extensive automation modernization and consolidation effort. The number of Federal Reserve staff increased 4 percent over this period, rising from 24,829 staff in 1988 to 25,744 in 1994. The largest increase in staffing was in bank supervision and regulation and, according to Federal Reserve officials, resulted from changes in bank supervision mandated by banking reform laws. System personnel expenditures accounted for about two-thirds of the Federal Reserve's total operating costs and increased by about 53 percent during the period. This increase was due to rising salary and benefit costs, staffing levels, and the changing composition of the Federal Reserve workforce.

The Federal Reserve's capital expenditures during the 1988 to 1994 period totaled about $1.7 billion, resulting from (1) a more than doubling of the book value of the System's data-processing and other equipment and capitalized leases and (2) the construction of a new Reserve Bank building in Dallas. Much of the investment in data-processing equipment was incurred as a part of a large-scale project to consolidate Reserve Bank mainframe computer services into a centrally managed facility known as Federal Reserve Automated Services.

Opportunities Exist to Reduce Costs

With the current budgetary climate, the Federal Reserve could do more to increase its cost consciousness and ensure that it is operating as efficiently as possible in its day-to-day operations. For example, personnel benefit packages varied among Reserve Banks and certain benefits—such as leave policies and savings plans—were generous compared to those of federal financial regulatory agencies with similar personnel requirements. To some extent, these benefit packages could be necessary to recruit and retain highly skilled professional staff, such as lawyers, economists, and financial analysts. However, more than half of the Federal Reserve's staff were administrative and clerical employees providing support services to financial institutions and government agencies.

Travel-related reimbursement policies also varied among Reserve Banks, resulting in significant differences in the reimbursable amounts allowed for lodging and meals. In addition, contracting and procurement practices at some Reserve Banks that GAO reviewed favored certain sources over others, despite Systemwide guidance that prohibits these practices. Such practices raise concerns about conflicts of interest and favoritism and about whether the Federal Reserve is receiving the most favorable prices.

Innovative methods of managing and controlling contracting and procurement costs, which GAO identified as "best practices" at some Reserve Banks, had not been formally disseminated among the other Reserve Banks. For example, GAO found that one Reserve Bank, in negotiating the award of large contracts, provided refined contract specifications on major contract components that, according to Reserve Bank officials, helped the Reserve Bank better negotiate the bids.

Any downward adjustment to the size of the Federal Reserve's surplus account—or perhaps its elimination—while not representing a reduction in the real cost of the Federal Reserve to taxpayers, would result in an increase in federal budgetary receipts in the year that the adjustment or elimination occurs.[1] Although the surplus account is intended to absorb possible losses, the Federal Reserve has recorded substantial net profits for 79 consecutive years. Even though the likelihood of the Federal Reserve's incurring losses exceeding its revenues appears remote, the total surplus increased 79 percent during 1988 to 1994, rising from $2.1 billion to $3.7 billion.

Major Developments Likely to Affect the Federal Reserve's Mission and Finances

A number of major legislative, technological, and marketplace developments could profoundly affect the nature, size, and distribution of the Federal Reserve's activities and resources. About 90 percent of the Reserve Banks' operating expenses in 1994 were associated with the delivery of payment system and financial services and bank supervision—the two areas that are most likely to be affected by these developments.

For example, as a result of increased competition from private sector suppliers and a continued shift to electronic banking, the Federal Reserve has experienced a decline in the volume of its check-clearing activity. The Federal Reserve's costs have been rising faster than corresponding revenues in several of its other service lines as well, and, in 1994, the System did not meet its cost recovery target for its priced services overall. If these trends continue and the Federal Reserve is not able to recover all of its costs over the long run, it could be compelled to pursue other options. These options may include the Federal Reserve's (1) reducing its

[1]The Joint Explanatory Statement accompanying the Fiscal Year 1996 Budget Resolution directed the Congressional Budget Office not to score for fiscal year 1996 any savings for new legislation that might affect the Federal Reserve's transfer of the surplus account to the U.S. Treasury. (H.R. Rep. No. 104-159 at 51 (June 26, 1995).) Accordingly, if such legislation had been passed, the transfer would not have been counted for purposes of determining compliance with the Budget Enforcement Act for Fiscal Year 1996.

uneconomical activities—perhaps by establishing a separate, private corporation to provide those priced services—and focusing more on regulation and standard-setting in many areas of the payments system or (2) subsidizing operations deemed essential to provide adequate nationwide service.

A major consolidation is also currently occurring in the banking industry that could significantly affect the magnitude and distribution of the Federal Reserve's supervisory activities. In particular, changes in the number and location of the bank-holding companies the Federal Reserve examines could require adjustments in the examination staffs of the various Reserve Banks. Current legislative proposals could also require the Federal Reserve to charge banks fees to cover the cost of its examinations. Although the Federal Reserve Act authorizes the System to charge fees for bank examinations, the Federal Reserve has decided not to do so because it would impose additional costs on state-chartered member banks. Thus, taxpayers in effect bear the cost of these examinations, which totaled $368 million in 1994.

Collectively, these developments present significant challenges to the Federal Reserve to rethink many aspects of its operations and raise important questions regarding the future role of the Reserve Banks, their management structures, and locations. Such a rethinking is also needed because the Federal Reserve's basic structure of 12 Reserve Banks and 25 branches has changed remarkably little since it was first established in 1913, despite the significant shifts in demographics and economic activity that have occurred since then.

Federal Reserve Could Benefit From Major Systemwide Review of Operations

Congress and the administration are pursuing efforts to reduce federal government discretionary spending, an effort that parallels corporate restructuring developments in banking and other industries. GAO's prior work in public and private-sector management reform showed that organizations that have been successful in improving their efficiency have done so by effectively implementing certain initiatives. These organizations' initiatives were implemented to focus on their primary missions and business lines, realign their structures to fit their mission, and apply technology to streamline their work processes. The Board's sustained leadership and the Reserve Banks' commitment will be needed if the Federal Reserve is to effectively follow such a strategy.

Without strong external pressure to minimize overall costs, the Federal Reserve must create the necessary self-discipline for the institution to adequately control its costs and respond effectively to future challenges. However, GAO found weaknesses in the planning and budgeting processes that are key mechanisms for helping accomplish these goals. The Federal Reserve requires Board divisions and Reserve Banks to set priorities and prepare plans, and the System has recently formed a strategic planning coordination group. However, the Federal Reserve did not have an integrated, systemwide strategic plan that identified the emerging issues and challenges affecting the entire System and how to effectively address them. In addition, the Federal Reserve's budgeting process assumed continued incremental growth in the Federal Reserve's budget and, thus, did not help contain costs as much as it could have.

GAO also found weaknesses in some of the Federal Reserve's oversight processes. The Federal Reserve had many oversight tools that were used to monitor and evaluate Reserve Bank activities. However, the combination of the Board's general supervisory responsibilities for Reserve Bank operations and the autonomy of the Reserve Banks has resulted in oversight that, in some areas, appears fragmented, inefficient, or lacking in independence. For example, GAO found issues that were either not adequately covered or were reviewed by both the Board's and the Reserve Banks' oversight organizations. Furthermore, some Systemwide internal auditing lacked clear independence. The Board's Office of the Inspector General, while independent, is not authorized to directly audit Reserve Bank operations. However, the Federal Reserve has recently decided to contract out for independent audits of its combined financial statements for the years 1995 through 1999. GAO commends this approach and urges that it be permanently instituted.

A major effort to review the Federal Reserve's operations could present it with profound challenges in planning and confronting possible changes. The essential missions as well as the locations of the Reserve Banks are set by law, and the autonomy of the Reserve Banks generally necessitates a consensus-oriented decisionmaking in systemwide planning. However, despite its unique structure, the Federal Reserve has begun to show that it can address operational issues strategically and work in a systemwide manner when necessary. This is evidenced by the recent establishment of a new Financial Services Committee to examine priced services and the consolidation of its data-processing facilities. As the Federal Reserve enters the next century, it is vital that both the Board and the Reserve

Banks continue to foster a systemwide focus so that the Federal Reserve can fulfill its mission in an efficient and effective manner.

Recommendations and Matters for Consideration

In analyzing opportunities to reduce the cost of Federal Reserve operations to the taxpayer, any potential adverse impact on the independence of monetary policy or on the Federal Reserve's ability to meet its key responsibilities should be considered carefully. However, GAO sees no inherent conflict between the Federal Reserve's independence or effectiveness and efforts to improve efficiency. Many of the functions performed by the Federal Reserve have little direct relation to monetary policy, and the Board, working with the Reserve Banks, has the authority and ability to take many cost-saving actions without jeopardizing the System's mission effectiveness. However, any decision to close Reserve Banks or establish a separate corporation for priced services would require congressional approval. Thus, GAO makes recommendations to the Board and suggests several matters for congressional consideration.

Recommendations to the Board of Governors

GAO recommends that the Board undertake a fundamental review of Federal Reserve operations focusing on the primary mission, business lines, and structure that would best support its overall mandate. Such an organizational review should include an assessment of

- the Federal Reserve's role in providing financial services to banks and government agencies and an analysis of the costs and benefits to the System and the taxpayers of various options for delivering such services (such options could include: discontinuing delivery of certain priced services to financial institutions; privatizing the delivery of other services by establishing a private corporation for delivering such services; or retaining responsibility for being the primary service provider);
- cost-saving opportunities that could result from streamlining its existing management structures and consolidating Federal Reserve operations, including possible mergers among the 12 Reserve Banks and 25 branches; and
- the potential for technology to support streamlined work processes in the Reserve Banks and reduce costs and improve quality.

In addition, GAO recommends that the Board

- strengthen its existing control and oversight mechanisms by, among other things, (1) reviewing the appropriateness of current budget assumptions that assume steady annual growth; (2) taking steps to better ensure the independence of the Federal Reserve's internal audit function and to expand the scope of its Inspector General's authority; and (3) ensuring that an independent financial audit of the Reserve Banks' combined financial statements is conducted every year;

- review benefit levels at the Board and the Reserve Banks to determine if these levels can continue to be justified, considering today's environment of increased governmental and private-sector cost containment and the composition of the Federal Reserve's workforce;
- assess whether there is any compelling need for the surplus account and whether the size of the account can be safely reduced; and
- reconsider its policy not to charge for bank examinations.

GAO is also making additional recommendations concerning the Federal Reserve's policies on travel, contracting, procurement, and other operational matters.

Matters for Congressional Consideration

Congress should consider the results of the Federal Reserve's assessments and determine

- whether it would be desirable to merge or close any of the 12 Reserve Banks or 25 branches;
- whether there is a continued need for the Federal Reserve's surplus account and, if so, what the appropriate amount of the account should be; and
- which of the various options for delivering priced services to financial institutions are in the best interests of public policy and represent the best balance between achieving cost savings and serving the nation's financial interests.

Congress should also consider

- requiring an annual independent audit of the Reserve Banks' combined financial statements;
- requiring the Federal Reserve to charge for bank examinations; and
- establishing a statutory requirement that the Federal Reserve annually return its remaining revenues to the Treasury.

Federal Reserve's Comments and GAO'S Evaluation

GAO requested comments on a draft of this report from the Federal Reserve Board of Governors. GAO's responses to the Board's comments on the specific recommendations contained in this report appear at the end of the chapters where those recommendations are made. Additional responses are contained in appendix V. In addition, the staff of the Board of Governors provided technical comments that were incorporated in this report as appropriate.

The Board took exception to what it termed the broad implication of the draft report that the Federal Reserve has not exercised appropriate budget constraint and has not adequately addressed the changing technological and financial environment within which it operates. The Board stated its belief that the Federal Reserve had exercised diligence in managing the cost of the System, and the System was as cost effective as the most efficient public and private sector institutions. As evidence of its cost control, the Board noted that, despite an increase in its supervisory responsibilities and a costly computer upgrade, its cost growth over the period of 1988 to 1994 was somewhat less than the increase in federal nondefense discretionary expenditures that occurred over the same years. This was one of the three standards of comparison that GAO used in this report. The Board also stated that the Federal Reserve's revenues from the provision of financial services to depository institutions consistently exceeded its direct and indirect costs, and thus earned money for the Treasury.

The Board recognized that the Federal Reserve could be made more efficient and effective, and stated that it would evaluate and implement some of GAO's specific cost-saving recommendations where appropriate. However, the Board noted that while some activities appear to be more cost effective if consolidated, deciding on the appropriate degree of consolidation was a difficult issue. Specifically, the Board agreed with GAO's recommendations to review the Federal Reserve's policies and practices regarding travel, contracting, and procurement, and agreed to consider managing health care benefits on a systemwide basis. The Board did not agree with GAO that it has significant opportunities to reduce its costs in such areas as personnel compensation and its management of large-scale building projects.

The Board also did not agree with most of GAO's broader recommendations, including the recommendations to assess whether cost-saving opportunities exist in streamlining its current management structure and consolidating Federal Reserve operations; to take steps to strengthen existing oversight and control mechanisms and improve its budgetary processes; to assess the costs and benefits of various options for providing financial services; and to reconsider its policy not to charge for bank examinations. With regard to the surplus account, the Board agreed that the appropriate level of the surplus is open to debate, but did not agree to consider reducing or eliminating the surplus, arguing in part that such a transfer would have no economic impact.

The Board believed that the Federal Reserve adequately planned for future significant changes affecting financial services and bank supervision. With regard to opportunities for streamlining operations, the Board stated that savings were most likely in the consolidation of electronic financial services, and that paper-based services offered only modest potential savings. Concerning consolidation of Reserve Banks and branches, the Board noted that their locations would likely be different if established today, but stated that relocations or realignments would have to result in substantial long-term savings to offset high transition costs.

GAO continues to believe that the Federal Reserve has significant opportunities to reduce its costs, that the major technological and marketplace developments discussed in this report are likely to have profound implications for the System's activities, and that the Federal Reserve could benefit from a major Systemwide review of its operations and structure. GAO agrees that such an undertaking would be difficult, but believes that a broad rethinking of the Federal Reserve's mission, structure, lines of business, and its strategic management processes is needed for the Federal Reserve to be as efficient and effective as it can be in fulfilling its critical role as our nation's central bank. GAO believes that without such a systemwide review, the Federal Reserve will be increasingly less competitive with private sector suppliers of financial services and less cost effective in its overall operations.

GAO commends the Federal Reserve for taking actions to consolidate some of its operations, such as its mainframe computer operations and its savings bond program, and to consider other potential cost-saving opportunities, such as managing health care benefits on a systemwide basis. However, GAO notes that these efforts fall far short of the broad rethinking GAO believes is needed and are unlikely to yield the truly significant savings that could result from such an effort. In particular, while GAO agrees that realigning and consolidating facilities would involve short-term transition costs, GAO believes that such costs could be outweighed by long-term savings from having a more rational and efficient structure.

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Abbreviations

ACH	automated clearinghouse
A&E	architecture and engineering
ATM	Automated Teller Machine
BEA	Budget Enforcement Act of 1990
CBD	Central Business District
COFVP	Conference of First Vice Presidents
COP	Conference of Presidents
CSRS	Civil Service Retirement System
DBS&R	Division of Banking Supervision and Regulation
DHRM	Division of Human Resources Management
DRBOPS	Division of Reserve Bank Operations and Payment Systems
EBT	Electronic Benefits Transfer
FAR	Federal Acquisition Regulations
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FEPCA	Federal Employees Pay Comparability Act
FERS	Federal Employees' Retirement System
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FOMC	Federal Open Market Committee
FRAS	Federal Reserve Automation Services
FRBRS	Federal Reserve Board Retirement System
GRH	Gramm-Rudman-Hollings Act
GS	general schedule
IMF	International Monetary Fund
NPR	National Performance Review
OCC	Office of the Comptroller of the Currency
OIG	Office of the Inspector General
PAYGO	pay-as-you-go
POS	point-of-sale
SDR	special drawing rights
SEC	Securities and Exchange Commission
SPCG	Strategic Planning Coordination Group
UAG	Uniform Acquisition Guidelines

Introduction

The Federal Reserve System (Federal Reserve or System), our nation's central bank, is unique among governmental entities in many respects, particularly in its finances. Unlike many government agencies whose operations are funded through the Congressional appropriations process, the Federal Reserve deducts operations and other expenses from its revenues and transfers the remaining amount to the U.S. Department of the Treasury (Treasury). Although the primary mission of the Federal Reserve is to support a stable economy, not to make a profit or maximize its transfer to Treasury, System revenues contribute to total U.S. revenues; thus, deductions from System revenues represent a cost to U.S. taxpayers. In today's constrained budget environment, Congress seeks to be well informed on all activities that affect the government's finances. For this reason, Members of Congress have requested our assistance in providing information about the revenues and costs of the Federal Reserve, factors that could affect Federal Reserve finances, and about the mechanisms used to control costs and conduct strategic planning.

The Federal Reserve's Unique Structure Reflects Efforts to Balance Differing Interests

The Federal Reserve was created by the Federal Reserve Act of 1913 ". . . to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

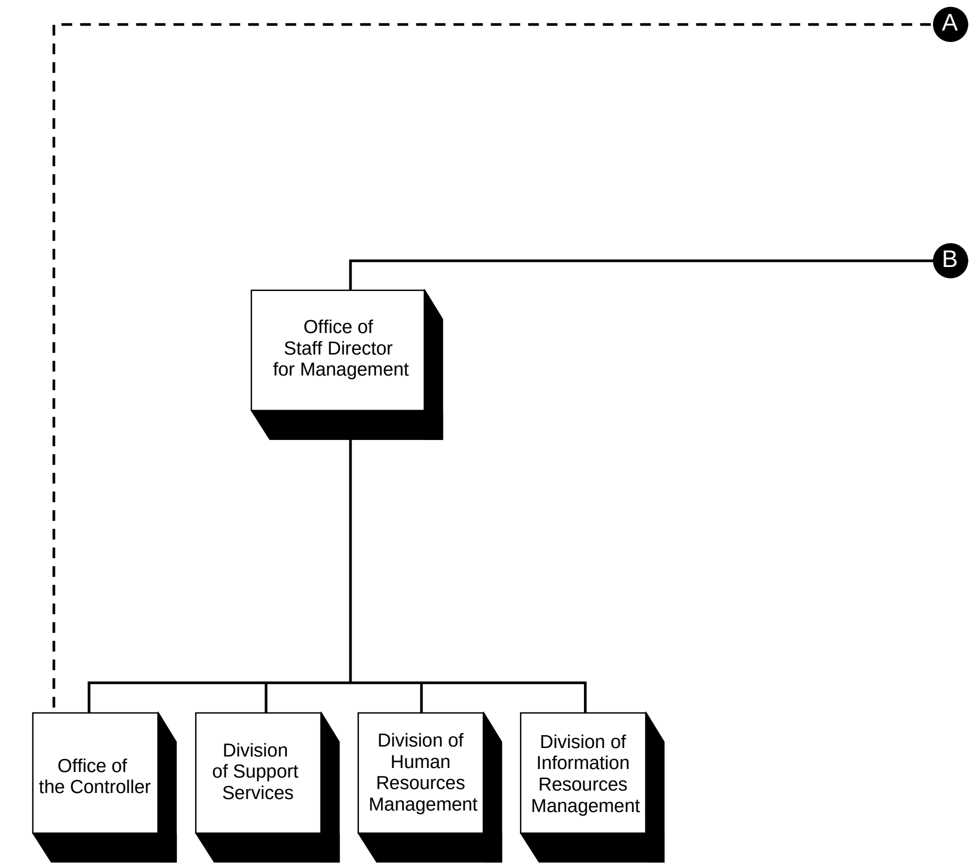
The Federal Reserve's basic structure includes a federal agency in Washington, D.C.—the Board of Governors of the Federal Reserve System (Board), whose seven members are appointed by the president and confirmed by the Senate.[1] Figure 1.1 shows the organizational structure of the Board. The structure also includes 12 federally chartered corporations, located in various regions of the country (Federal Reserve districts), known as Federal Reserve Banks (Reserve Banks). Figure 1.2 shows the boundaries of the Federal Reserve districts.

The Federal Reserve is unusual in many respects compared to other entities established to carry out public purposes. It is a federal system that is part public and part private; although the Board is a government agency, the Reserve Banks are not. Also, the Federal Reserve does not follow the familiar federal structure of a "top-down" hierarchy, with all policymaking powers centralized in Washington, D.C. Instead, the Board and the

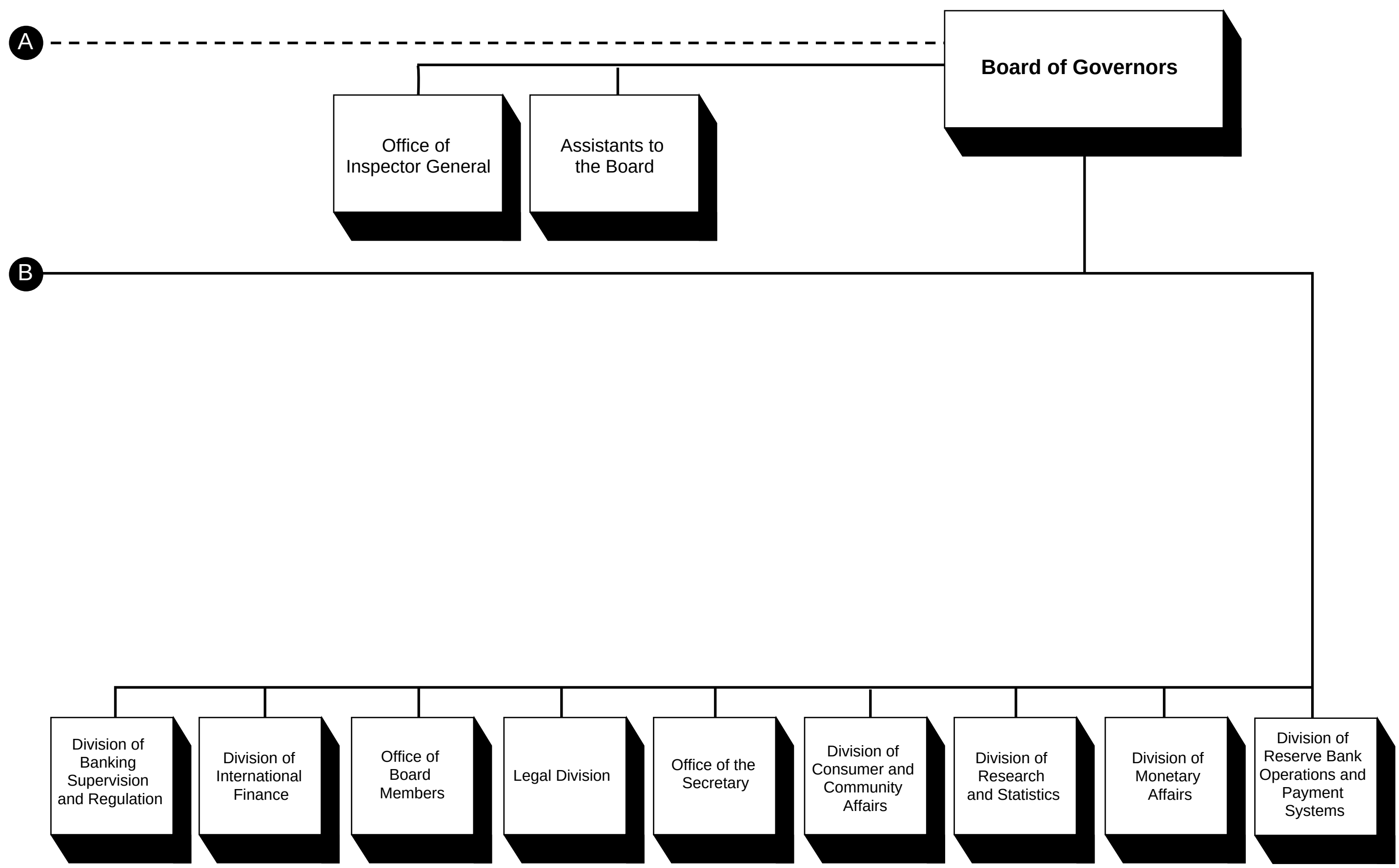
[1]Each of the seven Governors is appointed to serve all or the expired portion of staggered 14-year terms. No 2 members can be from the same region of the country, as defined by the boundaries of the 12 Federal Reserve districts.

Reserve Banks have shared responsibilities and policymaking authority in many areas of operation.

Figure 1.1: Organizational Chart of the Federal Reserve Board



Office of the Controller has direct fiscal responsibility for the Board of Governors.

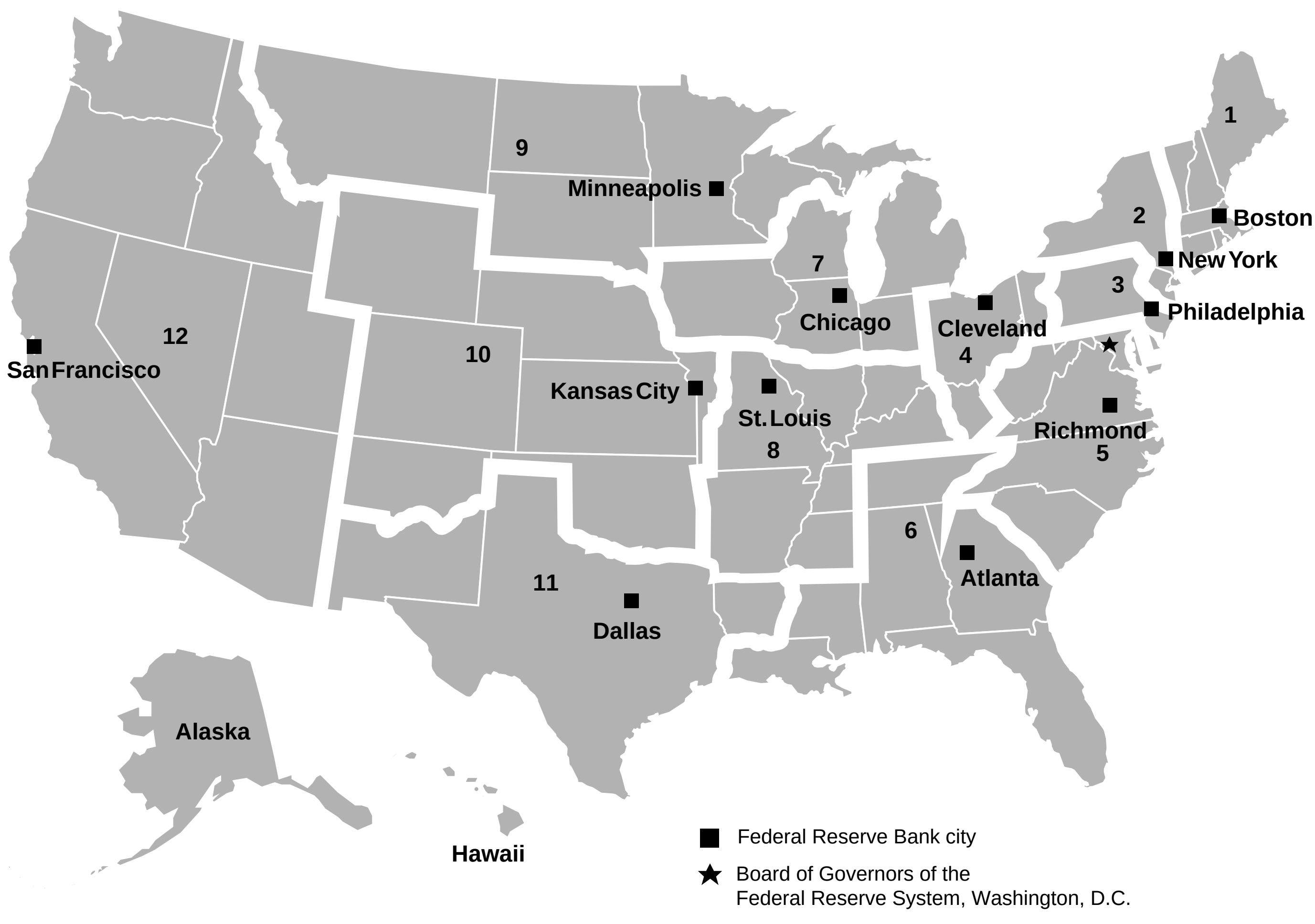


Note 1: The Federal Reserve officially identifies districts by number and by Reserve Bank city.

Note 2: In District 12, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii.

Source: Federal Reserve System.

Figure 1.2: Map of the Federal Reserve Districts



Source: Federal Reserve Board.

The Federal Reserve Is Part Public, Part Private

The Federal Reserve's part-public, part-private composition evolved from efforts to ensure our central bank's balanced consideration of public and private interests at national and regional levels. A related feature is the Federal Reserve's structural independence from political influence and direct taxpayer support. The Federal Reserve's budget is not subject to the approval of Congress or the administration, and the central bank receives no government appropriations. The Reserve Banks are structured as self-supporting corporations, and the Board is financed by a levy on the Reserve Banks.

The Reserve Banks are federally chartered corporations wholly owned by private-sector commercial banks (which, as members of the Federal Reserve, are known as member banks.)[2] In terms of assets and personnel, most of the Federal Reserve is in the Reserve Banks: virtually all of the Federal Reserve's assets, liabilities, revenues, and expenses are carried on the books of the Reserve Banks, and 94 percent of the over 25,000 employees of the Federal Reserve are employed by the Reserve Banks. As of December 31, 1994, the assets of the Reserve Banks were $437.0 billion, and their liabilities and equity were $429.5 and $7.4 billion, respectively.

Although the Reserve Banks are privately owned corporations, they differ from most such entities in important ways. The ownership of all stock of the Reserve Banks confers on member banks only some of the typical attributes of control and financial interest. For example, member banks receive dividends on Federal Reserve stock, but these dividends are set by law at 6 percent of paid-in capital. Member banks may not sell the stock or pledge the stock as collateral for loans. Also, member banks elect six directors of the Reserve Banks' boards of directors; the Board appoints three directors and designates one of these as chairman and another as deputy chairman of the board.[3] Finally, the Reserve Banks have been considered instrumentalities of the federal government in at least one context.[4]

The Board and the Reserve Banks Share Responsibilities and Decisionmaking

Although the Federal Reserve must report to Congress annually on its operations, decisions of System policymakers generally are not subject to ratification by the president or any presidential appointees in the executive branch or by Congress. The Federal Reserve Act not only gives the board of directors at each of the Reserve Banks powers of supervision and control over the Reserve Bank, but it also grants the Board of

[2]At year-end 1994, the member banks of the Federal Reserve numbered 4,115. These banks accounted for about 80 percent of the assets of the U.S. banking system.

[3]Member banks in each district elect three Class A directors, who represent member banks, and three Class B directors, who represent the public. The Board appoints three Class C directors who also represent the public. Each of the 25 branch offices of the Reserve Banks also has its own board of directors.

[4]For example, in Brink's, Inc. v. Board of Governors of the Federal Reserve System, 466 F. Supp. 116 (D. D.C. 1979), the Federal District Court held that certain "governmental" functions exercised by the Federal Reserve Bank of Richmond rendered the Reserve Bank a government entity for purposes of the Service Contract Act, 41 U.S.C. section 351 et seq.

Governors the power to exercise general supervision over the Reserve Banks. For example, the board of directors at each Reserve Bank appoint and determine the compensation of the top official of each Reserve Bank; however, the Board of Governors is authorized to approve or disapprove these decisions. The Federal Reserve Act does not specifically define the general supervisory responsibilities of the Board of Governors.

The Federal Reserve Uses a Conference System to Coordinate Decisionmaking

To help systemwide planning and decisionmaking in a system of shared responsibilities, the Board and the Reserve Banks participate in systemwide conferences. In 1994, the conference structure consisted of three major conferences:[5] the Conference of Presidents (COP), the Conference of First Vice Presidents (COFVP), and the Conference of General Auditors, as described in table 1.1. Each of these conferences is supported by committees, subcommittees, and task forces, involving many Federal Reserve officials and staff.

Table 1.1: Three Conferences of the Federal Reserve as of 1994

Conference	Members	Purpose
Conference of Presidents	Presidents of the Reserve Banks	The Conference is to consider managerial matters of common interest to Reserve Banks and consult with and advise the Board on these matters. These managerial matters include discounts and audits, management systems and budgets, strategic planning, personnel, legislation and regulations, supervision, and research.
Conference of First Vice Presidents	First vice presidents of the Reserve Banks	The Conference is to consider and coordinate Reserve Bank operations.
Conference of General Auditors	General auditors of the Reserve Banks	The Conference is to enable general auditors to discuss matters of mutual concern and to adopt uniform policies and solutions to problems.

Source: Federal Reserve Board.

In 1995, a new management structure for financial services took over many of the duties of the COFVP that were related to priced services. The new committee was established to streamline the Federal Reserve's decisionmaking process and to make the Reserve Bank first vice presidents more accountable for strategic planning of major business lines throughout the entire System. This new structure and details on the Federal Reserve's decisionmaking authority are discussed further in chapter 5.

[5]The conference structure also includes the Conference of Chairmen, which is composed of the chairman of each Reserve Bank. However, according to a Board official, the powers of this conference are limited.

The Mission of the Federal Reserve

Many, but not all, of the responsibilities of the Federal Reserve are shared by the Board and the Reserve Banks. This is perhaps best explained in the context of a discussion of the basic mission of the Federal Reserve.

The mission of the Federal Reserve today, which is critical to the nation's economy, can be generally described in terms of four major functions or responsibilities: conducting monetary policy; maintaining the stability of the financial system and containing systemic risk that may arise in financial markets; providing services to financial institutions and other governmental agencies; and supervising and regulating banks and bank-holding companies. Table 1.2 briefly describes the basic responsibilities of the Federal Reserve and explains how these responsibilities are shared by components of the System.

Table 1.2: The Basic Mission of the Federal Reserve System by Major Lines of Business

Responsibility	Explanation	How responsibilities are carried out
Conduct monetary policy	The Federal Reserve influences the money supply and credit conditions in the economy in pursuit of full employment and stable prices. For example, the System affects the money supply by buying and selling U.S. securities in the open-market (known as open-market operations). The Federal Reserve also buys and sells foreign currencies and securities to affect the dollar's exchange rate and help stabilize financial markets internationally.	The Federal Reserve's Federal Open Market Committee (FOMC) makes monetary policy. Voting members are the seven Board members and five Reserve Bank presidents, including the president of the Reserve Bank of New York, a permanent member of the committee. Other Reserve Bank presidents are voting members on a rotating basis. All Reserve Bank presidents participate in FOMC meetings. Staff support is provided by Board and Reserve Bank employees.
Maintain stability of financial markets	The Federal Reserve increases the liquidity of markets by temporarily supplying extra reserves to the banking system through open-market operations. The Federal Reserve lends to financial entities through discount window operations. To stabilize markets, the Federal Reserve can lend reserves directly to certain entities in financial difficulty by making discount window loans.[a]	FOMC carries this out through open-market operations. Discount window operations are carried out by each of the Reserve Banks in accordance with policies approved by the Board.

(continued)

Responsibility	Explanation	How responsibilities are carried out
Provide services to financial institutions	The Federal Reserve provides "priced services" to financial institutions, including check-clearing and processing and electronically transferring funds between financial institutions. The System also distributes and receives Federal Reserve notes (paper money) and coins and holds U.S. securities to back issued Federal Reserve notes. The System ensures that enough currency and coins are in circulation to meet public demand.	Each of the Reserve Banks provides check-clearing and funds transfers, subject to the Board's supervisory powers. Subject to the Board's supervision, each Reserve Bank issues Federal Reserve notes and coins; verifies deposits of financial institutions; replaces and destroys unfit currency; and identifies counterfeit currency.
Provide services to Treasury and other government agencies	The Federal Reserve issues and redeems government securities and performs other services for Treasury; also, the System provides services to other government agencies. For example, the Federal Reserve processes food coupons for the U.S. Department of Agriculture.	The Reserve Banks provide various services to Treasury and other government agencies subject to the Board's supervision.
Supervise and regulate banks and bank-holding companies	The Federal Reserve supervises all U.S. bank-holding companies, state-chartered banks that are members of the Federal Reserve, all Edge Act[b] and agreement corporations, the foreign activities of member banks, and the U.S. operations of foreign banks. The System establishes standards designed to ensure the safe and sound operation of financial institutions.	The Reserve Banks perform many supervisory duties—such as bank-holding company inspections and bank examinations—subject to the Board's supervision. The Board is responsible for establishing theses standards through relations, rules, policy guidelines, or supervisory interpretations, which may be established under specific provisions of a law or under more general legal authority.

[a]Any institution holding deposits subject to reserve requirements (such as transaction accounts and nonpersonal time deposits) has access to the discount window, subject to technical restrictions imposed by the Federal Deposit Insurance Corporation Improvement Act.

[b]Edge Act corporations are corporations chartered by the Federal Reserve to engage in international banking. The Board Of Governors acts on applications to establish Edge Act corporations and also examines the corporations and their subsidiaries.

The Federal Reserve's Internal Budgetary Controls and Oversight Reflect the System's Structure

The budgetary controls and oversight structures internal to the Federal Reserve reflect the fact that each of the Reserve Banks has its own management structure in addition to being supervised by the Board. Concerning budget controls—the primary control over spending—the Reserve Banks and the Board have similar, but separate, processes, and the Board approves all final budgets. The Federal Reserve's internal oversight structure includes general auditors at each of the Reserve Banks and the Office of the Inspector General (OIG) at the Board. The OIG is authorized to audit activities for which the Board has primary responsibility. In addition, some Board divisions, such as the Division of Reserve Bank Operations and Payment Systems (DRBOPS), Division of Human Resources Management (DHRM), and Division of Banking Supervision and Regulation (DBS&R), conduct operations reviews using the Board's delegated authority to supervise the Reserve Banks. DRBOPS also conducts financial examinations, operational audits, and annual performance evaluations of the Reserve Banks. The budgetary controls and oversight structures of the Federal Reserve are discussed further in chapter 5.

The Reserve Banks use accrual accounting to track expenses. For this reason, the Reserve Banks' operating expenses reflect only the depreciation costs of capital acquisitions. Each major unit of the Reserve Banks has an operations budget and a capital asset budget, and each is controlled by the same process.

The Federal Reserve Finances Its Operations From Current Revenue and Returns Remaining Revenue to Treasury

Each year, the Federal Reserve deducts operations and other expenses from current revenue and transfers the remaining amount to Treasury. For example, in 1994, the Federal Reserve deducted about $3.5 billion from the current revenue of about $24 billion and returned about $20.5 billion to Treasury. The amount returned to Treasury has varied during the period of 1988 to 1994, as shown in table 1.3. The return of these remaining revenues to Treasury is in accordance with a policy established by the Board of Governors, and is not required by statute.

Table 1.3: The Amount Returned to Treasury by the Federal Reserve, 1988-1994

Dollars in billions

Year	Payment
1998	$17.4
1989	21.6
1990	23.6
1991	20.8
1992	16.8
1993	16.0
1994	20.5

Source: Federal Reserve System.

The amount that the Federal Reserve transfers to Treasury each year is a function of the amount of System revenues and deductions, which are affected by a variety of factors.

Sources of Federal Reserve Revenue

The Federal Reserve has three major sources of recurring revenue: interest on U.S. securities held primarily to collateralize currency (currency-related securities), other interest earned, and fee income. Table 1.4 briefly identifies the sources of revenue and briefly describes the primary factors that determine the amounts received from each source. As detailed in this table, only in the case of priced services and net payments for fiscal agent services can the Federal Reserve set fees in response to fluctuations in the costs it incurs.

Table 1.4: Primary Sources of Current Revenue of the Federal Reserve

Source of revenue	Amount in 1994 (in thousands) and percentage of total revenues	Definition	Primary influences on amount of income
U.S. securities held by Federal Reserve to collateralize currency	$18.4 billion (87.3%)	Interest paid by Treasury and other U.S. agencies on securities held by the Federal Reserve to collateralize the currency.	Public demand for currency and fluctuations in interest rates.
Other interest income			
Noncurrency-related U.S. securities	$829.8 million (3.9%)	Interest paid by Treasury and other U.S. agencies on securities held by the Federal Reserve that are not used to collateralize the currency.	Actions taken to implement monetary policy and fluctuations in interest rates.
Interest on foreign securities	$894.5 million (4.2%)	Interest earned on account balances maintained with foreign banks. The accounts are used to stabilize fluctuations in international flows and exchange values of currencies.	Fluctuations in the value of the dollar exchange rates and interest rates paid by foreign banks.
Interest on loans	$34.7 million (0.2%)	Interest paid by financial institutions on loans granted by Reserve Banks because of liquidity needs, financial trouble, or to comply with reserve requirements.	Changing market conditions and fluctuations in interest rates.
Fee income			
Priced services	$734.4 million (3.5%)	Fees financial institutions pay for services such as clearing checks, electronic transfers of funds, and safekeeping securities.	Costs Reserve Banks incur to provide institutions these services and the competition from private sector vendors offering similar services.
Net payments for fiscal agent services	$176.9 million (0.8%)	Fees Treasury and other government agencies pay for services needed.	Costs Reserve Banks incur to provide agencies these services.
Total	**$21.1 billion**	**n/a**	**n/a**

Legend: n/a = not applicable.

Source: Federal Reserve System.

Revenue Is Dominated by Interest Income, Primarily Interest on Securities

Most Federal Reserve revenue comes from interest earned on U.S. government securities that are held by Reserve Banks and used to back, or collateralize, Federal Reserve notes. The Federal Reserve Act introduced Federal Reserve notes—the “paper money” that we use today. Before being issued to the public, Federal Reserve notes must be secured by legally authorized collateral—gold certificates, special drawing rights

(SDR),[6] and U.S. Treasury and federal agency securities purchased through open-market operations.[7] About $381.5 billion in Federal Reserve notes were in circulation as of December 31, 1994, and as shown in table 1.4, the assets that collateralized those notes accounted for about 87 percent of the Federal Reserve assets at that time. Those assets represented mainly U.S. Treasury and federal agency securities. Throughout the 1988 to 1994 period, interest received on such currency-related securities ranged from 79 to 87 percent of all System revenues.

Other Interest Income

Interest on noncurrency-related U.S. securities refers to interest earned on securities purchased to implement monetary policy. The Federal Reserve influences the economy mainly through a system of managed reserves.[8] The Monetary Control Act of 1980 requires all depository institutions to hold reserve balances in accounts with the Reserve Bank for their Federal Reserve districts or other designated institutions or, as permitted by Board regulations, in the form of cash in their vaults. The Federal Reserve sets reserve requirements for depository institutions and determines the total of reserves for the banking system. By purchasing securities in the market, the Federal Reserve expands reserves when it wants to lower interest rates and encourage more credit in the economy.[9] Conversely, by selling securities, the Federal Reserve reduces reserves when it wants to raise interest rates and restrict the amount of credit.

The Federal Reserve's control over bank reserves enables it to play a major role in protecting the economy against systemic risk—that is, excessive disruption from financial market disturbances. In the event of a financial crisis, such as a plunge in stock prices, the Federal Reserve may

[6]SDRs are created by the International Monetary Fund (IMF), after agreement by a majority of the IMF members, to serve as a supplement to the international monetary reserves of IMF members. SDRs are allocated to the members in accordance with the size of the members' quota, but without any payment. SDRs received by the U.S. government are, by law, held by the Secretary of the Treasury for the account of the Exchange Stabilization Fund.

[7]Almost all of the government securities held by the Federal Reserve are Treasury securities purchased in the open market, but the Federal Reserve also has purchased some agency securities that comprise less than 2 percent of the government securities portfolio.

[8]To a lesser extent, the Federal Reserve also influences the amount of reserves through adjustments to the discount rate (which affects the cost of borrowing) and, on occasion, changes in reserve requirement ratios.

[9]For example, to expand reserves, the Federal Reserve buys government securities through its open-market operations, which adds to reserves. When the Federal Reserve purchases securities, it pays by issuing a check on itself, in effect. On receipt of the check, the seller's bank presents it to the Federal Reserve for payment. The Federal Reserve honors the check by increasing the reserve account at the Reserve Bank of the seller's bank. The reserves of the seller's bank rise with no offsetting decline in reserves elsewhere; thus, the total volume of reserves increases. By adding to bank reserves, the Federal Reserve can seek to lower interest rates and expand the supply of money and credit available in the economy.

increase the liquidity of markets by temporarily supplying extra reserves to the banking system through open-market operations.

Interest on foreign securities was an additional source of revenue. In 1994, the Federal Reserve held $20.5 billion in foreign securities. The Federal Reserve also has a reciprocal swap network with different central banks, which is not included on the balance sheet.[10] The Federal Reserve earns interest on foreign-denominated assets, but also faces risks in that it can gain or lose on trades.

The Federal Reserve earns interest on loans provided to depository institutions through its discount window. Through the discount window, commercial banks and other depository institutions may borrow reserves from the Federal Reserve. These institutions are expected to draw on all other reasonably available sources of funds before coming to the discount window. The loans are made at a rate of interest—the discount rate—set by the Reserve Banks and approved by the Board.

The Federal Reserve Is Required to Set Fees for Priced Services to Recover Cost of Services

The Monetary Control Act requires the Federal Reserve to charge depository institutions for its services to financial institutions, setting fees in such a way that, over the long run, the revenues from these services will recover the costs of providing them. The act also requires all depository institutions to meet the Federal Reserve's reserve requirements and grants these same institutions access to System services at market prices as well as access to short-term or discount loans.[11] In addition to the services mentioned in table 1.2, the Federal Reserve provides securities safekeeping and transfer and noncash collection services. Services to financial institutions and Treasury constitute a large portion of the Federal Reserve expenses.

[10]The swap network consists of reciprocal short-term arrangements (comparable to repurchase and matched sale-purchase agreements in the domestic government securities market) among the Federal Reserve, other central banks, and the Bank of International Settlements. These arrangements, which have been used infrequently in recent years, give the Federal Reserve temporary access to the foreign currencies it needs for intervention operations to support the dollar and give the partner foreign central banks temporary access to dollars they need to support their own currencies.

[11]Before 1980, only banks that were members of the Federal Reserve had access to Federal Reserve services and discount loans at subsidized prices and interest rates. Nonmember banks, which had no direct access to System services and loans, could receive such services only by maintaining correspondent relationships with commercial banks that belonged to the System.

Federal Reserve Expenses and Other Deductions

From current revenues, the Federal Reserve deducts the cost of operating the 12 Reserve Banks and the Board and other expenses before transferring the remaining revenues to Treasury. Generally, these deductions can be categorized as expenses; other deductions; and losses, gains, and other adjustments. Table 1.5 briefly describes these deductions. For purposes of this report, operating expenses of the Federal Reserve include the cost of operating the Reserve Banks and the Board.

Table 1.5: Deductions the Federal Reserve Makes From Revenues

Deduction	1994 Amount (000 omitted)	Definition
Operating expenses		
Operating expenses of Reserve Banks	–$1,858,319	Under limits set by the Board, operating expenses for Reserve Banks' personnel, materials and supplies, equipment/software, shipping, travel, communications, and building depreciation.
Assessments for Board expenditures	–146,866	Expenses of the Board of Governors are financed through an assessment levied on the Reserve Banks.
Total	**–2,005,185**	**n/a**
Other deductions		
Interest on required clearing balances	–223,623	The Federal Reserve pays interest on the clearing balances that financial institutions maintain at Reserve Banks to protect against settlement risk. The Federal Reserve pays interest in the form of credits that financial institutions may use to defray check-clearing and other costs.
Purchase of currency from Treasury	–368,187	In response to public demand for currency and the need to replace unfit currency, the Federal Reserve pays Treasury for printing Federal Reserve notes.
Transfer to surplus	–282,122	At the discretion of the Board, the Reserve Banks retain from their net earnings amounts that would adjust their surplus account to equal their Paid-in Capital Account.
Dividends to stockholders	–212,090	As established by statute, the Federal Reserve pays an annual dividend of 6 percent to member banks that own Federal Reserve stock. The amount of dividends paid automatically increases when member banks' equity increases.
Total	**–$1,086,022**	**n/a**

Legend: n/a = not applicable

Note: Deductions from revenues are shown as negative numbers.

Source: Federal Reserve System.

Adjustments to Current Revenue May Increase or Decrease Total Current Revenue

As shown in table 1.6, the Federal Reserve makes other adjustments to current revenue.

Table 1.6: Losses, Gains, and Adjustments to Federal Reserve Revenue as of 1994

Losses, gains, and other adjustments	1994 amount (000 omitted)	Definition
Sales of U.S. Treasury and agency securities	–$24,286	As the result of actions taken to implement monetary policy, respond to public demand for currency, and fluctuations in interest rates, the net profit (or loss) resulting from FOMC trading of U.S. government securities.
Sales or changes in value of foreign exchange or assets denominated in foreign currency	+2,422,626	As the result of actions taken to stabilize U.S. and foreign currencies, the net profit (or loss) resulting from the trading or holding of assets denominated in foreign currencies, as authorized by FOMC. Trading gains or losses occur when assets denominated in foreign currencies are sold. Reserve Banks also record translation gains or losses when fluctuations in exchange rates change the value of assets denominated in foreign currencies.
Adjustment to revenue for accounting rule changes and other items	+75,246	In response to changes in accounting principles or other items, additions and subtractions to current revenue.
Total	**+$2,473,586**	**n/a**

Legend:

FOMC = Federal Open Market Committee
n/a = not applicable

Note: Deductions from revenues are shown as negative numbers. In a few cases, adjustments may either be deductions from or additions to revenues, depending on Federal Reserve actions and market conditions during the year. These items are shown as negative or positive numbers, as appropriate.

Source: Federal Reserve System.

For example, gains and losses resulting from sales of U.S. Treasury and agency securities or changes in value of foreign exchange or assets denominated in foreign currencies are accounted for in adjustments to current revenue. Other gains or losses, such as those realized as the result of changes to accounting rules, are also accounted for in this way. In 1993, the Federal Reserve experienced a significant one-time deduction to revenues, primarily the result of the initial accrual of postretirement employee benefits required by a change in accounting rules.[12] In recent years, adjustments have been volatile because of gains or losses on assets denominated in foreign currencies, both from actual transactions and from revaluation to dollars of assets held in portfolio.

Objectives, Scope, and Methodology

Our objectives were to (1) analyze trends in the cost of Federal Reserve operations during 1988 to 1994 and the System's management processes for controlling spending and overseeing operations, (2) identify opportunities to increase the System's efficiency without adversely affecting its effectiveness, (3) identify ongoing and future developments that could significantly affect the Federal Reserve's mission and finances, and (4) assess the System's strategic management processes and identify actions the Federal Reserve could take to successfully meet future challenges and ensure the efficiency and effectiveness of its operations.

To analyze trends in the Federal Reserve's spending during 1988 to 1994, we developed a 7-year trend analysis on the expenses of the Federal Reserve. In addition, we examined the Reserve Banks' and the Board's cost-accounting systems to identify trends in the Federal Reserve's operating expenses by mission-related activity (such as services to financial institutions and Treasury) and types of expense (such as salaries, benefits, and travel). However, we did not audit these numbers and did not verify their accuracy. We reviewed a variety of financial-accounting, cost-accounting, staffing, and budgetary reports prepared by the Board and the individual Reserve Banks. To analyze the Federal Reserve's spending trends, we compared the System's levels of spending to inflation and levels of discretionary spending of the federal government during the same period. Due to the limitations of our audit authority, we did not analyze direct costs relating to the buying, selling, and holding of securities and foreign currency or other valuables in connection with the implementation of monetary policy.

To identify opportunities that exist to increase the System's efficiency without adversely affecting its effectiveness, we concentrated our work on personnel compensation, travel, and procurement and contracting. More specifically, we

- reviewed Board and Reserve Bank personnel compensation data and policies, travel policies, and samples of travel vouchers;

[12]This change was the adoption of the Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions."

- compared personnel compensation policies and regulations to those of selected federal agencies;
- developed and mailed a standardized data collection instrument, or questionnaire, to obtain pay and benefits information from the human resource officers at the eight Reserve Banks where we did not do detailed audit work in these areas;[13]
- contacted questionnaire respondents by telephone to further clarify questionnaire responses;[14]
- did an in-depth review of the procurement process at the San Francisco Reserve Bank, focusing on items with a cost of more than $25,000; and
- interviewed officials at three Reserve Banks who were responsible for procurement, reviewed procurement guidance, traced purchases through the payment process, and reviewed selected contracts.

To identify ongoing and future developments that could significantly affect the Federal Reserve's mission and finances, we

- analyzed studies, data, and other information and interviewed knowledgeable officials of the Federal Reserve on issues related to check clearing, currency processing, and bank supervision and
- interviewed officials and analyzed supporting documentation from the Federal Reserve Bank of Kansas City to determine how the automation consolidation project, the Federal Reserve Automation Services (FRAS), had affected its check-clearing priced service.

To assess the System's strategic management processes and identify actions the Federal Reserve could take to successfully meet these challenges and ensure the efficiency and effectiveness of its operations in the future, we

- reviewed and analyzed current and potential future trends in the workload of, and the cost of operating, the System's major services and lines of business;
- reviewed Federal Reserve planning documents and interviewed System officials about planning and management processes;
- reviewed the Federal Reserve's budgeting process, including the various budget proposals made throughout the budgeting cycle at the Board and

[13]We obtained data and information for the Reserve Banks only. In some cases, the 25 branch banks may have had different benefits, such as different cafeteria or mass transit subsidies.

[14]The questionnaires and interviews were completed in June and July 1994, and the information collected was for the calendar year 1993. In some cases we asked for cost estimates for various benefits. Where we were able to update these cost figures using the System's cost-accounting information for calendar year 1994, we did so.

the Reserve Banks (Chicago, Dallas, New York, and San Francisco) for the years 1988 through 1993;
- compared each of the Banks' budget proposal within a cycle to the previous proposal to determine whether the process promoted reduction in the size of the budget proposals;
- compared the Federal Reserve's actual expenses to the operating budgets and actual expenditures to capital budgets for the years reviewed to determine whether the System operated within its approved spending limits;
- obtained an understanding of the controls on major capital acquisitions by reviewing the process the Reserve Bank of Dallas used to obtain approval from the Board to construct its new bank building and compared the results of the process to the initially approved plans;
- conducted interviews focused on oversight with officials from the Board's OIG and DRBOPS;
- reviewed a number of OIG reports and analyzed the Federal Reserve Act and the Inspector General Act of 1978 and its subsequent amendments;
- interviewed Board officials who managed the Financial Examination Program and the Annual Performance Evaluation; DRBOPS managers who oversee the operating areas at the Reserve Banks; and the general auditors of the Reserve Banks at Chicago, Dallas, New York, San Francisco, and Richmond;
- reviewed the 1989 to 1993 financial examination reports and the 1989 to 1993 annual performance evaluation reports for the Reserve Banks of Chicago, Dallas, New York, and San Francisco; and
- reviewed the operations review reports conducted by DRBOPS, DHRM, and DBS&R.

We did our work in accordance with generally accepted government auditing standards at the Board of Governors in Washington, D.C., and at the Federal Reserve Banks in Chicago; Dallas; Kansas City, MO; New York; Richmond; and San Francisco from January 1994 through September 1995. We obtained written comments on a draft of this report from the Federal Reserve Board of Governors. The comments are discussed at the ends of chapters 3 and 5 and reprinted in appendix V. Staff of the Federal Reserve Board provided additional technical comments on the draft report, which were incorporated as appropriate.

The Federal Reserve Has Become Increasingly Expensive to Operate

In the 7-year period from 1988 to 1994, as many commercial banks restructured to reduce operating costs and increase revenues and Congress and the Executive Branch acted to constrain discretionary federal spending,[1] the cost to operate the Federal Reserve has increased steadily and substantially—from $1.36 billion in 1988 to $2.00 billion in 1994, or 48 percent. This percentage increase exceeded the 25-percent inflation that occurred during the same period, was also greater than the 17-percent increase in overall federal discretionary spending, and was almost the same as the 51-percent increase in federal nondefense spending. The growth in Federal Reserve expenses was caused by significant increases that occurred in expenses for bank supervision and regulation, personnel compensation, and extensive automation modernization and consolidation.

In Recent Years, Congress Has Acted to Control Spending and Banks Have Sought to Increase Efficiency

Since the early 1980s, federal budgeting has been dominated by concern about the budget deficit. In the mid-1980s, the deficit was greater than $200 billion; in the early 1990s, the deficit approached $300 billion. By 1985, the high deficit prompted the enactment of the Gramm-Rudman-Hollings Act (GRH), which established deficit targets for each year through fiscal year 1991, when the budget was to be balanced. GRH was amended in 1987. In 1990, Congress revised the GRH process with the Budget Enforcement Act of 1990 (BEA). Rather than focusing on fixed deficit targets, BEA was designed to limit legislative actions by limiting appropriations and restricting the creation or expansion of any entitlement program or tax cut.

BEA categorizes all federal spending as either discretionary (funded through annual appropriation acts) or direct (entitlements or spending that results from laws other than appropriation acts). BEA set discretionary spending limits—called caps—to control the aggregate amount that can be appropriated and expended for all discretionary programs in a fiscal year. Thus, all discretionary programs compete with each other within the caps. Direct spending programs are controlled by BEA's pay-as-you-go (PAYGO) rules. The main PAYGO requirement is that legislation enacted during a session of Congress which increases direct spending or decreases revenues, must be offset by revenue increases or a cut in another direct spending program. If the legislative action increases the deficit for a fiscal year, a sequestration from certain direct spending accounts occurs.

[1]Discretionary spending is that spending controlled through the appropriations process. It excludes interest on the national debt and entitlement programs. Examples of entitlement programs are Social Security, Food Stamps, and Medicaid.

In addition to these budgetary control mechanisms, the administration and Congress are attempting to make the federal government smaller and more cost efficient by reforming or "reinventing" its agencies and work processes. For example, the National Performance Review (NPR), under the direction of the Vice President, is an administration initiative that seeks to propose recommendations on how the federal government could work better and cost less.

Throughout the 1980s and into the 1990s, many U.S. banks also made strategic decisions to restructure their activities, cut operating costs, and generally develop more efficient operations. The U.S. banking system underwent this transition in response to intense domestic and international competition, technological and financial innovations, and changing market conditions.[2]

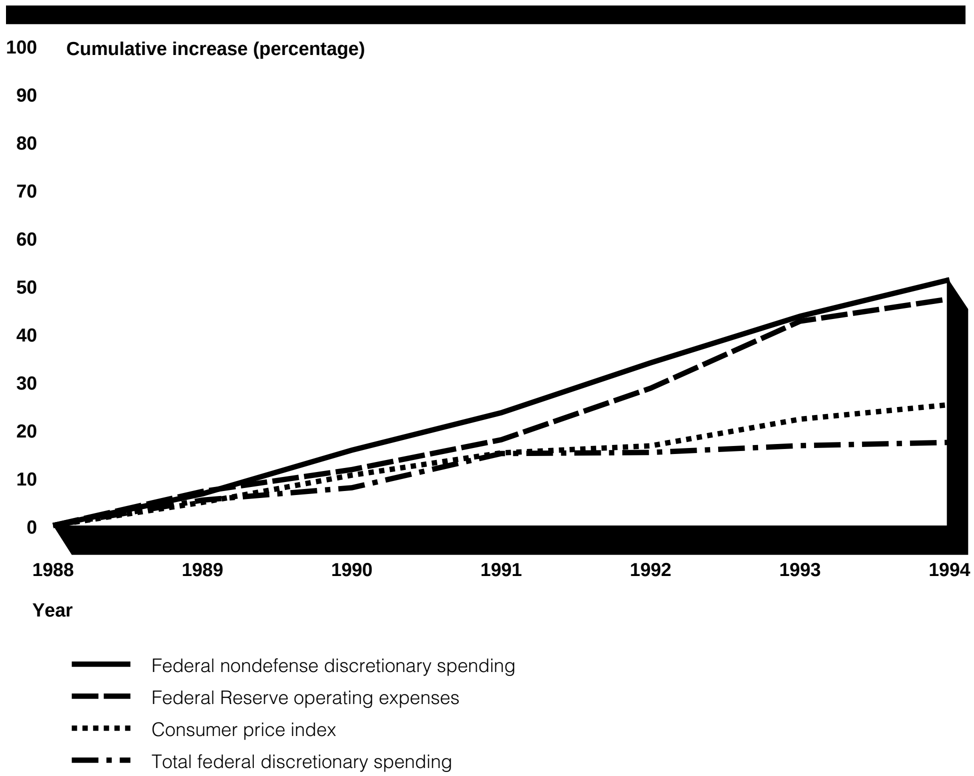
For several reasons, the Federal Reserve is not subject to the same cost-reduction pressures that are affecting both public agencies and private sector firms. The Federal Reserve, for example, is not subject to BEA, primarily because it operates without congressional appropriations and funds its operations and pays other expenses from the current revenue of the Reserve Banks. Also, unlike private firms, the Federal Reserve does not have a profit incentive to lower costs and increase efficiency.

The Increase in the Cost of the Federal Reserve Outpaced Inflation and Total Federal Discretionary Spending

From 1988 to 1994, as shown in figure 2.1, Federal Reserve operating expenses increased from $1.36 billion to $2.00 billion. This was an increase of about twice the amount of inflation and about 3 times the increase in overall federal discretionary spending that occurred in that period. During this same period, Federal Reserve operating expenses increased at about the same rate as the percentage increase for nondefense federal discretionary spending.

[2]Throughout the 1980s and into the 1990s, many U.S. banks faced serious asset quality problems resulting from problem loans to developing countries, excessive commercial real estate lending, and an economic recession and other factors.

Figure 2.1: Cumulative Increases in Federal Reserve Operating Expenses, 1988-1994



Sources: Federal Reserve Board and the budget of the United States.

The Federal Reserve Allocates Its Operating Budget to Mission-Related Areas and Expense Categories

The Federal Reserve uses cost-accounting systems that allocate operating budget expenditures to both mission-related categories and expense categories. For budgeting purposes and accounting, expenditures of the Federal Reserve are accounted for in five major mission-related areas of the System: monetary policy, supervision and regulation, services to financial institutions and the public, services to Treasury and other government agencies, and System policy and oversight. Costs of support and overhead, including Board expenditures for System policy direction and oversight, are allocated to each Federal Reserve mission activity.[3] The costs are distributed to the Federal Reserve mission activities in accordance with predetermined ratios derived by estimated usage. The Federal Reserve also categorizes operating expenses by expense categories. These categories include personnel compensation, equipment

[3]Support and overhead costs include, among other things, data communication and data-processing expenses, and legal and accounting expenses.

and software, buildings, travel, shipping, materials and supplies, and communication.

Supervision and Regulation Area Experienced the Highest Growth of All the Federal Reserve's Mission-Related Activities

As shown in table 2.1, although spending in all five of the Federal Reserve's mission-related activities increased during 1988 to 1994, the supervision and regulation area experienced the highest spending growth. The rate of spending increases in mission-related activities ranged from 34 percent (services to financial institutions and the public) to 102 percent (supervision and regulation). The growth in the supervision and regulation area resulted from staff increases in the area. Services to financial institutions and the public, services to government agencies, and bank supervision and regulation accounted for almost 90 percent of the Federal Reserve's costs. Within the services to financial institutions activity, expenses for priced services increased substantially less than those for nonpriced services. Priced services expenses increased the least of any mission-related activity.

According to Federal Reserve officials, growth in supervision and regulation expenditures was driven primarily by staff increases. These staff increases resulted from the implementation of the regulatory requirements mandated by banking reform laws, such as the Federal Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991.[4] The supervision and regulation area increased its staff over 42 percent during 1988 to 1994 from 2,456 to 3,498.[5] During the same period, both the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) had increased the size of their bank supervision and regulation staff by about 24 percent and 45 percent, respectively.

As shown in table 2.1, costs related to priced services rose by the smallest rate of growth during 1988 to 1994. The Federal Reserve has a significant incentive to restrain priced services costs because under the Monetary Control Act, fees for services are to be based on the recovery of expenses, and the System competes with the private sector in providing services to financial institutions. The Monetary Control Act requires the Federal Reserve to charge financial institutions for priced services, such as check

[4]According to Federal Reserve officials, about 200 examiners were hired just to implement the Foreign Bank Supervision Enhancement Act, Title 2 of FDICIA.

[5]The number of staff is derived from the average number of personnel, which measures the number of employees in terms of full-time positions for the time period.

processing, and to recover its costs. In addition, the Federal Reserve competes with private check clearinghouses and automated clearinghouse (ACH) networks in processing checks and conducting ACH transactions.

Table 2.1: Federal Reserve's Calendar Year Operating Costs by Mission-Related Categories, 1988 and 1994

Activities	1988 (millions)	1994 (millions)	Percentage change
Monetary and economic policy	$134.0	$185.4	38.4
Supervision and regulation	208.0	420.7	102.3
Services to financial institutions			
Priced services[a]	559.2	712.3	27.4
Nonpriced services[b]	296.3	436.9	47.4
Subtotal	**855.5**	**1,149.2**	**34.3**
Services to government agencies	141.5	218.2	54.2
System policy and direction	18.4	29.6	60.9
Total	**$1,357.5**	**$2,003.1**	**47.6**

[a]Priced services include Automated Clearinghouse, Fedwire, check, and book entry securities.

[b]Nonpriced services are those services for which the Federal Reserve does not charge financial institutions, such as currency processing and the lending of the discount window.

Source: Federal Reserve System.

Federal Reserve Operating Costs Increased Significantly, With Personnel Compensation Accounting for Most of the Increase

As shown in table 2.2, the three Federal Reserve expense categories with the largest growth rates were equipment and software (85 percent), travel (66 percent), and personnel compensation[6] (53 percent) during 1988 to 1994. The percentage growth in Federal Reserve expenses for personnel compensation, equipment and software, building, and travel all exceeded the amount of inflation (25 percent).

[6]Personnel compensation includes salaries; medical, dental, and life insurance; retirement contributions; and other benefits, such as transportation subsidies.

Table 2.2: Federal Reserve Expenditures by Expense Categories for Calendar Years 1988 and 1994 and Percentage Change During 1988-1994

Dollars in thousands

Expense category	1988	1994	Amount of increase	Percentage change
Personnel compensation	$858,311	$1,314,200	$455,889	53.11
Equipment and software[a]	157,016	290,962	133,946	85.31
Building[a]	120,564	170,364	49,800	41.31
Travel	28,519	47,238	18,719	65.64
Other[b]	193,061	180,366	–12,695	–6.58
Total	**$1,357,471**	**$2,003,130**	**$645,659**	**47.56**

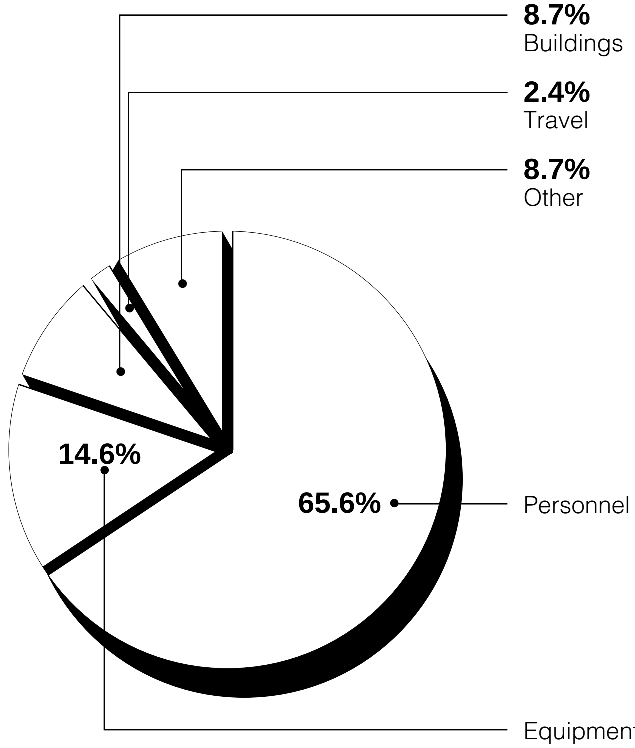
[a]The amounts and rates shown in these categories are derived from amounts in the Federal Reserve's operating expenses, which, for capital acquisitions, recognize only the cost of depreciation.

[b]The "Other" category includes expense categories for shipping, materials and supplies, and communication.

Source: Federal Reserve System.

The most significant expense category during the period of 1988 to 1994 was personnel compensation, which accounted, in 1994, for nearly two-thirds of the Federal Reserve's operating budget and over 70 percent of the total growth in the System's operating budget. (See fig. 2.2.) Personnel compensation expenses increased from $858 million in 1988 to $1.3 billion in 1994—an increase of $456 million, or about 53 percent.

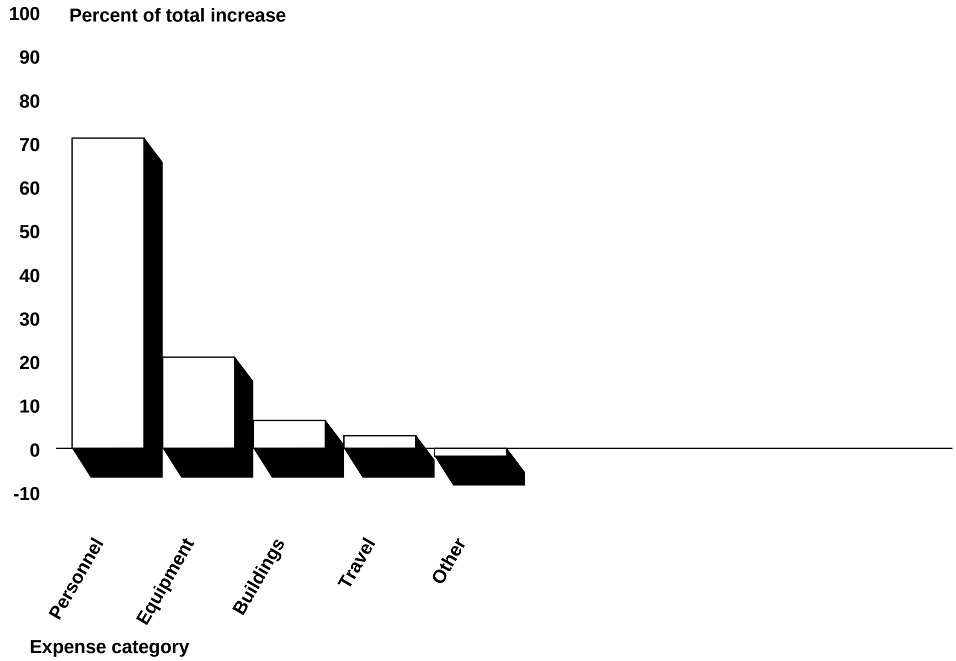
Figure 2.2: Federal Reserve's 1994 Operating Expenses, by Expense Category



Source: Federal Reserve System.

Thus, any increase in personnel compensation costs would have a disproportionate impact on the overall increase in Federal Reserve spending. As shown in table 2.2, the overall increase in Federal Reserve operating expenses from 1988 to 1994 was about $646 million; personnel compensation accounted for about $456 million, or 71 percent, of this increase. Figure 2.3 shows the contributions (by percentage) of each major expense category to this $646 million increase.

Figure 2.3: Contributions of Expense Categories to the Overall Increase in System Expenses



Source: Federal Reserve System.

Three Factors Contributed to the Increase in Federal Reserve Personnel Compensation Costs

Increases in staffing levels and in the overall cost of benefits as well as the changes in the workforce composition of the Federal Reserve contributed to the rising cost of System personnel compensation in the 1988 to 1994 period. The percentage increases for the Federal Reserve's staffing levels and its overall cost of benefits exceeded the comparable percentages for the federal government (see table 2.3). Salary growth in the Federal Reserve and the federal government was comparable during the period.

Table 2.3: Percentage Increases in Staffing and Overall Costs of Salaries and Benefits in the Period of 1988-1994

Factors	Federal Reserve System	Federal government
Staffing levels	4%	–2%
Benefits, per employee	96[a]	62
Salaries, per employee	39	36

[a]To compare the cost of Federal Reserve benefits with the federal government, we adjusted the data for the System benefits for accounting standards not followed by the federal government.

Source: Federal Reserve System and the U.S. budget.

More specifically, System benefits have been adjusted to account for the Federal Reserve's decision to start, in 1987, to amortize the overfunded portion of its pension plan. The effect of this action has been to reduce the Federal Reserve's expenses. In addition, the Federal Reserve started in 1993 to accrue the cost of health benefits for its retired employees. The federal government's employee pension program is prefunded, but it and postretirement health benefits have an unfunded liability.

Staffing and Salary Levels

While the federal government's overall staffing level declined by 2 percent, the overall staffing level of the Federal Reserve increased from 24,829 to 25,744, or by about 4 percent. This percentage increase is about the same as employment growth in the federal government outside the Department of Defense.[7] Viewed in terms of mission-related activities, the level of staffing shifted considerably from 1988 to 1994, as shown in table 2.4.

Table 2.4: Changes in Federal Reserve Staffing by Activity, 1988-1994

Category	1988	1994	Percentage change
Board of Governors[a]	1,484	1,635	+10
Reserve Banks, by activity			
Monetary and economic policy	766	729	–5
Services to Treasury and other agencies	1,819	1,754	–4
Services to financial institutions	9,033	8,302	–8
Supervision and regulation	2,209	3,079	+39
Support	4,562	5,062	+11
Overhead	4,956	5,183	+5
Total Reserve Bank staffing	23,345	24,109	+3
Total	**24,829**	**25,744**	**+4**

Note: Table staffing numbers reflect the average number of persons.

[a]System accounting does not allocate Board staffing by mission-related activity.

Source: Federal Reserve System.

The largest increase in staffing occurred in supervision and regulation, whose staff tend to be white-collar employees, primarily bank examiners.

[7]The decrease in federal government civilian employment reflects primarily a 14-percent decrease in the Department of Defense. Employment in the rest of the government increased by 4 percent over the 1988 to 1994 period. (Federal government employment is measured on a full-time equivalent basis.)

The second-largest increase occurred in support, due primarily to new, automated data-processing professionals, also white-collar staff. The largest decrease in staffing occurred in services to financial institutions, which is an area of activity with a larger proportion of blue-collar workers who handle functions in check and currency processing.

Federal Reserve salary costs, which amounted to a total of about $1 billion in 1994, constituted 79 percent of System personnel compensation costs in 1994. During 1988 to 1994, the Federal Reserve salary costs increased by 44 percent compared to an increase of 33 percent for the federal government. Adjusting for the Federal Reserve's increase in staffing, we compared the salary costs of the System and the federal government on a per employee basis for the period of 1988 to 1994. The results showed that the 39-percent increase in the per employee cost of Federal Reserve salaries was slightly higher than the 36-percent increase in the per capita salary cost in the federal government. The growth in the Federal Reserve's overall salary costs can be attributed to the increase in new professional positions created by the Federal Reserve during 1988 to 1994.

Cost of Benefits

During 1988 to 1994, the cost of benefits represented an increasingly larger share of the Federal Reserve's personnel compensation costs—16 percent in 1988 and 21 percent in 1994. During this same period, the cost of Federal Reserve benefits increased by 98 percent compared to an increase of 59 percent for the federal government. Again, adjusting for the Federal Reserve's increase in staffing, we compared the benefit costs of the System and the federal government on a per employee basis for the period of 1988 to 1994. The results showed that the increase in the per employee cost of Federal Reserve benefits (96 percent) was higher than the increase for the federal government (62 percent). The difference in the growth of Federal Reserve and federal government benefits can be attributed to (1) higher costs for benefits offered to existing staff and (2) the additional cost of benefits for new positions created by the Federal Reserve in the period.

Travel and Equipment and Software Had the Greatest Growth in the Federal Reserve's Operating Expenses

Although travel and equipment and software expenses constituted a small portion of the System's operating expenses, during 1988 to 1994, these expenses had the highest growth rates in operating expenses. As previously mentioned, equipment and software and travel expenses increased by 85 percent and 66 percent, respectively. The growth in the equipment and software expenses primarily resulted from the depreciation/amortization expenses in equipment, including computers and software.

The cost of the Federal Reserve's travel expenses increased significantly more than the federal government's travel expenses during 1988 to 1994. The Federal Reserve's travel expenses increased by 66 percent compared to 26 percent for the federal government. This may be due, in part, to differences in the travel policies of the Federal Reserve and the federal government.

Automation and Construction Projects Accounted for Much of the Reserve Banks' Capital Expenditures

During 1988 to 1994, the Reserve Banks spent about $1.7 billion on capital acquisitions. Costs for capital expenditures are allocated to a budget separate from the Reserve Banks' operating budget. During 1994, the Reserve Banks spent approximately $270 million to acquire capital assets, such as computer equipment and software for the Federal Reserve's automation and consolidation project, which is known as FRAS. The Reserve Banks' 1994 capital expenditures represented a 60-percent increase from the 1988 expenditures. However, unlike operating expenses, which increased steadily every year, the growth in the capital expenditures was somewhat sporadic, increasing in some years and decreasing in other years. We did not compare the Reserve Banks' capital acquisitions to the federal government's capital acquisitions because of the differences in the way capital spending is tracked.

As previously mentioned, the large growth in the Reserve Bank's capital expenditures was partially the result of FRAS. Three automation consolidation centers will consolidate most of the independent mainframe operations of the 12 Reserve Banks, providing consolidated mainframe and contingency support for, among other things, the Federal Reserve's mission-critical payments system. The three FRAS centers are at the Dallas and Richmond Reserve Banks and the East Rutherford Operations Center of the New York Federal Reserve. As of December 31, 1994, the total capital acquisition cost, primarily for computer and software, was $242 million.

Conclusions

While many commercial banks were downsizing their organizations and the federal government was constraining spending, the Federal Reserve's costs were steadily increasing. During 1988 to 1994, the cost of operating the Reserve Banks and the Board increased by 48 percent—nearly twice the amount of inflation. The growth in the Federal Reserve's operating budget was primarily produced by cost increases in the supervision and regulation area and in the expense categories of personnel compensation, travel, and equipment.

Although the Federal Reserve's expenditures increased in all five mission-related areas, supervision and regulation experienced the most growth during 1988 to 1994. The priced services area—where the Monetary Control Act requires the Federal Reserve to recover costs and the Federal Reserve competes with the private sector in providing services to financial institutions—had the lowest cost growth. Thus, where the System had significant incentives to constrain costs, it appeared to have done so.

Personnel compensation costs, accounting for nearly two-thirds of the operating budget, grew by 53 percent during 1988 to 1994. Also, personnel compensation costs represented over 70 percent of the growth in the Federal Reserve's operating budget. The growth in Federal Reserve benefits and the increase of professional employment at the Reserve Banks contributed to the rise in the Federal Reserve personnel compensation costs.

Opportunities Exist to Reduce Federal Reserve Operating Expenses

The results of our review of many policies and practices of the Board and Reserve Banks indicated that opportunities exist to reduce the Federal Reserve's spending. Federal Reserve personnel compensation (pay and benefits) varied within the Federal Reserve and included benefits that were relatively generous compared to those of government agencies with similar responsibilities. We also found that improvements and greater uniformity in Reserve Bank policies and practices relating to travel reimbursements, contracting and procurement, and construction planning could reduce operating and capital spending costs and reduce the Reserve Banks' risk of potential conflict of interest and favoritism. For example, we found that the Federal Reserve overlooked opportunities to reduce costs in planning and managing the design of the new Dallas Reserve Bank building. Finally, we found that a reduction in annual Federal Reserve transfer to its surplus account, while not representing a direct reduction in Federal Reserve expenditures, would have a positive budgetary impact in the year that any such reductions occurred.

The Federal Reserve's Personnel Compensation System Seeks to Compensate Employees on the Basis of the Local Labor Markets

The boards of directors of the 12 Reserve Banks supervise and control the Reserve Banks, subject to the general supervision of the Board of Governors. The Board employs individuals who are necessary to conduct the business of the Board. It also sets employee salaries and benefits; approves compensation paid by Reserve Banks to their employees; and establishes regulations, policies, and practices covering employee benefits. The Reserve Banks and Board have established differing employee pay levels and benefits. Except for the salaries of the Chairman and members of the Board, Federal Reserve salaries are not limited by ceilings established by the civil service pay system. Salaries at some other federal financial regulators, notably OCC and FDIC, also have not been limited by civil service pay rules.[1]

Two important objectives of the Federal Reserve's compensation system are to (1) attract, retain, and motivate qualified employees at all levels of responsibility and (2) be externally competitive with local and/or regional labor markets. To accomplish these objectives, the Board and 12 Reserve Banks conduct individual salary surveys of private and public institutions with related job positions in local labor markets. The Board and Reserve Banks also survey other organizations periodically as they make benefit decisions. While we sought to understand the nature and scope of the

[1]For example, FDIC is not bound by either the Classification Act or the general schedule (GS) pay scale. It can administratively establish its own salary structure. The fifth paragraph of section 1819 of Title 12, the FDIC Act of 1950, grants authority to the FDIC Board of Directors to fix compensation.

Federal Reserve's surveys, we did not verify or analyze the data and methodology used in these surveys.

To determine whether opportunities exist to reduce the Federal Reserve's costs of operation, we reviewed personnel pay and benefits at the Reserve Banks and Board. We compared the general procedures for setting Reserve Board and Banks' salaries to those of the federal government. We compared the specific benefits offered Board and Reserve Bank employees to those of federal financial regulatory agencies with responsibilities analogous to some responsibilities of the Federal Reserve. The federal agencies whose salaries and benefits served as comparisons were FDIC, OCC, and the Securities and Exchange Commission (SEC). OCC and FDIC generally are not subject to civil service limitations in providing salaries and benefits to their employees, while SEC is subject to such limitations. We did not attempt to analyze differences in employee responsibilities when we compared Federal Reserve salary levels and benefits to those of FDIC, OCC, and SEC.

Federal Reserve Salary Levels Were Adjusted to Be Competitive With Local Labor Markets

The Federal Reserve attempts to offer salaries competitive with private sector organizations. The Federal Reserve is not constrained by maximum limits when setting its salaries for most positions. (The notable exceptions are the salaries for the Governors of the Board, including the Chairman.)[2] In addition, both Board and Reserve Bank salaries are based on independent salary surveys of organizations that have similar local labor forces. As a result, the Federal Reserve offers salaries that are competitive with private sector organizations in a given locality. In contrast, most civil service salaries are subject to maximum levels, the highest of which is level IV of the executive pay schedule, which was $115,700 in 1994.

In 1990, Congress passed the Federal Employees Pay Comparability Act (FEPCA), which provided for a comprehensive, long-term pay reform program designed to ultimately make federal salaries more competitive with the private sector. Under FEPCA, locality pay adjustments were to be phased in over a 9-year period beginning in 1994. The goal was to reduce pay disparities between federal white-collar workers and nonfederal workers to no more than 5 percent by the year 2002. However, budget constraints have already resulted in reductions of scheduled locality pay adjustments for federal workers for 1995 and 1996. Thus, in contrast to the

[2]Salaries of the Chairman and other Board members are established by law (5 U.S.C. 5313 and 5314) under the Federal Executive Pay Schedule.

Federal Reserve, civil service agencies, including SEC, have been unable to offer their employees salaries comparable to those in local labor markets.

Other federal financial regulators do not face these constraints. FDIC employees received salaries with geographic differentials that amounted to up to 31 percent more than civil service basic pay levels. OCC's salary structure, which had a maximum base salary of $166,400, also provided employees with geographic pay differentials of up to 34 percent of OCC's base salary levels. FDIC and OCC salaries are, with some exceptions, not limited to ceilings established by the civil service pay system; notable exceptions are the salaries of members of FDIC's board of directors and the salary of the Comptroller of the Currency.

One interesting result of the statutory limits on the Governors' salaries, coupled with the ability of the Federal Reserve to set competitive salaries for other positions, is that a substantial number of Federal Reserve employees are paid more than the Chairman of the Board. Specifically, 120 top-level Federal Reserve officials, including all Reserve Bank presidents, earned more in 1994 than the Chairman. In 1994, the annual salaries of Reserve Bank presidents ranged from $159,600 to $229,600, while the Board Chairman's salary was $133,600 (the maximum allowed), and each of the other Board members' salary was $123,100. Appendix III provides the titles and the number of Federal Reserve employees who earn more than the Board Chairman and also shows the 1994 salaries for the presidents of the 12 Reserve Banks.

The Board and Reserve Banks Offered a Variety of Benefits

Although employee benefits at the Board and Reserve Banks differed in many respects, some Federal Reserve benefits were systemwide and available at the same levels to all Federal Reserve employees. Systemwide benefits included retirement plans, the thrift savings plan, business travel/accident insurance, life and survivor insurance, and a long-term disability income plan. Other benefits not offered on a systemwide basis included mass transit subsidies and leave granted for marriage, bereavement, family care, and floating holidays.

From our review of the Federal Reserve's personnel policies and practices, we found that a few Federal Reserve benefits were more generous than those available to OCC and FDIC and many were more generous than civil service benefits, such as those available to SEC. Also, the Federal Reserve provided additional benefits to some high-level officials, including home security systems, bodyguards, and home-to-work transportation in Federal Reserve-owned vehicles.

Federal Reserve Health Care Benefits Were Managed on a Decentralized Basis

All 12 Reserve Banks offered their employees comprehensive health insurance packages. Although the Board paid the same health care premiums as other federal agencies (payments that ranged from about 60 to 75 percent) the percentage of premiums paid by Reserve Banks differed. Most Reserve Banks paid 75 to 90 percent of health insurance premiums. Appendix III shows the percentage of health insurance premiums paid by the Reserve Banks, the Board, FDIC, OCC, and SEC. The total health care cost paid by the Board and the Reserve Banks in 1994 was $7.5 million and $64.9 million, respectively.

Recognizing that health care costs are escalating, Reserve Banks are attempting to reduce health plan costs. Federal Reserve health care benefits were managed on a decentralized basis, with each Bank negotiating its own health care coverage. One Reserve Bank eliminated its preferred provider option previously available to employees, replaced it with a managed care network, and reduced the number of available health maintenance organizations. Federal Reserve officials estimated that health care costs would have been about $900,000 more for 1993 without these changes. Another Reserve Bank reduced the number of health care plans available to employees to two effective in April 1994; officials estimated resulting savings of about $2.3 million over the following 3 years. Although the Reserve Banks have individually made efforts to reduce health care costs, the Reserve Banks have not worked together to determine whether their combined bargaining powers would further reduce these expenses.

Some Federal Reserve Leave Policies Differed From Those of Other Federal Financial Regulators and Civil Service

The number of days allowed for annual and sick leave differed significantly among the Reserve Banks and between the Reserve Banks and the Board. The Board, along with FDIC, OCC, and SEC, followed the civil service guidelines, which provide between 13 and 26 days for annual leave and 13 days for sick leave each year. The number of annual leave days available to Reserve Bank employees ranged from 10 to a maximum of 23 to 32 days per year, depending on length of service. Thus, relatively junior Reserve Bank employees were granted fewer annual leave days than civil service permits, but more senior employees could accrue more annual leave days each year than civil service permits. However, some Reserve Banks offered additional paid leave for certain purposes, such as bereavement or marriage, which was in addition to annual leave. Among the Reserve Banks, the number of sick days employees accrue varied considerably. Six Reserve Banks offered fewer sick leave days annually than civil service employment (ranging from 8-1/4 to 12 days), while two others offered sick leave in the range of 15 to 18 days. Other Reserve Banks appeared to offer more generous sick leave policies. Tables III.7 and III.9 in appendix III show the leave benefits available at the Reserve Banks, the Board, FDIC, OCC, and SEC.

Comparison of Federal Reserve and Other Federal Employee Retirement Programs

Federal Reserve Board and Bank employees do not participate in the retirement programs that cover most federal civilian employees. Separate retirement programs apply to Board and Reserve Bank employees.

Before 1983, Board employees, along with federal employees in general, were not covered by the Social Security program. Board employees were under the Federal Reserve Board Retirement System (FRBRS), and other federal employees were under the Civil Service Retirement System (CSRS). Even though they were separate, the two systems' provisions were virtually identical. In contrast, Reserve Bank employees were not considered to be employed by the federal government. They were covered by Social Security and a separate retirement system designed to complement their Social Security benefits.

The Social Security Amendments of 1983 required all federal employees, including Board employees, first hired after December 1983 to participate in Social Security. Accordingly, new retirement systems had to be developed to recognize the availability of Social Security benefits for the covered employees. The Federal Employees' Retirement System (FERS) was developed to cover federal employees in general. However, rather than develop a new retirement system for future Board employees, the Federal Reserve decided that they would be covered by the retirement system already in place for Reserve Bank employees.

In addition to the pension benefits available from the FRBRS and Reserve Bank retirement systems, Board and Reserve Bank employees can earn additional retirement income through participation in a thrift plan sponsored by the Federal Reserve. The thrift plan includes two components—a savings account and a deferred compensation account. Employees may contribute to either or both accounts. Employee contributions to the savings account are made with after-tax dollars, and contributions to the deferred compensation account are made with pretax dollars. For each dollar an employee contributes to the thrift plan, up to

6 percent of salary, the Federal Reserve matches 80 percent of the employee's contributions. Thus, the maximum employer contribution to any employee's thrift plan is 4.8 percent of salary. Employees may contribute additional amounts to the thrift plan with no matching contributions by the Federal Reserve.

Even though the pension benefits available to other federal employees in CSRS and Board employees in FRBRS are the same, Board employees have the distinct advantage of being eligible to participate in the thrift plan and receive matching contributions from the Federal Reserve. Employees in CSRS may contribute to a thrift plan, but receive no contributions from their employing agencies.

The Reserve Bank pension plan differs from the FERS pension plan that applies to federal employees in general. Some of the features of the Reserve Bank plan are less generous than the counterpart features of FERS. For example, Reserve Bank plan's benefits are based on employees' average salaries earned during their 5 highest-paid years, while FERS' benefits are based on employees' average salaries earned during their 3 highest-paid years. Also, Reserve Bank employees must be at least age 60 with 30 years of service to retire with unreduced retirement benefits, while FERS provides unreduced benefits as early as age 55 with 30 years of service.[3] However, these FERS advantages are more than offset by a number of significant features of the Reserve Bank plan that are superior to FERS. Some of the features where the Reserve Bank plan is more generous than FERS are as follows:

- The Reserve Bank plan is free to employees; FERS requires employees to contribute .8 percent of their salaries toward plan costs.
- The Reserve Bank plan's benefit calculation formula provides considerably greater benefits than the FERS formula. In the Reserve Bank plan, benefits are equal to 1.3 percent of average salary up to the Social Security integration level and 1.8 percent of average salary over the integration level multiplied by total years of service. (The integration level is the average of the maximum amounts of salary covered by Social Security from 1959 through the year of retirement. For employees retiring in 1995, the integration level was $24,312). In the FERS plan, the formula for each year of service is 1.1 percent of average salary for retirees who are at least age 62 with 20 years of service. For retirees who are younger than

[3]Under provisions of the FERS Act, the FERS retirement age advantage will be less in the future. Retirement eligibility at age 55 is available under FERS only to employees who were born before January 1, 1948. The age requirement gradually increases until it reaches age 57 for employees born after December 31, 1969.

age 62, the FERS benefit formula is 1 percent of average salary for each year of service.

- The Reserve Bank plan allows employees as young as age 50 to voluntarily retire early with reduced benefits. FERS does not have a similar provision. Under FERS, employees cannot voluntarily retire before age 55 unless they or their agencies are facing involuntary employee separations.

FERS also includes a thrift plan to which covered employees and their agencies can contribute to increase retirement income. The FERS thrift plan is designed somewhat differently from the Federal Reserve thrift plan; overall, it provides slightly greater benefits to participating employees. Unlike the Federal Reserve thrift plan, all employees in FERS receive agency contributions equal to 1 percent of their salaries regardless of whether the employees make any contributions. The agencies then match, dollar-for-dollar, employee pretax contributions of up to 3 percent of salary and 50 cents on the dollar for the next 2 percent of salary that employees contribute to the thrift plan. Thus, compared to the maximum 4.8 percent of salary the Federal Reserve will contribute to an employee's thrift plan, employing agencies will contribute as much as 5 percent of employees' salaries to the FERS thrift plan. Also, to receive the maximum employer contribution of 4.8 percent of salary, Board and Reserve Bank employees must contribute 6 percent of their salaries. Employees in FERS can receive employer contributions of 5 percent of salary by contributing 5 percent of their salaries to the FERS thrift plan.

A Number of Other Federal Reserve Benefits Were Not Available to Civil Service Employees

As shown in table 3.1, the Federal Reserve offered a few benefits to its employees that are generally not offered to civil service employees. These benefits included separate dental insurance, subsidized employee cafeterias, premium conversion accounts, flexible spending accounts, matching contributions for savings accounts, and mass transit subsidies. In addition, some banks offered marriage, bereavement, parental care, and floating holiday leave as leave categories separate and distinct from the usual annual and sick leave offered. Appendix III provides a full description of these selected Federal Reserve benefits and their availability at FDIC, OCC, and SEC.

Table 3.1: Benefits Available to Federal Reserve, FDIC, OCC, and SEC Employees During 1993

Benefits	Board of Governors	Number of Reserve Banks (12 total)	FDIC	OCC	SEC (civil service)
Health insurance	Yes	12	Yes	Yes	Yes
Dental insurance	Yes	12	Yes	Yes	No
Subsidized cafeteria/Dining room	Yes	12	Yes	Yes	[a]
Premium conversion account	Yes	12	Yes	Yes	No
Flexible spending account	Yes	11	Yes	Yes	No
Thrift savings plan	Yes	12	Yes	Yes	Yes
Savings plan	Yes	12	Yes	Yes	No
Annual leave	Yes	12	Yes	Yes	Yes
Sick leave	Yes	12	Yes	Yes	Yes
Marriage leave	No	4	No	No	No
Bereavement leave	No	11	No	No	No
Family care leave[b]	No	3	No	No	No
Floating holidays	No	10	No	No	No
Mass transit subsidy	Yes	4	No	No	Yes
Home security systems	Yes (for the Chairman)	8 (for 8 presidents, 5 first VP, 1 executive VP, and 1 senior VP)	No	No	No
Home-to-Work transportation in agency vehicle	Yes (Chairman only)	12 (59 employees, including all presidents)	No	No	No
Employee store	Yes	6	No	No	No
Employee lounge	No	10	No	No	No
On-site exercise facility	Yes	11	Yes	Yes	Yes
Employee parking	Yes	12	Yes	Yes	Yes
Tuition assistance program	Yes	12	Yes	Yes	Yes[c]
Business travel/Accident insurance	Yes	12	Yes	Yes	No (covered by credit card)
Civil Service Retirement System	Yes	[d]	Yes	Yes	Yes
FERS	Yes	[d]	Yes	Yes	Yes
Other agency-managed retirement plan	Yes	12	No	No	No
Long-Term Disability	Yes	12	Yes	Yes	Yes
Life insurance	Yes	12	Yes	Yes	Yes

(Table notes on next page)

Legend:

FDIC = Federal Deposit Insurance Corporation
OCC = Office of the Comptroller of the Currency
SEC = Securities and Exchange Commission
VP = Vice President
FERS = Federal Employees' Retirement System

[a]SEC has no cafeteria.

[b]The Federal Reserve Board of Governors, some Federal Reserve Banks, FDIC, OCC, and SEC allow their employees to use annual or sick leave for family care.

[c]Available only to employees in grades GS-8 and below.

[d]The Reserve Banks are not covered under these plans.

Sources: GAO analysis of information provided by the Federal Reserve Board; 12 Federal Reserve Main District Banks; and FDIC, OCC, and SEC headquarters.

Federal Reserve Bank Travel Policies Are Not Uniform and Represent an Opportunity to Reduce Costs

To determine whether opportunities existed to reduce the Federal Reserve's operational costs, we also reviewed travel reimbursement policies within the Federal Reserve. Each year, the Board and the Reserve Banks spend millions of dollars for employee travel. In 1994, for example, the total of travel expenditures for the Federal Reserve was $42 million. According to Board officials, Board personnel are authorized to use government rates for lodging and airfare. Some Reserve Bank officials we interviewed stated that Reserve Bank employees are ineligible for government rates for lodging and airfare because the Reserve Banks are not federal agencies.[4] However, one Bank official disagreed, stating that Reserve Bank employees can request government rates for lodging, but cannot insist on receiving government rates.

Travel Reimbursement Policies Varied Within the Federal Reserve

Under regulations comparable to those for other federal employees, Board employees are reimbursed for lodging and meal expenses on a per diem basis. However, members of the Board are permitted to receive reimbursement for domestic lodging and meals on either an actual expense or per diem basis, when deemed appropriate. The Board's general policy directive for Reserve Bank travel expenditures allows for variations in Reserve Bank reimbursement procedures. These differences can result in additional expenditures. One Reserve Bank we reviewed had maximum lodging reimbursement rates, while another Reserve Bank had

[4]Reserve Bank employees performing Board-delegated duties, such as financial institution examinations, are reimbursed on the basis of the Reserve Bank's travel policies, not the Board's. Bank examiners at FDIC and OCC are able to take advantage of Federal airfare and lodging rates.

recommended reimbursement rates.[5] However, two Reserve Banks reimbursed at cost without maximum or recommended rates. As a result of these policy differences, two travelers' overnight lodging allowances for the same city could vary widely, depending on each traveler's Reserve Bank.

In addition to the differences noted in lodging costs, Reserve Banks reimbursed employees for meals using varying schedules and rates. Two Reserve Banks reimbursed travelers for meals on the basis of a schedule that divided the day into four quarters, while another Reserve Bank used a more narrowly defined schedule that aligned with typical meal times. Additionally, another Reserve Bank reimbursed travelers for meals depending on whether they were traveling to a Federal Reserve System entity versus other locations. Of the Reserve Banks we reviewed, two also allowed employees to choose actual cost reimbursement rather than a flat per diem rate. As a result of these policy differences, the total meal reimbursement for a 3-day trip to the Board in Washington, D.C., could range from $76 to $105.

We believe making travel policies uniform within the Federal Reserve could provide an opportunity to reduce Federal Reserve expenses, particularly if caps on reimbursements were set below current levels. In addition, more uniform policies could result in some administrative costs reductions, particularly if common travel policies would enable travel expenses to be managed on a more centralized basis, thus reducing the need for staff time devoted to travel administration at each Reserve Bank.

Improved Contracting and Procurement Practices Could Result in Cost Efficiencies

To determine whether opportunities existed to reduce the Federal Reserve's operational costs, we also reviewed procurement and contracting practices at several Reserve Banks. Unlike personnel costs that remain relatively stable, expenses associated with capital acquisitions can vary significantly from year-to-year, offering additional opportunities for controlling and reducing procurement costs. The 12 Reserve Banks spent more than $560 million in 1994 to acquire buildings, equipment, supplies, and services. Nearly half of the total ($267 million) was used to buy capital items (buildings and equipment) and fund building projects. As discussed in chapter 1, only depreciation costs of capital assets are accounted for in annual operating budgets.

[5] The maximum lodging rate is a set dollar amount above which the employee will not be reimbursed, except in special, approved circumstances. On the other hand, the recommended reimbursement rate is a suggested dollar amount used by employees as a guideline when making travel arrangements.

Because the Board and Reserve Banks spend millions each year for goods and services, certain controls should be in place to ensure that those dollars are spent wisely. For example, the Reserve Banks should have an effective procurement and control process in place to ensure that they receive goods and services at the most reasonable cost. Moreover, to prevent fraud and abuse, the procurement practices should also preclude potential conflicts of interest between the Reserve Banks and contractors.

The Board and the Reserve Banks used different procurement guidelines. Although not specifically directed to do so by the Federal Reserve Act, a spokesman for the Board told us that the Board follows the spirit of the federal government contracting rules, which are contained in the Federal Acquisition Regulations (FAR). Reserve Banks are not required to follow these rules.

However, each Reserve Bank is required to follow general procurement guidance, called Uniform Acquisition Guidelines (UAG), which were adopted by the Reserve Banks in 1985. The UAGs were developed by the Reserve Banks in conference committees. They were designed to provide minimum requirements for Reserve Bank procurement activities. By providing opportunities for all interested bidders to become a selected source, the guidelines attempt to ensure that Reserve Banks treat sources fairly and impartially. By fostering competition in the procurement process, Reserve Banks will also have a greater opportunity to realize cost savings through lower competitive pricing.

Despite the UAGs, we observed the following:

- Practices at individual Reserve Banks differed significantly and some practices favored certain sources over others. For instance, some Reserve Banks did not allow an equal opportunity for new bidders to bid for large procurements and limited bidders lists to sources with which the Reserve Banks had traditionally done business. This practice existed even though other equally qualified sources were both available and interested. Furthermore, some Reserve Banks retained incumbent contractors for certain services for years without recompeting the award, thus precluding other firms from competing for those services. At one of the four Reserve Banks we visited, the records indicated that the cafeteria contract was last competed over 9 years ago. At another Reserve Bank we visited, personnel could not locate documentation of their last cafeteria contract negotiations, which they believed occurred in the late 1980s. By limiting the ability of other sources to compete for a contract, Reserve Banks tend to reduce competition, thereby missing opportunities to reduce procurement costs.

- Proper controls over conflict of interest were not followed at certain Reserve Banks. For instance, the UAGs prohibit disclosure of specific information contained in bids or proposals to anyone except Reserve Bank personnel before awarding the contract. However, two of the four Reserve Banks we visited transferred almost all functions leading up to the award of major building contracts to architecture and engineering (A&E) firms. A&E firms receive and evaluate bids and recommend the source that should receive the award. In contrast, at the other two Reserve Banks we visited, only Reserve Bank personnel were allowed to receive and evaluate the bids or proposals and choose the successful source. The building department's vice president at one of the four Reserve Banks told us that the larger the role the A&E firm plays, the greater the potential for favoritism and conflict of interest.
- Practices at certain Reserve Banks lacked independent checks and reconciliations. Although each Reserve Bank should have controls for independent checks and reconciliations of voucher payments, at two of the four Reserve Banks we visited, only the building department was responsible for authorizing progress payments made to construction contractors. At both Reserve Banks, officials responsible for the payment function, where the reconciliation should take place, did not track payment amounts against the total available contract dollars. Instead, when vouchers were received that showed the approval of the building department, the vouchers were paid.
- Noteworthy practices used by certain Banks were not disseminated among the Reserve Banks. Several Reserve Banks had procedural strengths or notable practices that were missing in others. Building department officials at one of the four Reserve Banks requested and analyzed various elements of cost included in construction proposals, which enabled them to evaluate the proposed prices. They had found that challenging the bids/proposals from construction contractors resulted in improved understanding of what is required, as well as better quality and lower prices. However, we found no evidence that information about these "best practices" was being disseminated within the Federal Reserve. Specifics on these practices are described in appendix IV.

The Federal Reserve Could Be More Cost Conscious When Planning and Managing Large-Scale Building Projects

To determine whether opportunities exist to reduce the Federal Reserve's operational costs, we also reviewed decisions related to the construction of the Dallas Reserve Bank facility. Even though the cost of the Dallas building project was $8 million less than the initially approved budget and construction was completed ahead of schedule, opportunities existed for the Federal Reserve to reduce costs. In two areas, we found that the Reserve Bank could have cut costs approved by the Board. First, the Dallas Reserve Bank building was larger than the plan initially specified; second, the Reserve Bank purchased more land than necessary. Since the building contained enough square footage to meet the projected space-study needs through 2017, the purchase of additional acreage for expansion purposes had questionable value.

The Dallas Reserve Bank Outgrew Its Original Bank Building

By July 1988, the Dallas Reserve Bank had outgrown its original building. The building could not house all employees, no longer complied with the evolving building codes, and contained many space deficiencies. Faced with these problems, Dallas Reserve Bank officials commissioned a study, to identify alternatives that would resolve the space problems.

As a result of that study, in November 1988, the Dallas Reserve Bank recommended that the Board:

- approve a space plan for a building with 540,334 net usable square feet, which would satisfy the Reserve Bank's projected needs through 2017;
- locate the new building on land within the Central Business District (CBD), which would provide the most effective and appropriate solution for satisfying the Reserve Bank's space needs over the long term;
- approve a target budget of $171.8 million for the construction of a new building on a new site; and
- authorize the Reserve Bank to proceed with a site selection and conceptual design for a new building.

The Board Approved the Cost of a New Dallas Reserve Bank Building

In January 1989, the Board approved the Dallas Reserve Bank's proposal to construct a new building at a new location within the Dallas CBD. The Board-approved plan had a target budget of $171.8 million and a target completion date of August 1992. In July 1990, the Board authorized the Dallas Reserve Bank's proposal to follow an expedited (or "fast track") construction plan. This approach allowed the Reserve Bank to begin construction with incomplete construction drawings and without finalized subcontract agreements. Additionally, the Board lowered the final budget for the land purchase and new building design and construction to $164.5 million. The expedited construction plan also allowed occupancy 3 months ahead of schedule.

The Facility Was Overbuilt

The proposal submitted by the Dallas Reserve Bank to the Board called for the construction of a 540,334 square foot building. The building requirements for the Reserve Bank's new facility were based on the Board's projected space requirements. The Board requires that new building projects allow for 15 years of personnel growth and 25 years of vault and other space growth. The Dallas Reserve Bank hired a consultant to determine the projected space needs on the basis of the Board criteria. The space study found that 540,334 square feet would allow for 15 years of personnel growth through 2007 and that 580,093 square feet would allow for 25 years of equipment growth though 2017.

The completed building contains 595,385 square feet, which is 55,051 square feet more (about 10 percent) than the initially approved square footage. In addition, the new building's square footage was more than the 580,093 square feet the bank is projected to need in 2017. The two areas most overbuilt, in terms of total square feet and percent authorized, were the data services and lobby areas. In the data services area, 70,167 square feet were authorized by the Board. However, in the completed building, the final square footage for data services was 90,860, or 29 percent more than was authorized. The building's two lobby entrances called for 7,800 in total square feet, while the actual square footage on completion was 27,369, or an increase of 250 percent.

According to a Reserve Bank official, the architect's plan provided for more space than was approved by the Board. However, the additional space did not cause concern since the design and construction costs for the plan were less than the budgeted amount approved by the Board.

Land Purchased Was Unnecessary

The Dallas Reserve Bank purchased, with the Board's approval, 8.02 acres of land for $27.7 million, or $79.30 per square foot. They needed 6.02 acres for new building construction and purchased the additional 2 acres for future building expansion or sale. Since the building design exceeded projected space needs through 2017, the need for additional land was redundant. According to a senior official at the Dallas Reserve Bank, the Bank could have purchased only the 6.2 acres for approximately

$20.7 million and foregone the additional 2 acres for a total savings to the Federal Reserve of $7 million.

Opportunities May Exist to Reduce or Eliminate the Surplus Account

Downward adjustments to the surplus account, or its elimination, would have a positive budgetary impact by increasing the amounts returned to Treasury in the years that they occur. The current formula for calculating the amounts to be contributed to surplus accounts is as follows. Each Reserve Bank's capital stock is by law equal to 6 percent of the paid-in capital and surplus of its member banks.[6] Annually, as banks' paid-in capital and surplus grow or shrink, member banks are required to adjust the amount of their Federal Reserve Bank stock to equal 6 percent of their paid-in capital and surplus. The Reserve Banks then contribute, out of Federal Reserve earnings, amounts to their surplus accounts so that the surplus balances are equal to the amount of paid-in capital. During 1988 to 1994, the total of the surplus accounts systemwide increased 79 percent, from $2.1 billion in 1988 to $3.7 billion in 1994.

The Federal Reserve has stated in its publications that the purpose of the surplus accounts is to ensure that adequate capital is available to absorb possible losses. In its monetary policy, lender of last resort, and payment system activities, the Federal Reserve is exposed to risks that could potentially generate large losses. However, because the Federal Reserve's interest income so far exceeds its expenses, we believe it is highly unlikely the Federal Reserve will ever incur sufficient annual losses such that it would be required to use any funds in the surplus account. In the years 1914 and 1915, the first 2 years of its operations, the Federal Reserve experienced net losses. However, every year since then, for 79 years, the Federal Reserve has recorded substantial net profits. The profits for 1994 were $20 billion and expenses, including losses, were about $3 billion.

We could find no criteria to use in assessing the amount held in surplus. According to Federal Reserve officials, the methodology for deciding that amount has changed and is somewhat arbitrary. Currently, and in the past, the levels of the surplus account have been discretionary because the requirement to have the surplus account equal to paid-in capital has been a matter of Federal Reserve policy; it was not required by law. However, in a provision of the Omnibus Budget Reconciliation Act of 1993, Congress required the Federal Reserve, in fiscal years 1997 and 1998 only, to calculate the surplus account using the current formula and then to reduce

[6]Member banks must subscribe to stock equal to 6 percent of their paid capital and surplus. However, only half of this amount (3 percent) must actually be paid; the remaining amount, 3 percent, is subject to the call of the Reserve Bank.

the account by $106 million in fiscal year 1997 and $107 million in fiscal year 1998. Although the law did not specifically state the purpose of those transfers, its effect was to reduce the federal government's projected deficit in those years. Considering that this provision only applies to fiscal years 1997 and 1998 and the general lack of criteria for assessing surplus amounts, Congress may wish to determine whether these surplus accounts are necessary and, if so, set permanently in law an appropriate amount for these accounts.

Conclusions

Because the Federal Reserve's spending represents a cost to U.S. taxpayers, the Federal Reserve should operate as efficiently as possible. Our review indicates opportunities exist to reduce Federal Reserve spending. Federal Reserve expenditures for personnel benefits varied among Reserve Banks and some benefits were generous compared to those of federal agencies with similar responsibilities.

Also, we believe that opportunities exist for reductions in discretionary spending for health care and travel costs through the systemwide management of these areas. Although several Reserve Banks have undertaken efforts to reduce their health care costs, we believe that centralized management of the Federal Reserve's health care plans could further reduce health care costs. Furthermore, we believe travel expenses could be reduced by adopting the most cost-effective "best practices" in travel reimbursement policies. Although instituting uniform, cost-conscious practices at all Reserve Banks may appear contrary to the tradition of independently managed Reserve Banks, the Reserve Banks have adopted uniform policies and procedures in many areas of operation.

Our review of contracting and procurement practices at some Reserve Banks also indicate opportunities to reduce discretionary spending for goods and services. We believe that the Federal Reserve could better ensure the purchase of goods and services at reasonable cost through increased compliance with UAG as well as systemwide adoption of "best practices" in procurement and contracting. Moreover, in its planning and management of the Dallas Reserve Bank construction project, the Reserve Bank overlooked opportunities to reduce spending that the Board had approved.

Downward adjustments to the surplus account, or its elimination, would have a positive budgetary impact by increasing the Federal Reserve's annual transfer to Treasury in the years that any such reductions occur.[7] Federal Reserve deductions would have to exceed the billions of dollars transferred to Treasury annually before the Federal Reserve's use of the account would be necessary. Since the chances of an occurrence of such an event are extremely remote, we believe that capping, reducing, or even eliminating the surplus account represents an opportunity to decrease deductions to the amount transferred to Treasury each year.

Recommendations to the Board of Governors of the Federal Reserve

We recommend that the Board of Governors

- review pay and benefits levels at the Board and the Federal Reserve Banks to determine if current levels can continue to be justified in today's environment of increased governmental and private-sector cost containment;
- assess whether managing the Federal Reserve's health care coverage on a systemwide basis could reduce health care costs;
- review travel policies at the 12 Reserve Banks and change those policies that increase costs;
- review contracting and procurement practices at the 12 Reserve Banks to ensure that these practices are in compliance with the system acquisition guidelines and result in cost-effective contracts;
- ensure that the "best practices" in contracting and procurement at the 12 Reserve Banks are regularly identified, disseminated, and adopted by the Reserve Banks; and
- review policies regarding the size of the surplus account and determine if opportunities exist to decrease the amount held in the account.

Matter for Congressional Consideration

Congress should consider the results of the Board's review and decide if there is a continued need for the Federal Reserve's surplus account and, if so, what the appropriate amount of the account should be.

Federal Reserve's Comments and Our Evaluation

In written comments on a draft of this report, the Federal Reserve's Board of Governors did not agree with our recommendations that they review pay and benefits levels and consider reducing or eliminating the surplus account. The Board stated that the Federal Reserve strives to provide

[7]The Joint Explanatory Statement accompanying the Fiscal Year 1996 Budget Resolution directed the Congressional Budget Office not to score for fiscal year 1996 any savings for new legislation that might affect the Federal Reserve's transfer of the surplus account to the U.S. Treasury. (H.R. Rep. No. 104-159 at 51 (June 26, 1995).) Accordingly, if such legislation had been passed, the transfer would not have been counted for purposes of determining compliance with the Budget Enforcement Act for Fiscal Year 1996.

salaries and benefits competitive with local private sector markets and that its current pay and benefits levels are necessary to attract and retain skilled employees. The Board agreed that the appropriate level of the surplus account is open to debate, but it did not agree to consider reducing or eliminating the surplus account. The Board stated that reducing the surplus account would have no real economic impact and cited the possibility that, without the surplus account, temporary short-term losses could lead to a perceived impairment of its capital that could raise investors' concerns about the System's ability to conduct sound monetary policy. The Board agreed with our recommendations concerning the Federal Reserve's policies and practices regarding travel, contracting, and procurement. The Board also agreed with our recommendation concerning the management of health care benefits.

Because personnel costs accounted for almost 70 percent of the Federal Reserve's total operating costs and increased by over 50 percent in the 1988 to 1994 period, we believe these costs should be one of the first areas to be examined for potential savings. We acknowledge that certain benefit levels may be necessary for the Federal Reserve to attract and retain a skilled workforce. However, we do not believe the Board has made a convincing case that these benefits need not be reexamined with a view toward greater cost containment. In addition to the private sector, the Federal Reserve also competes with public sector employers, and its benefits are clearly more generous than those of the federal government overall. In some cases, the Federal Reserve's benefits are more generous than those of the other financial industry regulators who are the major employer-competitors in areas such as bank supervision. Moreover, we note that less than half of the Federal Reserve's total workforce is highly skilled professional staff, such as lawyers, economists, and financial analysts.

We maintain, and the Board agreed, that reducing or eliminating the surplus account, by transferring these funds to Treasury, would increase overall government receipts and reduce the unified budget deficit in the year that any such transfer occurred. We also agree with the Board that reducing or eliminating the surplus account would be offset by a reduction in subsequent years of interest payments to Treasury that the Federal Reserve would have otherwise earned by investing these funds in government securities. However, we believe Congress has a legitimate interest in deciding whether it would be more appropriate to have these funds returned immediately, either to reduce the outstanding public debt or for other purposes, rather than to receive them over a longer period of time. To allow for the possibility that a small, temporary loss could raise investor concerns about the Federal Reserve's ability to conduct sound monetary policy, we suggested that Congress may wish to set an appropriate level for the surplus account as an alternative to its elimination.

The Federal Reserve System Faces Major Mission-Related Challenges

The Federal Reserve System faces major challenges in its mission and lines of business, particularly in services to depository institutions and government agencies and in bank supervision. These challenges include (1) increased competition from the private sector and increasing difficulties in recovering costs in priced services, (2) increasingly widespread use of electronic transactions in the financial services industry, and (3) the continuing rapid consolidation of the banking industry, which could affect both the need for, and the distribution of, bank examination staff. Because these areas account for the largest part of the Federal Reserve's expenses and staffing, addressing these challenges effectively will likely result in major changes in how the Federal Reserve operates. As the Federal Reserve undertakes to meet these challenges, it is also likely to find that its current structure, established in 1913 when the nation's financial industry was much less complicated, is increasingly inappropriate for the fast-paced, global financial world of today and the next century. However, if major changes to the Federal Reserve's structure are to be made to promote increased efficiency and competitiveness, such changes will need to be carefully weighed against any potential effects on the independence of our nation's central bank.

Challenges Facing the Federal Reserve Will Likely Affect Most of the Workload at the Reserve Banks

The overwhelming majority of the workload and expenses incurred at the Reserve Banks is related to three lines of business—services to depository institutions, services to government agencies, and bank supervision and regulation. These lines of business account for over 90 percent of all Federal Reserve Bank expenses, as shown in table 4.1.

Table 4.1: Federal Reserve Banks' Operating Costs by Mission-Related Categories, Calendar Year 1994

Activities	1994 (millions)	Percentage of total
(1) Monetary and economic policy	$125.5	6.75
(2) Services to depository institutions	1,146.5	61.70
(3) Services to Treasury and other government agencies	218.2	11.74
(4) Supervision and regulation	368.1	19.81
Subtotal: (2)+(3)+(4)	$1,732.8	93.25
Total	**$1,858.3**	**100.00**

Source: Federal Reserve System.

Except for bank supervision, most of this workload is production-oriented, whether paper driven, such as processing currency for banks and clearing checks, or electronic in nature, such as running the automated clearinghouse and funds transfer systems. In these areas, employees often work in shifts, under fairly rigid deadlines and production expectations. These three lines of business are precisely the areas subject to an increasing variety of external and internal environmental pressures and challenges.

The Federal Reserve Faces Major Competition, Workload Reductions, and Cost Pressures in Delivering Services to Depository Institutions

In providing services to depository institutions, the Federal Reserve faces its most immediate and significant challenges to its mission. The Monetary Control Act of 1980 requires that the Federal Reserve base its fees for certain services—check processing, automated clearinghouse (ACH) transactions, Fedwire, securities transfers, etc—on, among other things, the costs of providing such services. At the same time, the Federal Reserve is required to promote the accessibility and efficiency of the nation's payments system, a role that may make it difficult for the Federal Reserve to raise prices sufficiently to recover its costs. Because services to depository institutions represent over 61 percent of all Federal Reserve Bank expenses and employ the largest part of Reserve Bank staffing, these changes are likely to have a dramatic effect on the size of the Reserve Banks' expenses, workload, and staffing needs.

The Federal Reserve Faces Increasing Competition in Priced Services

The Federal Reserve faces intense competition in check clearing. In 1993, for the first time in a number of years, the actual volume of checks handled by the Federal Reserve declined, albeit by a modest 0.2 percent. The Federal Reserve reported that the total volume of commercial checks for 1994 declined by almost 15 percent from 1993 levels. The implementation of same-day settlement rules[1] by the Federal Reserve, beginning on January 3, 1994, is partly responsible for this declining trend. Federal Reserve officials told us they expect further declines in the years ahead.

A significant factor in the Federal Reserve's loss of volume and market share in check clearing is the growth of private clearinghouses. The nation's check-clearing volume is still growing slowly, but on a per capita basis, the volume is stagnant. At the same time, private clearinghouses

[1]Beginning in January 1994, an addendum to Regulation CC requires the Federal Reserve and banks engaged in private check-clearing arrangements to return or refund, by the end of the same business day, checks presented for interbank settlement before 8 a.m. In addition, the clearing organization cannot charge an additional fee for this service.

competing with the Federal Reserve have grown. The California Bankers Clearing House, the Chicago Clearing House, and the Clearing House Association of the Southwest reported increases in the numbers of member banks in 1994. The California Bankers Clearing House also reported that it is delivering checks to 200 nonmember banks for same-day settlement and, in the process, saving its member banks $3.2 million a year in fees these banks would have had to pay the Federal Reserve for these services.

Other factors promise even further reductions in check-clearing volume for the Federal Reserve. These factors include

- electronic check presentment, in which only the essential check data are recorded and transmitted to the payor bank so that payment or return decisions can be accelerated;
- check imaging, which involves the use of digitized images of entire checks to perform processing operations;[2]
- banking consolidation and increased interstate banking, resulting in the increase of "on us" checks, which will not need to go through a clearinghouse, and
- electronic banking, which is now being offered by some banks, could, in the long term, make paper checks an anachronism.

In combination, these factors indicate a continued and perhaps accelerating decline in the Federal Reserve's check-clearing business. About 22 percent of all Reserve Bank employees were involved in check clearing in 1994. As volume declines, the Federal Reserve will need to prepare for reductions in staff required for cost-competitive services.

In other priced services, the Federal Reserve is also likely to face increased competition. The market share of private ACH providers, such as the New York Automated Clearinghouse, the Arizona Clearinghouse Association, and VISA will likely increase. Even in book-entry securities transfer services, an area where the Federal Reserve currently faces only nominal competition, the Federal Reserve is anticipating that future developments could lead to increased competition.

[2]Since March 1994, the Minneapolis Federal Reserve Bank has offered check imaging to its customers.

Potential Revenue Shortfalls Present Challenges in Meeting Pricing Provisions of the Monetary Control Act

The Federal Reserve is facing increased difficulty in recovering its costs for priced services. As shown in table 4.2, costs have outpaced revenues since 1990 in three of the Federal Reserve's priced services.

Table 4.2: Percentage Changes in Revenue and Expenses for Payments for Federal Reserve Services, 1990-1994

Service	Revenue	Expenses
Check clearing	–.2%	13.8%
ACH	22.0	41.1
Fedwire	12.0	25.8

Legend: ACH = automated clearinghouse.

Source: Federal Reserve System.

Some of the difficulties in recovering costs stem from higher than anticipated automation consolidation costs associated with the Federal Reserve Automation Services (FRAS). (See chs. 2 and 5 for details on the FRAS project.) These costs have been a particular problem in check clearing.

In recent times, the Federal Reserve has been able to mitigate the effects of these trends in several ways:

- The Federal Reserve has simply deferred certain automation consolidation costs to future years.
- The Federal Reserve has reduced its targeted return on equity.[3] In 1993 and 1994, the target rate of return was about 5 percent, which was historically a low rate of return, primarily because of losses that bank-holding companies experienced in 1989 and 1991.
- Past overfunding of the Federal Reserve's pension plans has enabled the Federal Reserve to offset some additional costs of providing priced services by allocating a portion of the overfunding to priced services, resulting in a decrease in expenses for those services. In 1993, for example, the amount of the overfunded plan allocated to priced services

[3]The Monetary Control Act requires the Federal Reserve to include in its costs a private-sector adjustment factor, which contains adjustments for taxes and a return on equity similar to those that would be factored into private sector institutions' pricing policies. The Federal Reserve has adopted a formula that calculates the return on equity as the average after-tax rate of return over the preceding 5 years by the top 25 bank-holding companies.

was $36.7 million. Even so, the impact of the overfunded pension plan was not sufficient to enable the Federal Reserve to meet its targeted return on equity in 1994. The overfunding will be completely amortized in the year 2002.

These conditions are all temporary. The Federal Reserve will be faced with increasing pressures on its pricing policies. For example, with regard to the return on equity, median rates of return on equity among large bank-holding companies are now in the 15- to 16-percent range, so the target rate of the Federal Reserve may have to move toward that number. Meeting a 15-percent target rate of return on equity would require the Federal Reserve to increase its revenue by about $50 million, which amounts to about a 7-percent across-the-board price increase.

The Federal Reserve Could Face Major Workload Reductions in Providing Services to the Department of the Treasury and Other Government Agencies

Several changes in services to Department of the Treasury and other government agencies, and depository institutions, could have a significant impact on Federal Reserve costs as well as on staffing levels and alignment. These changes include consolidation of U.S. savings bonds operations,[4] increased government use of electronic benefit transactions, and changes in the U.S. currency.

Treasury, which directs the U.S. government's savings bonds program, ordered the Federal Reserve to consolidate its savings bonds operations to five locations.[5] This consolidation has resulted in the need to relocate staff at Reserve Banks that were losing savings bonds operations. Most of the savings bonds employees at nonconsolidation Reserve Bank locations have been relocated to other departments at their respective Reserve Banks. However, one Reserve Bank could not relocate all of its savings bonds employees to other departments and was forced to lay off some of those employees.

An increased use of electronic payments in services provided to Treasury and other government agencies may also result in realignments or reductions in staff at Reserve Banks. The National Performance Review's (NPR) recommendation that the U.S. Department of Agriculture distribute food stamp benefits through Electronic Benefits Transfer (EBT) may result in the realignment of Reserve Bank staff. EBT uses an automated financial

[4]The Reserve Banks issue, service, and redeem U.S. savings bonds on behalf of Treasury.

[5]The following are the consolidated locations: (1) Buffalo branch of the New York Reserve Bank, (2) Pittsburgh branch of the Cleveland Reserve Bank, (3) Richmond Reserve Bank, (4) Minneapolis Reserve Bank, and (5) Kansas City Reserve Bank.

transaction process and card access technologies to electronically deliver federal and state benefits to recipients via point-of-sale (POS) terminals and Automated Teller Machines (ATM). Currently, the Federal Reserve receives the paper coupons deposited by merchants at their financial institutions, confirms the totals, checks for counterfeit coupons, destroys the coupons, credits the sending institution's account, and debits the U.S. Treasury account for the value of the food coupons. Under the EBT system, funds would be transferred electronically from the U.S. Treasury's bank account to the retailer's depository account via the automated clearinghouse (ACH).

Recently, Texas converted its food-stamp operations to an EBT arrangement. This necessitated the Dallas Federal Reserve Bank's eliminating 22 positions in its food-stamp processing area.

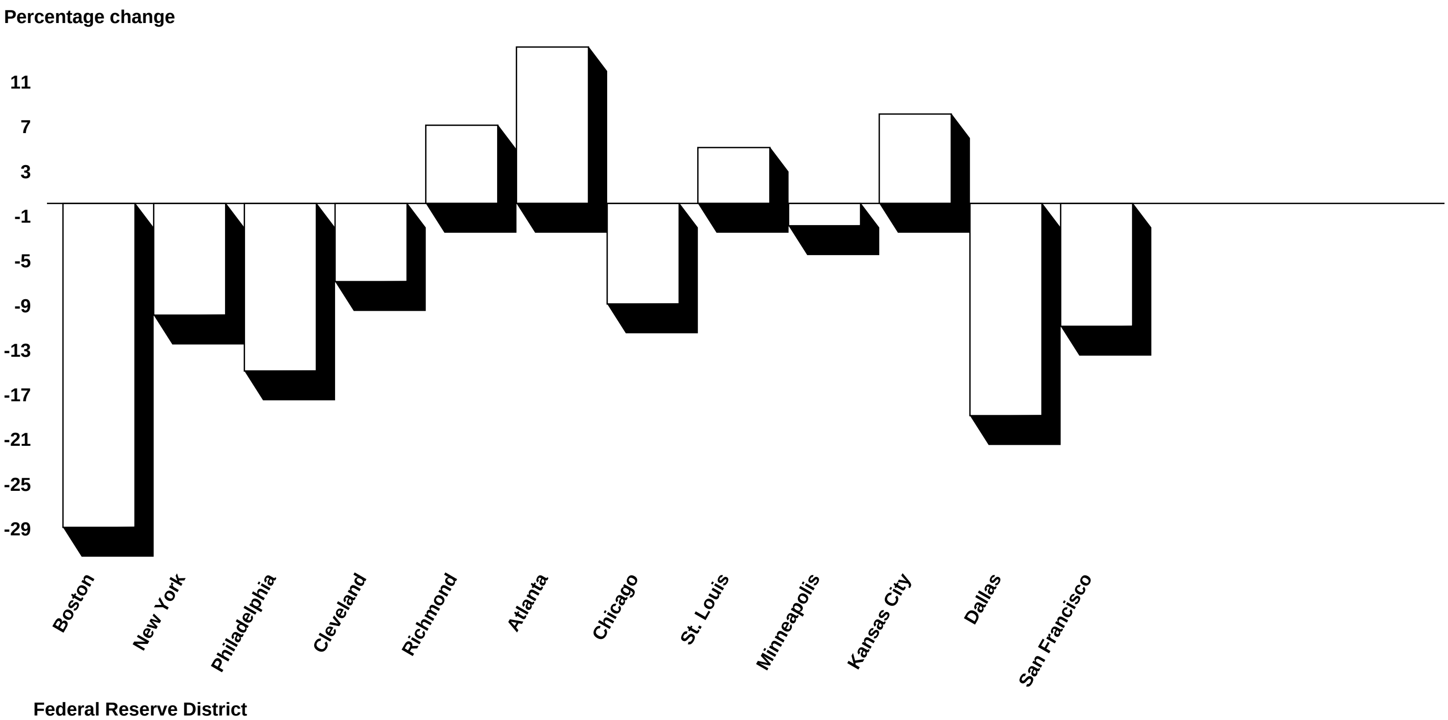
Introduction of a 1-dollar coin, which is currently being considered by Congress, could result in dramatic staffing reductions in Reserve Banks' currency processing operations. Many nations use a coin for monetary transactions at, and in many cases well above, the level for which the United States uses a paper dollar. Although the Susan B. Anthony 1-dollar coin was not accepted by the public when it was introduced in 1979, a switch to a 1-dollar coin, particularly if the paper dollar were withdrawn from circulation, could nevertheless reduce Federal Reserve expenses and result in savings to the taxpayers.

One-dollar paper notes make up approximately 40 percent of the currency processed by Federal Reserve Banks. Officials told us that if the 1-dollar coin were introduced and the 1-dollar bill were removed from circulation, substantial reductions in currency processing staff would need to be made, perhaps resulting in the elimination of the second shift processing at many Reserve Banks.

Changes in Bank Supervision and Regulation Could Affect Staffing Alignments and Revenues

The continuingly intense banking industry consolidation would likely affect the locations and need for Federal Reserve bank examination staff. As banks merge or are acquired, the Federal Reserve will face the need to reexamine its current distribution of examination staff. Some Reserve Banks may see a need for increased staffing; others may find that they must radically reduce their examination staffs. As an example, figure 4.1 shows the percentage changes in the number of state-member banks by Federal Reserve district for the period of 1990 to 1995.

Figure 4.1: Percentage Change in State-Member Banks by Federal Reserve District, 1990-1995



Note: Data are as of December 1990 and as of June 1994.

Source: Federal Reserve System.

Less certain are the potential effects of any bank regulatory consolidation Congress may enact. Differing consolidation proposals have been made to consolidate federal financial institutions' regulatory responsibilities. Some proposals would provide for the complete consolidation of all regulation into a single federal regulator. Other proposals envision retaining or even increasing the responsibilities of the Federal Reserve in bank supervision.

Some proposed changes to the banking regulatory structure have raised policy issues about the Federal Reserve's role in bank regulation. The Federal Reserve has raised strong objections to a new regulatory system in which its role in direct bank supervision would be eliminated or substantially reduced. Federal Reserve officials argue that the System's ability to conduct monetary policy and operate the payments system and the discount window would be greatly impaired by the removal of its responsibilities for regulating and supervising bank-holding companies and state-member banks. Likewise, those who support maintaining the Federal Reserve's involvement in bank regulation argue that if the Federal Reserve is to be responsible for forestalling financial crises and effective as the "lender of last resort," the Federal Reserve must have direct experience with at least a portion of the depository institutions. On the other hand, others argue that the Federal Reserve can obtain information needed for monetary control through other means, such as reports from other agencies or Board representation on other agencies.

Because supervision and regulation activities account for approximately 20 percent of Federal Reserve Bank operating expenses, a reduction in the central bank's direct role in bank supervision and regulation could have a significant impact on the Reserve Banks. Conversely, if the Federal Reserve were given responsibility for some or all of the largest banks, the percentage of the banking system assets for which the Federal Reserve would be the primary regulator could increase. While assigning large banking organizations to the Federal Reserve would address concerns about systemic risk, this could change the geographic distribution of Federal Reserve supervisory responsibilities. Such a redistribution would, of course, affect expenditures at individual Reserve Banks.

The Federal Reserve's revenues, and hence its return to the taxpayers, would be enhanced by charging fees for bank examinations. Federal bank regulators differ in their policies regarding the assessment of fees for bank examinations. The Office of the Comptroller of the Currency (OCC) charges national banks for examinations that it conducts. In contrast, state-chartered banks, which are supervised by either the Federal Reserve or the Federal Deposit Insurance Corporation (FDIC) in conjunction with state-banking agencies, are charged fees by those state-banking agencies but not by their federal regulator. Thus, the costs of the Federal Reserve's bank examinations—$368 million in 1994—are borne by the taxpayers, while for national banks, the costs of examinations are borne by the banks that are examined. The Federal Reserve Act authorizes the Federal Reserve to charge fees for bank examinations, but the Federal Reserve has not done so, either for the state-member banks it examines or the bank-holding company examinations it conducts. Similarly, FDIC is authorized to charge for bank examinations but does not do so. The administration's fiscal year 1996 budget includes provisions for both FDIC and the Federal Reserve to charge for bank examinations.

The Federal Reserve is concerned that if it instituted charges for its bank examinations it could create incentives for state-member banks, who are already charged for state examinations, to either change their charters to national charters or resign membership in the Federal Reserve (opting to be supervised by FDIC as state-nonmember banks), to avoid paying fees for both state and federal examinations. Such incentives, the Federal Reserve believes, would have major disruptive effects on the dual banking system.

We believe any disruption would be small. At the end of 1994, there were 3,078 national banks with 56 percent of total bank assets, 6,398 state-chartered nonmember banks with 23 percent of total bank assets, and only 974 state-chartered member banks with 21 percent of total bank assets. Thus, the number of banks that would be affected is relatively small. If the FDIC also adopted examination fees, incentives for banks to become state-nonmember banks to avoid such fees would be eliminated. With respect to double-charges for bank examinations, we believe an equitable fee-sharing arrangement with state agencies that is based on the division of supervisory responsibility seems possible. Moreover, charging for bank-holding company examinations would not present such possible disruptions because the Federal Reserve is their federal regulator, regardless of whether the subsidiary banks are chartered by OCC or the states. Charging holding company examination fees might also encourage greater efficiency in supervising banking organizations.

Mission-Related Challenges and Efforts to Reduce Expenses Are Likely to Raise Questions About the Structure of the Federal Reserve System

Addressing the challenges discussed above will likely result in dramatic changes in staffing and how work is done at the Reserve Banks. In addition, continuing pressures to contain costs, in part fueled by the increasing competition from the private sector in priced services, may result in changes in how Federal Reserve programs are managed. Taken together, such changes will likely call into question the continuing appropriateness of the Federal Reserve's current structure.

Effectively Addressing Challenges Will Likely Result in Smaller Reserve Banks

Changes that can affect many of the Federal Reserve's lines of business—particularly those concentrated at the Reserve Banks, such as check clearing, currency processing, and bank supervision—may result in substantial reductions in staffing at the Reserve Banks in the years ahead. These trends are already beginning to occur. Overall staffing at the

Reserve Banks has declined modestly by 1.4 percent from the first quarter of 1994 to the first quarter of 1995. And staffing in the line of business, services to financial institutions and the public, which includes priced services, declined somewhat more—by 2.2 percent. Some Reserve Banks have offered "early out" retirements to some employees to encourage reductions during 1988 to 1994.

As Reserve Banks contract in size, the continuing justification for the overhead structure, replicated at 12 Reserve Banks, will be called into question. Federal Reserve overhead expenses rose from $355 million in 1988 to $564 million in 1994, an increase of about 59 percent. This is one of the greatest increases among the Federal Reserve's lines of business for this period. As the Federal Reserve faces the challenges we have just described, it will have significant opportunities to reduce staffing and, therefore, costs, particularly at the Reserve Banks. As this occurs, the Federal Reserve should plan to reduce overhead expenses comparably.

Cost Minimization Pressures Could Result in More Centralized Management of Federal Reserve Programs

Increased competition from the private sector and the continuing need to make governmental functions as cost efficient as possible will likely require that the Federal Reserve achieve significantly greater efficiencies in its operations—for example, in personnel pay and benefits, travel costs, procurement, and other areas. Systemwide management of many Federal Reserve activities has the potential to reduce costs to taxpayers, the government, and financial institutions. The Federal Reserve has often chosen in the past to manage programs on a systemwide basis for reasons of efficiency and to ensure effective operations of Reserve Bank programs. For example, some Federal Reserve benefits are established systemwide and are available at the same levels to all employees, regardless of where they work. In this regard, the Board of Governors sets benefits for all Federal Reserve employees. These systemwide benefits include retirement plans, thrift savings plans, business travel/accident insurance, life and survivor insurance, and a long-term disability income plan. Benefits that are not established systemwide include health benefits and various types of leave, such as marriage leave and bereavement leave (see app. III).

For large System projects, the Federal Reserve has often taken a systemwide approach to procurement and management. When the Federal Reserve determined the need for a new generation of currency processing equipment, a single contract was used to purchase all 132 machines from a single vendor. According to the Board's Division of Reserve Bank Operations and Payment Systems' (DRBOPS) Cash Manager, this helped ensure a better price compared to prices resulting from the Reserve Banks' purchasing the machines individually. When the Federal Reserve determined the need for the Federal Reserve's data processing and communications to have improved reliability, risk management, and security, among other things, Reserve Bank and Board decisionmakers chose to centralize those operations at three centers rather than continue separate operations at each of the Reserve Banks.

Finally, when the Office of the Inspector General (OIG) criticized the individual ethics programs at the Reserve Banks, the Federal Reserve responded by establishing uniform ethics standards (the Uniform Code of Conduct) and standardizing financial disclosure and other ethics-related forms throughout the Federal Reserve.

We have also identified several opportunities for the Federal Reserve to better control costs and increase efficiencies through increased systemwide management. These include the Federal Reserve's taking the following steps:

- review benefits programs at the 12 Reserve Banks to reduce or eliminate benefits that are not necessary to attract and retain a quality workforce;
- manage other benefits—such as health plans—on a cost-effective systemwide basis, utilizing the combined bargaining power of the 12 Reserve Banks;
- standardize travel policies and procedures to eliminate anomalies among the Reserve Banks that may result in unnecessary expenditures; and
- review contracting and procurement practices at the 12 Reserve Banks to (1) eliminate practices that could result in excessive costs and (2) promote and publicize "best practices" that are identified.

As more centralized management is instituted, the continuing need for separate management structures at the 12 Reserve Banks may increasingly be called into question. For example, increasingly uniform Reserve Bank personnel policies would reduce the need for 12 separate Reserve Bank personnel departments. Similarly, if travel policies are made more consistent, travel may be able to be managed more efficiently on a systemwide basis.

Many Aspects of the Rationale for the Federal Reserve's Structure Are Outmoded

The structure of the Federal Reserve was shaped when the U.S. economy was much more regional in nature. For example, during congressional debate on establishing the Reserve Banks, a Member of Congress said that the numbers and locations of the Reserve Banks should be such that ". . . no bank be more than an overnight's train ride from its Reserve Bank." Today, the increased use of electronic funds and securities transfers make the geographical location of Reserve Banks irrelevant for many functions.

Demographics that shaped decisions about the location of Reserve Banks have also changed profoundly. Except for minor boundary changes, the geographical structure of the Federal Reserve has remained unchanged since 1914, while the nation's population has shifted dramatically. Although population statistics are an inexact proxy for all matters considered in the original decisionmaking, they have rough parallels in bank assets, check-clearing volume, currency needs, and other factors that have an impact on the Federal Reserve's lines of business.

Since 1914, population growth and shifts have resulted in increasing disparities in population in the 12 Reserve districts, which were fairly similar in size in 1914.[6] For example, the San Francisco Reserve Bank in 1914 served 6 percent of the nation's population; the St. Louis Reserve Bank served almost 10 percent. As of 1990, the San Francisco Bank served almost 20 percent of the population, while the St. Louis Bank served just 5 percent. Overall, in 1914, the populations served by the Reserve Banks represented a range of 5 to 14 percent of the nation's population. By 1990, the range had spread to 3 to 19 percent of the nation's population, as shown in table 4.3.

[6]The 1910 census data were the closest to 1914, which was the year the Federal Reserve opened for business.

Table 4.3: A Comparison of the Population Within Federal Reserve Districts, 1910 V. 1990

District	1910 population	Percent	Rank	1990 population	Percent	Rank
Boston	6,307,000	7	8	12,378,000	5	10
New York	11,329,000	12	2	20,514,000	8	5
Philadelphia	5,953,000	6	9	11,506,000	5	11
Cleveland	8,375,000	9	5	16,108,000	7	7
Richmond	8,479,000	9	4	23,305,000	10	4
Atlanta	9,094,000	10	3	31,833,000	13	2
Chicago	13,114,000	14	1	30,601,000	12	3
St. Louis	8,273,000	9	6	12,528,000	5	9
Minneapolis	4,432,000	5	12	7,574,000	3	12
Kansas City	6,899,000	7	7	13,541,000	6	8
Dallas	4,539,000	5	11	18,467,000	8	6
San Francisco	5,434,000	6	10	46,500,000	19	1
Total	**92,228,000**			**244,855,000**		

Source: U.S. Bureau of the Census.

Further changes in the nation's population, coupled with reduced staffing at the Reserve Banks and increasing systemwide management of the Federal Reserve, call into question the continuing need for 12 Reserve Banks.

In addition, an examination of the continuing need for maintaining 25 branch banks may be appropriate. Although the Board has authority to open or close branch banks, it has not done so frequently. Twenty-four of the current 25 branch banks were established by 1927. Since then, the Board has opened only one additional branch bank—the Miami branch of the Atlanta Federal Reserve Bank in 1975. The Board has only closed one branch bank in the Federal Reserve's history; the Spokane branch of the San Francisco Reserve Bank was closed in 1938. Considering the substantial changes in the nation and its financial system since most of the branches were established, an overall review of the branch bank structure would seem appropriate.

Any Structural Changes Will Need to Be Weighed Against Concerns About the Independence of Our Nation's Central Bank

The Federal Reserve's structure, established in 1913, was the end result of many compromises designed to promote Federal Reserve accountability to the public, and, at the same time, to maintain Federal Reserve independence from the nation's political processes. The importance of the banking industry was acknowledged by establishing member banks as owners of Reserve Bank stock. At the same time, representation from the public was ensured through the membership of the Reserve Banks' Boards of Directors, which are chosen to include a diverse representation from agriculture, commerce, industry, services, labor, and consumers across each Reserve Bank's district. The importance of money centers, such as New York and San Francisco, was geographically balanced through the creation of 12 Reserve Banks—the maximum allowed under the Federal Reserve Act—thus ensuring that both rural and urban interests would be represented in the work and the deliberations of our central bank. In the same way, the power of the Board was tempered by establishing the Reserve Banks as independent entities subject only to the "general supervision" of the Board. Finally, while the Federal Reserve was created by an act of Congress and is required to report periodically to Congress, its actions do not need to be ratified by Congress or the president and, as explained in previous chapters, it is funded independently from the congressional appropriations process.

In many ways, these compromises have served the nation well and have created additional benefits for the Federal Reserve perhaps not fully envisioned when the Federal Reserve Act was passed. Federal Reserve officials believed that the broad geographic diversity represented by the Reserve Banks aids in the conduct of monetary policy by ensuring that various regional perspectives on the nation's economy are heard. A total of 281 individuals, many of whom are prominent leaders of industry, the financial services community, labor groups, and consumer interests, serve as directors of the Reserve Banks and their branches. These directors provide both a sounding board for Federal Reserve policies as well as an established "community of interest" to support the Federal Reserve when challenges to its independence arise, as they have from time to time in the past. Federal Reserve officials also feel that this community of directors provides a very useful network of relationships for the nation's economy during times of financial crisis.

We are not in a position to fully evaluate the merits of these benefits for the Federal Reserve or the nation. If, because of the major challenges facing the Federal Reserve, changes to the Federal Reserve's structure are contemplated, these issues would need to be carefully evaluated when doing so. As to the benefit of having diversity of economic information for monetary policy purposes, in today's information age, it is likely that sufficient quality economic information could be gathered in some manner, even if the number of Reserve Banks were reduced. As to the benefits of its directors' network of support, the effects of a reduction in the numbers of Reserve Banks or a diminution of their responsibilities is less clear. If some Reserve Banks were to become, in effect, merely payments system processing centers, for example, the ability of these banks to attract prominent directors might be jeopardized. Any actual or perceived effects this might have on the independence of the Federal Reserve would need to be weighed carefully against any potential improvements in efficiency and cost savings that such changes would yield.

Conclusions

In this and previous chapters we have discussed a number of changes facing the Federal Reserve. These are summarized below in table 4.4.

Table 4.4: Impact of Changes in Lines of Business on Federal Reserve Staffing and Finances

Change/Potential change	Status	Actual or potential impact on Reserve Banks' staffing and/or finances
Changes affecting priced services		
Automation consolidation— FRAS	Under way	Some reduction in personnel who run mainframe operations; increasing costs for priced and other financial services
Check imaging; growth of electronic payments	In process	Reduced need for personnel who process checks
Growth of private check clearinghouses	In process	Reduced need for personnel who process checks
Same-day settlement rules	Implemented	Has already resulted in decreased check volume; may contribute to further reductions of staff who process checks
Interstate banking	In process	Further reduction in personnel who process checks due to increase of "on us" checks; uncertain effects on bank examination staff
Revenue shortfalls in priced services	Currently occurring	Threatens cost recovery mandate of the Monetary Control Act
Changes affecting services to Treasury and depository institutions		
Savings bond consolidation	Completed	So far has resulted in staff realignments, but no major reductions, at Reserve Banks and branches

(continued)

Change/Potential change	Status	Actual or potential impact on Reserve Banks' staffing and/or finances
1-dollar coin	Proposed	May reduce need for staff who process currency; reduced currency costs for the Federal Reserve
Electronic food stamps/EBT	Under way	Some net reduction in personnel who process paper food stamps
Changes affecting bank supervision and reserves		
Bank regulatory consolidation	Congress must enact law	Uncertain, but could result in reductions in bank examination staff
Charging for bank examinations	Federal Reserve currently has authority	Increases in fee income of approximately $300 to $400 million per year
Banking industry consolidation	Under way	Changes in distribution of, if not reductions in, bank examination staff
Changes in managing the System as a whole		
Systemwide approaches in personnel (e.g., health benefits, travel, etc.)	May be inevitable	Reductions in overhead-bank administration
Reduction of Federal Reserve overhead	Should occur as other expenses are reduced	Reduced Federal Reserve costs

Legend:

EBT = Electronic Benefits Transfer
FRAS = Federal Reserve Automation Service

Source: GAO analysis.

Taken together, these changes will likely result in substantial reductions in staffing at the Reserve Banks, which will likely call into question the continued appropriateness of the Federal Reserve's current structure. We believe that responding to these challenges and making any accompanying structural changes that may become desirable can best be effectively accomplished through strategic management and planning by both the Reserve Banks and the Board working together for the System. In chapter 5, we focus on strategic planning and how the Federal Reserve can take steps to proactively manage for these current and future challenges.

Greater Systemwide Focus Would Strengthen Strategic Management Processes

If the Federal Reserve is to effectively meet the challenges it faces and streamline operations, the Board and the Reserve Banks must work together to strategically plan for the future. Our prior work in public- and private-sector management reform showed that organizations that have been successful in improving their efficiency have done so by effectively implementing initiatives to focus on their primary missions and business lines, realign their structures to fit their mission, and apply technology to their work processes. Without strong external pressure to minimize overall costs, the Federal Reserve must create the necessary self-discipline for the institution to adequately control its costs and respond effectively to future challenges. However, we found weaknesses in the planning, budgeting, and internal oversight processes that are key mechanisms for helping accomplish these goals. A fundamental review of the Federal Reserve's missions, structure, and use of technology would present the Federal Reserve with profound cultural challenges; however, the Federal Reserve has begun to show that it can address operational issues strategically and work in a systemwide manner when necessary. As the Federal Reserve enters the next century, it is vital that both the Reserve Board and the Banks continue to foster a systemwide focus so that the Federal Reserve can fulfill its mission in an efficient and effective manner.

Public and Private Organizations Achieved Success Through Management Reform

On the basis of our earlier work in public- and private-sector management reform, we found that leading organizations were able to effectively adapt to changes and challenges in their environment by planning strategically for the future.[1] These organizations had the management processes in place—strategic planning, budgeting, and performance measurement—that supported their top leadership in setting strategic direction and establishing organizationwide priorities. Through strategic planning, organizations were able to better identify emerging issues and challenges and posture themselves to address these changes proactively. Successful organizations also integrated their planning processes with budgeting and performance management. With sound budgeting processes, these organizations were better able to weigh the priorities of the moment against those of the future. These organizations were also able to identify mistakes and make the appropriate adjustments by linking their budgeting processes to performance management.

[1]See Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology (GAO/AIMD-94-115, May 1994); Managing for Results: State Experiences Provide Insights for Federal Management Reforms (GAO/GGD-95-22, Dec. 21, 1994); Managing for Results: Experiences Abroad Suggest Insights for Federal Management Reforms (GAO/GGD-95-120, May 2, 1995); and Government Reform: Goal-Setting and Performance (GAO/AIMD/GGD-95-130R, Mar. 27, 1995).

Our work has also shown that public and private sector organizations that were able to achieve significant cost reductions while improving performance and service delivery did so by fundamentally rethinking their mission, strategic goals, lines of business (products and services), and customer needs. As a result of these reassessments, organizations sometimes found it necessary to redefine all or part of their missions, set new strategic goals, and modify their lines of business.

In redefining their missions and strategic goals, organizations sometimes found that a fundamental rethinking and radical redesign of their key business and work processes was needed. Known as business process reengineering, this fundamental rethinking seeks to achieve dramatic improvements in critical performance measures. In reviewing their core management and business processes, these leading organizations identified those that were highest in cost, were most customer sensitive, and presented the most significant opportunities and risks for improvement. They then considered the full range of information technology alternatives and information needs to determine how information technology could simplify and reduce the time and cost of carrying out these work processes. After considering the range of needs and available alternatives, these organizations radically redesigned these work processes to better carry out their core missions.

Strategic Planning Processes Could Benefit From Greater Systemwide Focus

As discussed in chapter 4, the Federal Reserve faces major challenges to its business lines, particularly in the delivery of priced services to financial institutions. To effectively address these challenges, the Board and Reserve Banks need to work together to strategically plan for the future. We found that the Federal Reserve had a range of strategic plans and strategic planning initiatives in place or under development. For example, Board divisions and Reserve Banks had strategic planning processes that supported the formulation of strategic plans. According to Federal Reserve planning documents, the strategic planning process is to be linked to the Federal Reserve's budgeting and resource allocation process. In addition to these strategic plans, strategic plans at the System-level had been adopted, or were being developed, for Financial Services and Information Technology. However, the Federal Reserve did not have a process for integrating these individual planning processes and providing a systemwide focus for assumptions involving the future environment and relationships among functions. As a result, the Federal Reserve may not be making the best use of its many strategic planning processes to prepare for the future and undertake the bold thinking that is needed to address current and future challenges.

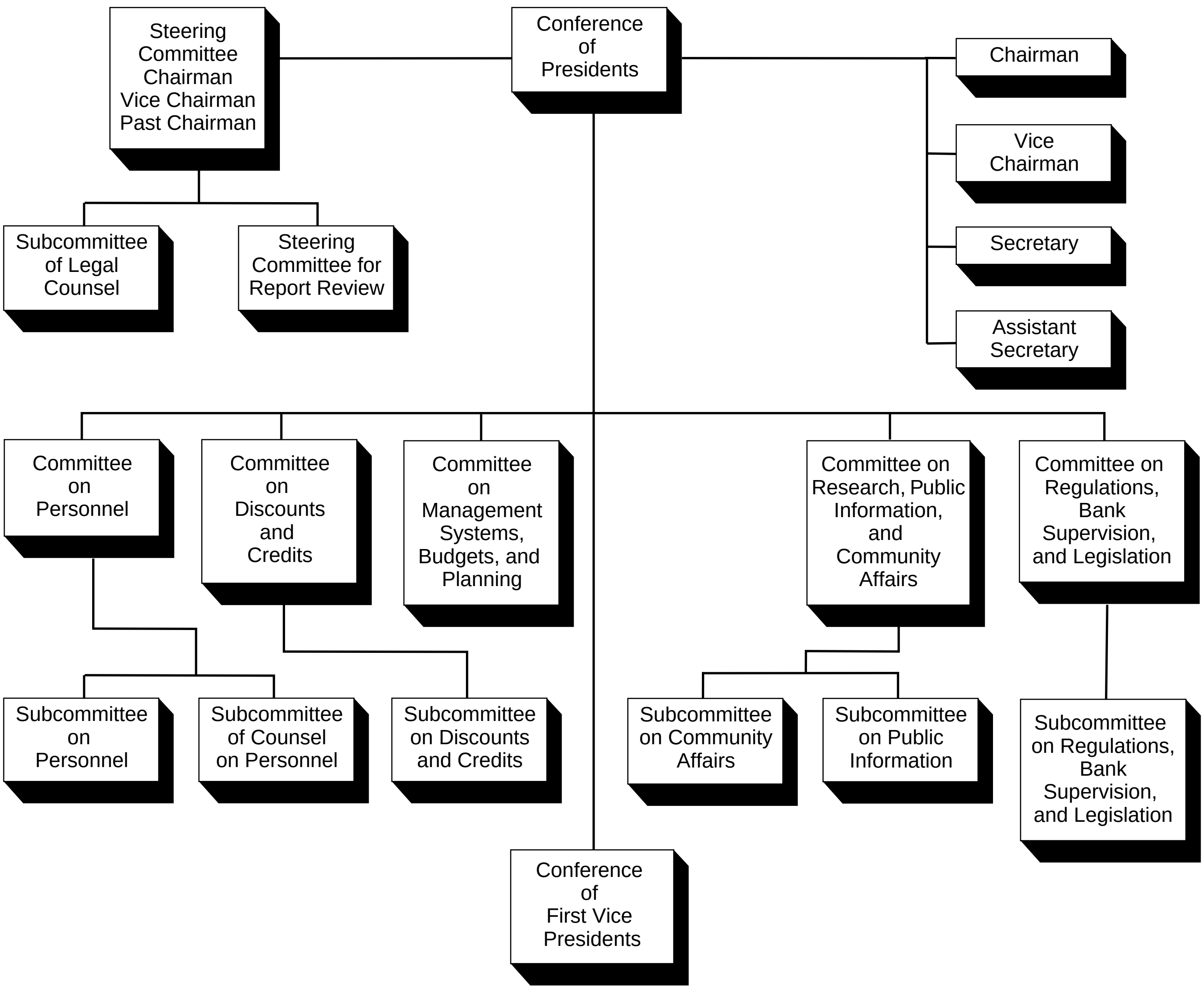
Chairman, Board, and Reserve Banks Have Roles in Strategic Planning

Strategic planning within the Federal Reserve is carried out by the Chairman, the Board, and the Reserve Banks. As the chief executive officer of the Board, the Chairman is responsible for, among other things, providing (1) overall leadership and organizational direction to help establish major policy goals of the Federal Reserve and (2) administrative direction to the other Governors, the Board staff, and Reserve Banks. In his leadership capacity, the Chairman is involved in key decisions relating to major organizational structure changes that are designed to achieve strategic goals. The Chairman also conveys his views on the future direction, goals, and objectives of Federal Reserve policy through participation in meetings with the chairmen of Reserve Banks' boards of directors and various Federal Reserve conferences.

The Board, which sets policy for the Federal Reserve, also has a role in strategic planning. The Board carries out its work through regular meetings and is assisted by standing committees and ad hoc committees. The standing committees perform a range of functions. The committees help formulate policy, review annual budgets for the relevant Board staff units, and monitor the performance of Board staff units or Reserve Banks against the approved budget. One of the standing committees, the Committee on Reserve Bank Activities, is responsible for overseeing the administrative operations of the Federal Reserve. Its purview includes general supervision over Reserve Bank operations, budgets, and planning activities and oversight of DRBOPS.

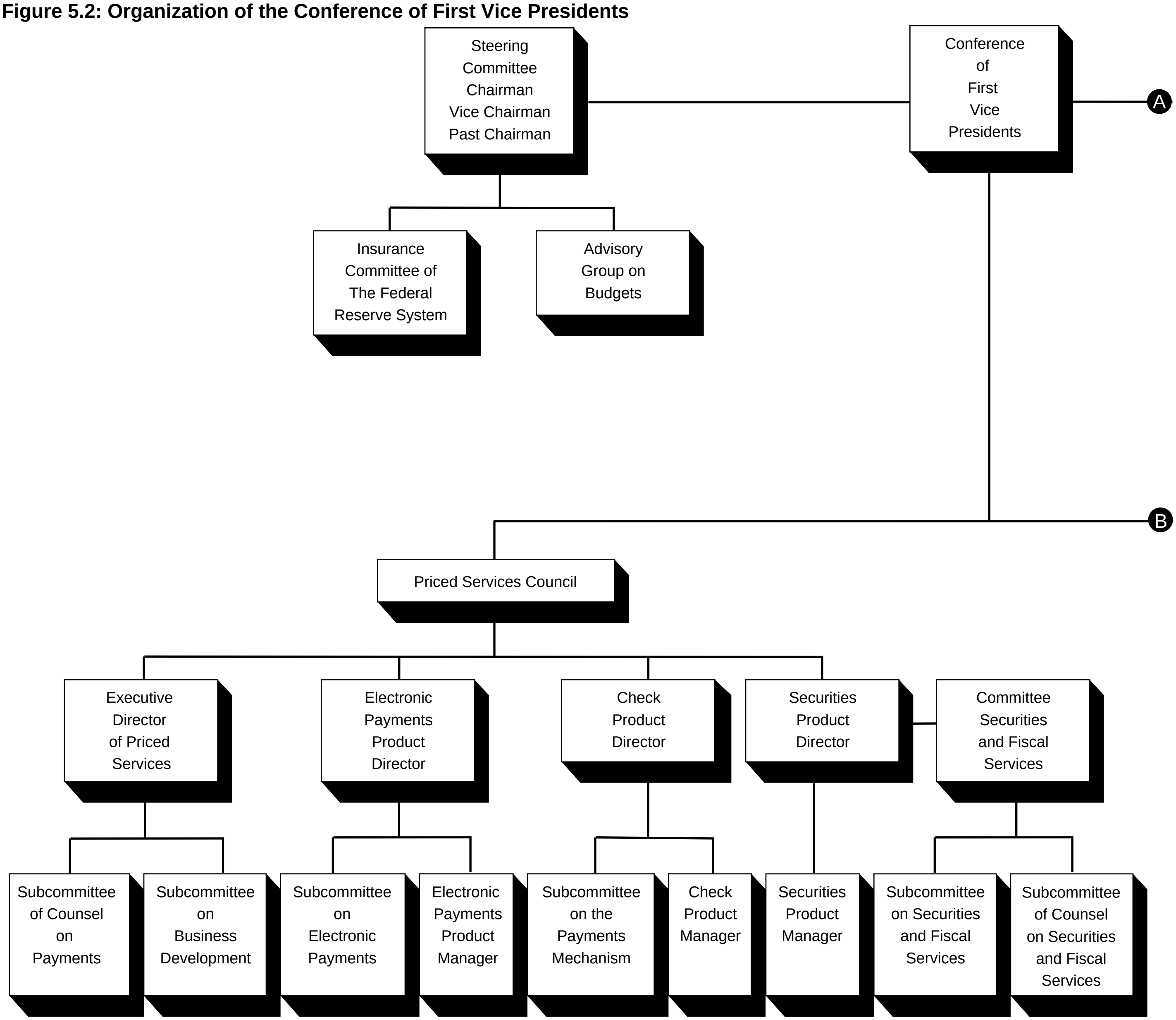
Each of the Reserve Banks has a strategic planning process that establishes goals and direction for the Reserve Bank. Because of the independent structure of the Reserve Banks and shared supervisory authority within the Federal Reserve, the Reserve Banks have established a conference structure, composed of the Conference of Presidents (COP) and the Conference of First Vice Presidents (COFVP), to help develop systemwide consensus on issues and proposals that affect all Reserve Banks. COP, representing the Reserve Bank presidents, focuses on issues related to discounts and credits, management systems, strategic planning, personnel, legislation and regulations, supervision, and research. COFVP, representing the Reserve Bank first vice presidents, focuses on operational issues affecting the Reserve Banks. The conferences are supported by committees and subcommittees that administer the bulk of the conferences' work and often initiate projects. The organizational structures of COP and COFVP are shown in figures 5.1 and 5.2.

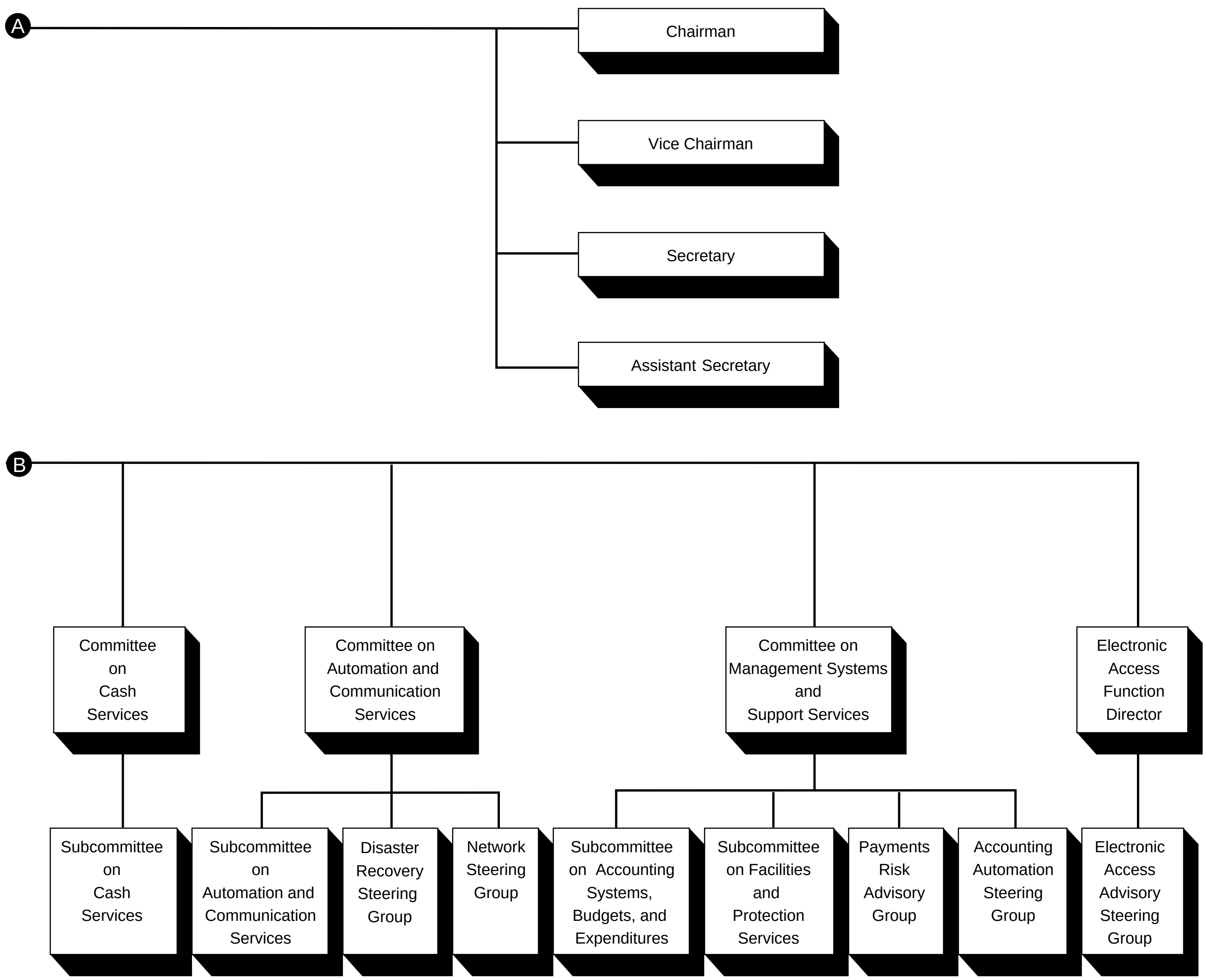
Figure 5.1: Organization of the Conference of Presidents



Source: Federal Reserve System.

Figure 5.2: Organization of the Conference of First Vice Presidents





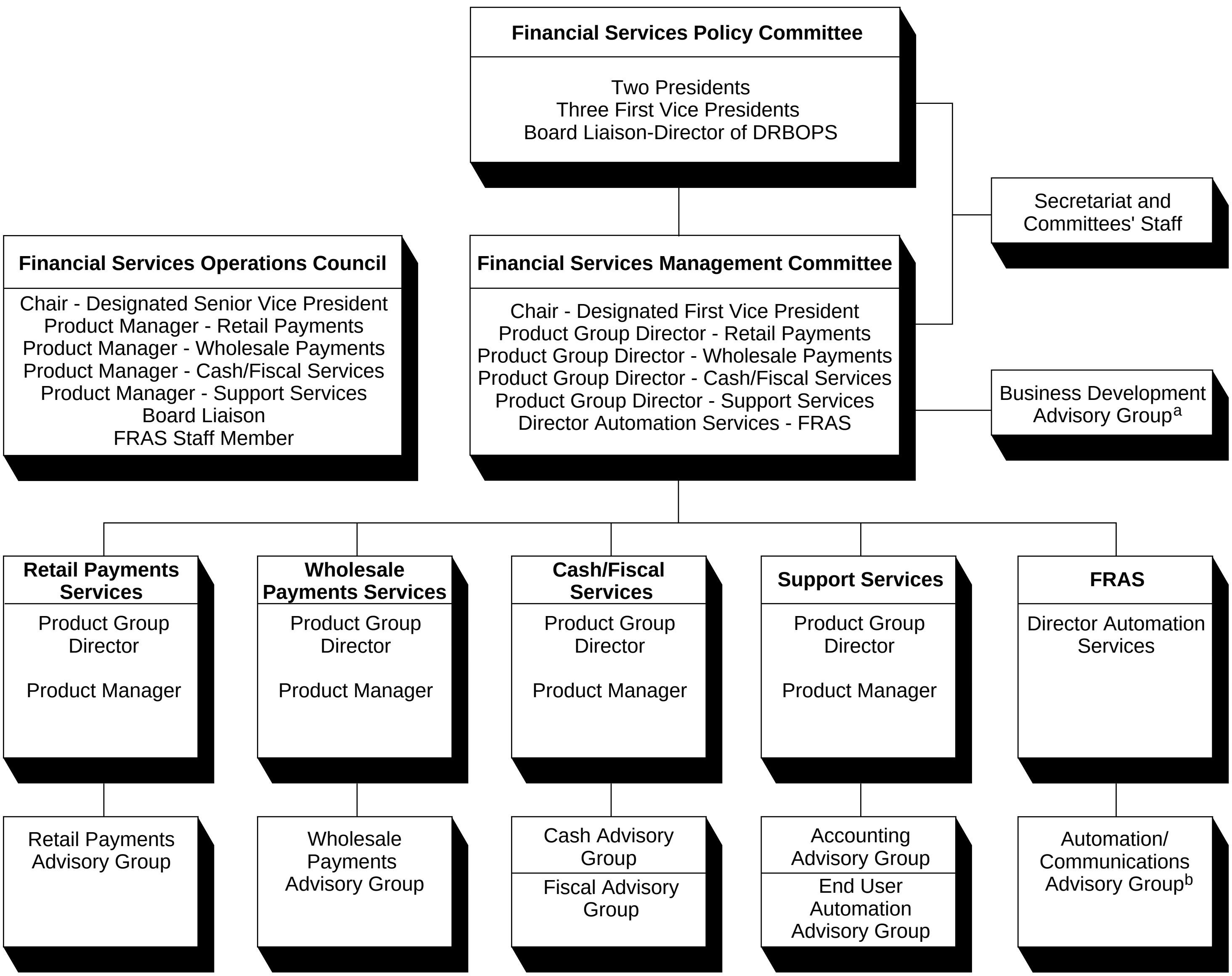
Source: Federal Reserve System.

In late 1994, a new management structure was installed to streamline the decisionmaking process and increase the accountability of Reserve Bank first vice presidents for strategic planning of financial services—which are priced services and other services, such as cash operations—provided to financial institutions. Under the new structure, the Financial Services Policy Committee, which is composed of two presidents and three first vice presidents, is responsible for the overall direction of financial services and related support functions. Furthermore, the committee serves as the vehicle for conveying major issues to the Board for discussion and actions.

The new structure has dramatically altered the responsibilities of COFVP. COFVP maintains responsibility over the budget process. The Financial Services Management Committee is composed of six first vice presidents—the chairperson, four product group directors, and the director of automation services. The management committee is responsible for developing and implementing business plans for the financial services and monitoring budgets and projects. The Financial Services Operations Council is responsible for coordination and provides advice to the management committee. The product offices are responsible for planning the future direction of each service area and receive support from their respective advisory groups. To carry out the Board's supervisory role, DRBOPS staff serve as liaisons to the various groups in the new structure.

Figure 5.3 illustrates the new structure for financial services management.

Figure 5.3: Organization of Financial Services Management



[a]The Business Development Advisory Group reports to the Management Committee Chair.

[b]The Automation/Communications Advisory Group will work with both FRAS and Support Services.

Source: Federal Reserve System.

Planning Processes Focused on Individual Goals and Objectives

Although the Federal Reserve has a range of strategic planning processes or programs in place or under development, we found these processes were not designed to address, on behalf of the Federal Reserve, the critical challenges raised by an increasing need to constrain costs, likely changes for System business lines, or the possible implications of those changes on the Federal Reserve's structure. In reviewing the Federal Reserve's strategic plans and strategic programs under development, we found that they were generally focused on the strategic goals and objectives of individual divisions, Reserve Banks, or functions. While we believe these plans serve an important purpose in defining the direction of these Federal Reserve entities, we believe that the emerging issues and challenges facing the Federal Reserve will necessitate bold strategic planning focused on the System as a whole. For example, the Federal Reserve may find the System's long-term interest better served, both from a cost-reduction and performance perspective, by a review of (1) the System's mission and business lines; (2) the need for all Reserve Banks to perform many of the same functions; and (3) the potential for further consolidation or centralization of certain missions and functions. Determining the future direction of the Federal Reserve and what is best for the System overall, will require the Chairman, the Board, and the Reserve Banks to make hard decisions that will raise further issues and concerns regarding their impact on the Federal Reserve's system of shared leadership and control.

Limited Authority May Hamper Recently Established Federal Reserve Planning Coordination Group

The Federal Reserve recently took action toward achieving greater integration of its strategic planning processes. Recognizing the need for a more systemwide focus, the Board, in mid-1995, chartered the establishment of a new planning entity known as the Federal Reserve System Strategic Planning Coordination Group (SPCG). In assembling SPCG, the Federal Reserve put together an organizationally diverse group whose membership includes the Chairman of the Board (who serves as an ex officio member) and representatives of the Board, and the Reserve Banks, and all major functional and support areas. SPCG is to provide a common framework for the development and refinement of the many individual strategic plans and action plans within the Federal Reserve. According to Federal Reserve planning documents, several Board members and Reserve Bank presidents believed that the discrete strategic planning processes within the Federal Reserve would benefit from greater coherence, especially in terms of assumptions about the future environment and interrelationships among functions.

While we believe the establishment of SPCG is a positive step for the Federal Reserve, we are concerned that SPCG's scope of responsibility and authority may be too limited. Specifically, SPCG was tasked to develop for senior management (governors, presidents, first vice presidents, and certain Board division directors) a document setting forth a common

- view of the mission, vision, values, and priorities of the Federal Reserve;
- view of, and assumptions about, the future environment in which the Federal Reserve will operate;
- understanding of the strengths and opportunities, as well as the weaknesses and vulnerabilities, of the Federal Reserve; and
- recognition of major challenges or redirections facing the Federal Reserve.

In describing the scope of SPCG's work, the Board also identified the following four important issues that the group might address.

- How can the Federal Reserve Board and Reserve Banks work better as a System rather than as 13 separate entities?
- How can the Board and Reserve Banks achieve better coordination across functional areas within units and within the Federal Reserve?
- How can the Board and Reserve Banks achieve better coordination across units within functional areas?
- Are there changes or innovations in the structure or governance of the Federal Reserve that would make it work better?

If the Federal Reserve is to more fully use SPCG, it may need to (1) broaden the group's responsibilities to specifically include a fundamental review of Federal Reserve operations focusing on the primary mission, business lines, and structure that would best support the Federal Reserve's overall mandate in an environment of an increasingly constrained federal budget and (2) better empower the group to have an impact by changing expectations throughout the Federal Reserve about the nature of the changes that could result from the group's work. The SPCG Chairman and Vice Chairman have stated that SPCG is not intended to develop new specific action plans or objectives or to override plans or objectives already in place, for either functional areas or organizational units. Rather, the results of the planning coordination process would be the common framework for developing and refining constituent strategic plans and action plans. Minutes of a September 1995 SPCG meeting indicated the group's concern about its limited authority. The minutes identified several important questions as being planned to be addressed by the group. Two of these questions were (1) how the group could guide organizational decisionmaking, help set priorities for the Federal Reserve, and drive the System's budget processes and (2) how the group could strike an appropriate balance between a system framework and the system strength derived from district/functional autonomy.

Better Linkage of Information Technology Planning to Strategic Decisionmaking Needed

Beginning in the latter 1980s, information technology within the Federal Reserve underwent a profound change. Between 1988 through 1994, the Federal Reserve spent hundreds of millions of dollars on information technology. By late 1995, according to Federal Reserve planning documents, most mission-critical applications had been or were being completely rewritten; a new network, FEDNET,[2] had been built and was being deployed; and the FRAS organization, established to consolidate the mainframe processing function, had assumed responsibility for most mainframe processing.

While we did not do an in-depth review of FRAS, we believe that such an approach makes sense. However, Reserve Banks have remaining concerns about the spillover implications of a systemwide approach to mainframe processing consolidation for the System's future. Because of the size of the information technology investment and the potential that such technology holds for providing higher quality services at a faster and lower cost, it is critical that the Federal Reserve ensures that its strategic information technology planning is an integral part of the Federal Reserve's strategic planning process and business planning and that assumptions about the future environment are fully considered.

Federal Reserve Adopted Systemwide Approach to Mainframe Consolidation

In the 1980s, several Reserve Banks, primarily seeking cost efficiencies, proposed that their Reserve Banks consolidate mainframe processing. On the basis of this effort, the Board later established a committee to study the feasibility of consolidation for the Federal Reserve as a whole. This committee proposed that the Federal Reserve replace the independent mainframe operations of the 12 Reserve Banks and consolidate these operations into 3 automation centers.[3] This proposal also included a unique organizational structure for overseeing mainframe computer operations, placing the responsibility for the consolidated operations

[2]FEDNET is the Federal Reserve's communications network connecting all Reserve System offices and depository institutions.

[3]Before FRAS, each of the Reserve Banks operated its own data processing mainframe operations, including system applications. Over the years, some Reserve Banks modified their applications to suit their own designs. The modifications created the potential for 12 different applications being operated nationally for the same function.

under a Senior Automation Executive located within the Richmond Reserve District as a separate organizational entity called FRAS. In 1990, the Board and the Reserve Banks adopted this proposal, setting a new precedent for a systemwide approach to an important operational function. The Federal Reserve's approach to implementing FRAS represented a major departure from the decentralized approach traditionally used by the Federal Reserve to carry out its operational functions.

The objectives of automation consolidation, in descending order of importance, were to

- improve reliability and disaster recovery,
- increase control of payment system risk in a national banking environment,
- improve security of the total automation environment,
- enhance responsiveness to changing business requirements, and
- improve efficiency.

The Federal Reserve anticipates that FRAS will be responsible for operating mission-critical systems, such as Fedwire (which handles more than $1 trillion in transactions each business day from almost every U.S. financial institution) and key information systems, such as the Federal Reserve's bank statistics database and payroll system.

The systemwide approach to automation consolidation prompted concerns about the control of automation resources and the impact of this approach on the Reserve Bank autonomy and the future of the Federal Reserve. These concerns were twofold: (1) that the consolidation of this activity would lead to the consolidation of other activities and (2) that the Reserve Banks would lose control of the automation resources.

The Reserve Banks worried whether they would continue to manage the automation resources or whether the Board's staff would become more involved in the planning and day-to-day management of automation resources. Concerns were also expressed that, as consolidation progresses, a few "significant" Reserve Banks would emerge. The emergence of such Reserve Banks could cause other Reserve Banks to have a harder time recruiting prestigious directors, thereby diminishing the regional character and local support of the Federal Reserve.

Scope of FRAS Grew

As originally conceived, FRAS was to be a system to provide cheaper mainframe processing support for the delivery of services to Treasury and the financial institutions. However, as is often the case with major information technology projects, the scope of the project grew to include applications not originally envisioned in the original plans for FRAS.

Planning for FRAS could have taken into greater account the needs of the Reserve Banks. Some Reserve Bank officials told us that the growth in scope of FRAS, particularly to include check processing, had made it difficult for them to comply with the requirement in the Monetary Control Act that service fees should recover the costs of priced services.

As the Federal Reserve proceeds in the implementation of FRAS, it needs to better identify the Federal Reserve's overall mission needs, the needs of the Reserve Banks, and those work processes that hold the most promise for improved service delivery through information technology. While we did not do an in-depth review of FRAS, it appears that the design of FRAS assumes the retention of all key missions and business lines. Furthermore, we did not observe an identification of those work processes that could be reengineered and that hold the most promise and risk for the application of information technology. If the Federal Reserve revises its assumptions about the future environment and the Federal Reserve's core missions and business lines, it must ensure that these decisions are well integrated with its information technology strategic planning.

Strategic Information Technology Plan Under Development

The Federal Reserve is currently working on a strategic plan for Federal Reserve information technology. The plan seeks to lay out a planning horizon for the Federal Reserve through the year 2000. As of February 1996, the strategic plan was still in draft. In reviewing the draft plan, we observed that it lays out the strategic goals and strategies by mission. The draft plan also assumed the retention of all missions, business lines, and operating structures. As the Federal Reserve refines its information technology strategic plan, it is vital that the Federal Reserve continually checks its key strategic assumptions and makes sure that the information technology strategic goals keep pace with key strategic decisions.

Budgeting Process Can Better Support Cost Constraint

An effective budget process should support top management in constraining costs, weighing current priorities against future priorities, and allocating resources according to organizational priorities. For an institution such as the Federal Reserve, it is especially important that there be a rigorous budget formulation and execution process in place to constrain cost and foster the internal self-discipline necessary to periodically reassess its strategic goals and priorities. The Federal Reserve's budget process seeks to ensure that overall Federal Reserve objectives are accomplished efficiently and effectively. In reviewing the budgeting process for both the Board and Reserve Banks, we found that the Federal Reserve had a budgeting process that imposed some discipline in that there was no material overspending of approved budgets. However, we found the Federal Reserve's budget process had a weakness in that it used a current services approach that assumed existing functions would be retained and that assumed continued incremental budgetary growth. Such an approach, we believe, did not adequately support top management in constraining costs and imposing the internal self-discipline necessary for the Federal Reserve to respond effectively to future priorities.

The Board and Reserve Banks Used Current Services Approach

In reviewing the budgeting process for 1988 to 1994, we found the operating budgets of the Board and the Reserve Banks were formulated on the basis of the assumption that existing units would generally continue to perform their required functions and their budgets would increase from year-to-year to account for expected increases in inflation and salaries. With no formal constraints on overall spending, the extent of increases in unit budgets was left ultimately to the discretion of the Board.

Formulation and Approval of the Board's Budget

The formulation of the Board's budget was overseen by the administrative governor under authority delegated by the Chairman of the Board and managed by the Board's Office of the Controller. The process began in the spring of each year with the development of a budget guideline and extends through November. In the spring, each Board division developed a strategic plan, which identified and prioritized objectives, and a proposed budget.[4] Next, the Board Governor (or Governors) with administrative responsibility for the division reviewed the plans and commented on the merit of the proposed budget. The divisions had the opportunity to revise their strategic plans on the basis of those comments.

The Program Analysis and Budgets section of the Controller's Office then developed a proposed budget guideline, or acceptable percentage increases in Board expenses for the upcoming year. According to officials

[4]These sessions helped to develop the Board's long-term direction, according to the Board officials we interviewed.

we interviewed, the percentage increases were based on such factors as inflation and the expected cost of programs and initiatives identified in strategic planning sessions. The proposed percentage increases were first reviewed by the administrative Governor and the Board Chairman; if they were satisfied, the Board received the proposal for approval during the summer.

Each Board division used the approved percentage increase to prepare a revised budget proposal that they submitted to the Controller in the fall. After reviewing the budget proposals and making any necessary adjustments, the Controller coordinated meetings to discuss the budget proposal with each division and the appropriate administrative Governor(s). On the basis of these meetings, the Controller could make additional adjustments before consolidating the division budgets. The consolidated budget was then given to the Administrative Governor for review and presentation to the Board Chairman. After all appropriate adjustments had been made, the Administrative Governor presented the consolidated budget to the full Board for approval at a public meeting shortly before the new budget year, which began in January.

Formulation and Approval of Reserve Bank Budgets

Percentage increases and proposed Reserve Bank budgets were formulated and approved in a process separate from formulation and approval of the Board's increases and budget. The Reserve Banks' process generally took 6 months, culminating in the Board's approval of the proposed increase in late spring of the year before the subject budget year. During 1988 to 1994, the Federal Reserve's conferences—COP and COFVP—along with their supporting committees, subcommittees, and task forces, provided a systemwide mechanism for the development and sequential review at many System levels of budgetary proposals and objectives that affect all Reserve Banks. Various data were considered in developing the percentage increase proposal, including volume and cost projections for priced services, Federal Reserve project cost projections, and information on Reserve Bank initiatives affecting expenses.

Shortly after the Board's approval of the allowed increase in Reserve Bank budgets, each Reserve Bank developed budget documents and materials, including a proposed budget. These proposals were initially reviewed by COFVP and then forwarded to COP for review. The COP's budget recommendations were then reviewed and approved, in turn, by DRBOPS, the Board's Reserve Bank Activities Committee and, finally, by the full Board shortly before the start of the budget year.

Board and Reserve Bank Budgets Were Monitored Throughout the Year

The budgets for the Reserve Banks and the Board were monitored throughout the year. For example, the Board's actual expenditures were compared to the budget plan throughout the year to ensure compliance with approved budget and program plans. The Office of the Controller had lead responsibility for monitoring the Board's budget. The Controller submitted quarterly reports to the Board that compared each division's performance with its expenses and conducted midyear reviews with each division to control costs and provide a baseline for analyzing the upcoming year's budget request. Generally, if the Reserve Banks and the Board did not deviate from their respective budgets by more than 1 percent, they were allowed to reprogram funds from one spending category to another without seeking Board approval.

Reserve Bank budgets were also monitored throughout the year—both at the Board and Reserve Banks. These budgets were monitored mainly through the Reserve Bank's cost-accounting system by the individual Reserve Bank controller and staff of DRBOPS. The cost-accounting system facilitated the comparison of the financial and operating performance at Reserve Banks individually and as a whole.

In exercising its statutory authority to generally supervise the Reserve Banks, the Board required the Reserve Banks to submit budgets annually and to seek approval, on an ad hoc basis, for large purchases (capital acquisitions). In addition to the budget approval process, the Board established various levels of approvals for Reserve Bank operations for expenditures related to buildings, equipment acquisitions, and price changes for Reserve Bank services. Over certain dollar amounts, these proposed expenditures must be approved by the Board. For proposals that fell below the specified threshold, the Board delegated its approval authority to DRBOPS or the Reserve Banks. In addition, DRBOPS may forward Reserve Bank proposals that may have systemwide policy implications to the Board. According to a DRBOPS official, proposals approved at the Reserve Bank-level are routinely forwarded to the Board as an information item.

Budgetary Compliance Differed Between Operating and Capital Budgets

In reviewing the execution of the Federal Reserve's budget between 1988 and 1994, we observed that the budget processes of the Board and the Reserve Banks resulted in budgets that increased each year. However, amounts finally approved were generally lower than those initially requested. As a whole, we found that Reserve Banks and the Federal Reserve sometimes exceeded the initially approved operating budgets, but generally by amounts that were less than 1 percent of the approved operating budget.

Concerning the Federal Reserve's capital budget, we found that in every year except 1992, the Federal Reserve spent less than was budgeted. In most years, the underspending was primarily related to data processing and data communications equipment. However, in 1992, the Federal Reserve overspent its data processing and data communications budget by almost $52 million. In that year, the Federal Reserve's initial capital budget did not call for purchasing any computer equipment for FRAS. However, in 1992, the Federal Reserve began FRAS-related acquisition and development; by year-end, the Federal Reserve had spent nearly $96 million to purchase computer equipment.

Systemwide Perspective Needed in Internal Oversight Processes

Internal oversight processes, such as performance measurement, internal audit, and financial audits, can and should play key roles in assisting management in achieving its strategic vision for the organization. The Federal Reserve had many oversight mechanisms in place. However, we found that these mechanisms either did not support performance evaluation from a systemwide perspective or were becoming increasingly inappropriate in the changing environment. As a result, the Federal Reserve may not be making the most use of its resources devoted to Federal Reserve oversight.

Federal Reserve Had a Variety of Oversight Mechanisms

The Board and Reserve Banks had a variety of mechanisms to oversee many activities. Oversight of Board programs and operations is provided by the Board's OIG.[5] The various oversight mechanisms of the Federal Reserve are summarized in table 5.1.

[5]Offices of the inspector general were established by the Inspector General Act of 1978, as amended, to create independent and objective units to (1) conduct and supervise audits and investigations relating to programs and operations of the various agencies; (2) provide leadership and coordination and recommend policies to promote economy, efficiency, and effectiveness and prevent and detect fraud and abuse in agency programs and operations; and (3) provide a means for keeping the head of the establishment and Congress fully and currently informed of such issues.

Table 5.1: Major Oversight Mechanisms Within the Federal Reserve, by Major Components of the System, the Board, and Reserve Banks

Federal Reserve	Explanation of oversight mechanisms
Oversight of the Board	
OIG audits and reviews	Operating under the authority of the Inspector General Act of 1978, as amended, the OIG is to audit and review Board programs, including the Board's examinations and programs for overseeing Reserve Bank activities and Board-delegated programs carried out by the Reserve Banks, such as bank supervision and regulation. The OIG is also to report to Congress on its findings twice a year. The OIG is required to follow generally accepted government auditing standards, which require that auditors be independent of the entities they are auditing. The OIG is not authorized to directly audit Reserve Bank activities.
Oversight of Reserve Banks	
Annual performance evaluations	Under delegated authority of the Board, DRBOPS is to evaluate each Reserve Bank's operational areas on their unit costs and quality measures and review cost-accounting and cost data. The performance ratings are used in determining the salaries for each Reserve Bank president and first vice president.
Financial examinations	Under delegated authority of the Board, DRBOPS is to ensure the accuracy and reliability of each Reserve Bank's balance sheet, propriety and adequacy of supporting documentation of expenditures, and review procedures and controls for compliance with system policies and applicable regulations and procedures.[a]
Operations reviews	Under delegated authority of the Board, DRBOPS is to (1) review certain Reserve Bank functions to ensure compliance with Federal Reserve policies and standards and (2) promote effective and efficient Reserve Bank operations.[b] Other divisions of the Board also conduct operations reviews under delegated authority. For example, the Board's Division of Human Resources Management reviews human resources operations at each of the Reserve Banks.
Internal audits	Reporting to the Reserve Bank's board of directors through the directors' audit committee, each Reserve Bank has a general auditor and staff that are to evaluate internal control systems and determine the Reserve Bank's compliance with applicable policies and regulations.
External audits	Under a contract with the Board, an independent public accounting firm is scheduled to audit the combined financial statements of the Reserve Banks for each year from 1995 through 1999. During these years, the financial statements of each individual banks will also be audited.

Legend:

ACH = automated clearinghouse
DRBOPS = Division of Reserve Bank Operations and Payment Systems
OIG = Office of the Inspector General

[a]We agree with a recent OIG's recommendation that the Financial Examination Program should become organizationally independent from DRBOPS and report directly to the Board. The OIG concluded that the financial examination program, as currently organized within DRBOPS, presents the appearance that it may not be fully independent.

[b]DRBOPS conducts operations reviews on, among other things, check, cash, fiscal agency, ACH, electronic processing, and cost-accounting operations.

Source: Federal Reserve System.

Development of Joint Performance Measurement Indicators Is Needed

Through involving key stakeholders in developing performance measurement systems keyed to organizational goals, performance measurement can be used to assess how all parts of the organization are contributing to overall effectiveness in achieving the organization's key goals. In conducting our work, we noted that the evaluation and assessment of Reserve Bank performance had received considerable attention from both Reserve Bank management and the Board. DRBOPS conducted annual assessments of Reserve Bank operations in various areas. Reserve Bank management tracked performance on a variety of measures on an ongoing basis. And other oversight mechanisms—internal and external financial examinations, operations reviews, and OIG evaluations—provided other information on performance. However, many of these current performance measures were too narrowly focused on such Bank-specific measures as the numbers of checks processed or the amount of fees collected for ACH processing. In the context of the Federal Reserve's new efforts on systemwide planning for the Board and the Reserve Banks together, the Federal Reserve would appear to lack major systemwide benchmarks to measure how effectively the Federal Reserve—as a whole—is meeting its new challenges.

Concerning systemwide goals and objectives, it may now be appropriate for the Federal Reserve to redesign its key performance indicators to more accurately reflect overall organizational goals and objectives. As a part of this new strategy, outcome-linked performance measures should be developed, for both the Board and Reserve Banks, that show how organizational components can best contribute to overall organizational effectiveness.

Existing Oversight Structures Likely to Become Increasingly Inappropriate for Reserve Bank Operations

Even given the numbers of oversight mechanisms available to the Federal Reserve, we identified specific problems—the coverage of audit and evaluations, the potential for the lack of independence, and possible audit reporting problems—that all could be improved with certain changes in Federal Reserve oversight. These problems stemmed in part from the unique structure of the Federal Reserve and the authority provided to those entities supporting the Board. For example, the Inspector General is authorized to review only the activities of the Board while DRBOPS is responsible for overseeing the Reserve Banks and for developing policies. As the Federal Reserve increases systemwide projects and consolidations, the need for stronger, comprehensive Federal Reserve oversight is likely to increase. With improved oversight, the Federal Reserve can better identify areas where efficiencies can be achieved, particularly areas with reengineering potential, and ensure that organizational results are both outcome-linked and responsive to multiple organizational priorities that may cut across various parts of an organization.

Improvements Needed in Audit and Evaluation Coverage

The lack of a systemwide perspective has affected the audit and evaluation coverage within the Federal Reserve. Until recently, the Federal Reserve's oversight mechanisms did not include an independent audit of the combined financial statements of the Reserve Banks. DRBOPS, which lacks clear independence, conducted individual financial examinations of each Reserve Bank on behalf of the Board. In November 1994, the Board awarded a contract to have an independent public accounting firm audit the combined financial statements of the Federal Reserve Banks for the years 1995 through 1999. We believe this would be helpful toward improving financial auditing within the Reserve. However, we also believe that a permanent policy to require an annual independent financial audit of the combined Reserve Banks' financial statements is needed. We recommended that this be done in some of our previous work.[6] Government experience has shown that emphasis on financial management and oversight can change with agency leadership. Therefore, legislating an annual audit requirement, as was done by the Government Management Reform Act of 1994, which expanded the Chief Financial Officer Act's requirements to the 24 largest executive agencies to obtain annual financial statement audits, would ensure that emphasis on financial management is continued.

We also noted in our review that some areas were the subject of possibly redundant audit attention. For example, at the time of our review, we observed separate evaluations of various aspects of work on the Federal Reserve Automation Services project at the Richmond Reserve Bank being conducted by the Richmond General Auditor, the OIG, and DRBOPS staff. While we did not do an in-depth analysis of areas of overlap in these audits, we nevertheless found possible areas of overlap. At the same time, in our review of a sample of contracting and procurement practices at selected Reserve Banks, we found potential for possible conflicts of interest within the bid selection processes and some lax practices in ensuring that correct payments were being made on contracts. Yet despite the fact that contracting received some audit attention at the Reserve Banks we visited, these problems were not identified.

[6] Federal Reserve Banks: Internal Control, Accounting, and Auditing Issues (GAO/AIMD-96-5, Feb. 9, 1996).

Possible Reporting Problems in Systemwide Audits

The use of the existing oversight structure to conduct systemwide audits may not be appropriate because the general auditors do not report to a systemwide board of directors. At the time of our review, one General Auditor was serving as the head of the systemwide audit of the ISS-3000 currency processing equipment. The General Auditor was to report the audit findings to that Reserve Bank's Audit Committee even though this review was conducted for the Federal Reserve as a whole. In our view, the findings of an audit of a major systemwide project should be reported directly to the Board, which has direct fiscal responsibility for the project.

Oversight Concerns Could Be Addressed Through Better Focus

We believe that the Federal Reserve could alleviate some, if not all, of these problems by providing a more focused and efficient approach to Federal Reserve oversight. The Federal Reserve could accomplish this by taking steps to better ensure the independence of its internal audit function and to expand the scope of the OIG's authority to include responsibility for auditing the Reserve Banks and systemwide projects. As Reserve Banks are moving toward more systemwide projects and more centralized decisionmaking, the Federal Reserve's fragmented oversight structure is increasingly inappropriate to provide adequate oversight of centralized Reserve Bank operations. If the OIG's authority was expanded, the problems of redundant audits would be addressed. The expansion of the OIG's authority would necessitate both an increase in staff and spending for the OIG. However, it may be possible to simultaneously reduce staffing in other oversight mechanisms.

Conclusions

We believe that the Federal Reserve, to effectively plan for the future, needs to conduct a fundamental assessment of its operations focusing on its missions, strategic goals, and structure. Such an assessment should also include a review of the Federal Reserve strategic management processes. We believe that the Federal Reserve faces some difficult constraints in conducting such an effort. For example, the Board will need to work with the Reserve Banks to rethink their mutual roles in the shared leadership of the system. Furthermore, they will face profound challenges in planning and confronting possible changes. Planning deliberations related to redefining core missions and business lines and realigning the Federal Reserve's structure and governance would require strategic planners to "think beyond" the statutory powers of the Board and Reserve Banks. The essential missions as well as the locations of the Federal Reserve's Reserve Banks are set by law, and the autonomy of the Reserve Banks generally necessitates consensus-oriented decisionmaking in systemwide planning. For example, the Federal Reserve is required by law to develop and implement monetary policy, supervise and regulate banks, regulate and provide payments system services, and provide fiscal agency services to government agencies upon request.

In rethinking its mission and business lines, the Federal Reserve may face conflicts and difficult policy choices, which may require that it consult with Congress for help in resolving them. For example, the Federal Reserve is required to base check-clearing fees on the recovery of its costs; at the same time, it must also function as the "clearer of last resort" and promote the safety and soundness of financial institutions. In addition, neither the Board nor the Reserve Banks is authorized to change the numbers or locations of Reserve Banks or essential elements of Federal Reserve governance. Changes that might be considered in the context of a fundamental assessment of Federal Reserve operations could require legislative action to accomplish.

Because it lacks the cost minimization pressures common to most public and private entities, the Federal Reserve must work extra hard to overcome internal pressures for budgetary increases. As discussed in chapter 1, the Board is a government agency and provides Congress with an annual report of the Federal Reserve's operations; however, the Federal Reserve is not subject to the congressional appropriations process that serves as a constraint on spending by federal entities. Furthermore, because the Federal Reserve Act sets dividends to member banks at 6 percent and prohibits them from selling their shares, shareholders, who are member banks, do not have the usual financial incentives to encourage cost-efficient operations. Additionally, the amount of interest the Federal Reserve receives on securities acquired through the issue of Federal Reserve notes is so great that it tends to mask the net decline of all other revenue sources that occurred over the 1988 to 1994 period. Therefore, it is especially important for the Federal Reserve to have management processes that support top management in constraining costs and that instill a high level of internal self-discipline that would allow the Federal Reserve to overcome institutional resistance to major management reform.

However, despite its unique structure, the Federal Reserve has begun to show that it can address operational issues strategically and work in a systemwide manner when necessary, as evidenced by the recent establishment of a new Financial Services Committee to examine priced services and by the consolidation of its data-processing facilities. The

Board and the Reserve Banks must work together to meet the emerging challenges and to ensure that the nation's central bank keeps pace with the changing environment and remains a strong and competitive institution.

Recommendations and Matters for Consideration

In analyzing opportunities to reduce the cost of Federal Reserve operations to the taxpayer, any potential adverse impact on the independence of monetary policy or on the Federal Reserve's ability to meet its key responsibilities should be considered carefully. However, we see no inherent conflict between the Federal Reserve's independence or effectiveness and efforts to improve efficiency. Many of the functions performed by the Federal Reserve have little direct relation to monetary policy, and the Board, working with the Reserve Banks, has the authority and ability to take many cost-saving actions without jeopardizing its mission effectiveness. However, any decision to close Reserve Banks or establish a separate corporation for priced services would require congressional approval. Thus, we make recommendations to the Board and suggest several matters for congressional consideration.

Recommendations to the Board of Governors

We recommend that the Board of Governors undertake a fundamental review of Federal Reserve operations focusing on the primary mission, business lines, and structure that would best support its overall mandate. Such an organizational review should include an assessment of the following:

- the Federal Reserve's role in providing financial services to banks and government agencies and an analysis of the costs and benefits to the Federal Reserve and the taxpayers of various options for delivering such services (such options could include discontinuing delivery of certain priced services to financial institutions, privatizing the delivery of other services by establishing a private corporation for delivering such services, or retaining responsibility for being the primary service provider);
- cost-saving opportunities that could result from streamlining the Federal Reserve's existing management structures and consolidating Federal Reserve operations, including possible mergers among the 12 Reserve Banks and 25 branches; and
- the potential for technology to support streamlined work processes in the Reserve Banks and to reduce costs and improve quality.

In addition, we recommend that the Board strengthen its existing control and oversight mechanisms by, among other things, (1) reviewing the appropriateness of current budget assumptions, which assume steady annual growth; (2) taking steps to better ensure the independence of the Federal Reserve's internal audit function and to expand the scope of its OIG's authority; and (3) ensuring that an independent financial audit of the Reserve Banks' combined financial statements is conducted every year.

Matters for Congressional Consideration

Congress should consider the results of the Federal Reserve's assessments and determine

- whether it would be desirable to merge or close any of the 12 Reserve Banks or 25 branches and
- which of the various options for delivering priced services to financial institutions are in the best interests of public policy and represent the best balance between achieving cost savings and serving the nation's financial interests.

Congress should also consider

- requiring an annual independent audit of the Reserve Banks' combined financial statements;
- requiring the Federal Reserve to charge for bank examinations; and
- establishing a statutory requirement that the Federal Reserve annually transfer its remaining revenues to the Treasury.

Federal Reserve's Comments and Our Evaluation

The Federal Reserve's Board of Governors did not agree with any of our recommendations to the Board or with our suggestions to Congress. The Board did not agree to undertake a fundamental review of the Federal Reserve System's operations, because it believes such reviews are an ongoing and integral part of the Board's oversight of the System. The Board stated that the Federal Reserve's role in providing financial services to depository institutions is constantly being tested in the marketplace, and the Board noted that the System is consolidating the management of some financial services. The Board stated its belief that most savings from such consolidation efforts would be possible in electronic payment functions, such as Fedwire, with lesser savings possible in paper-based financial services, such as check clearing. The Board also did not agree to consider alternatives to the current way the System provides priced services.

Concerning merging or closing any of its 12 Reserve Banks or 25 branches, the Board stated that, while the Federal Reserve's structure would likely be different if established today, any such realignments or relocations would have to yield substantial long-term savings to offset the transition costs. Concerning the potential for technology to support streamlined work processes in the Reserve Banks, the Board stated that the Federal Reserve routinely assesses technologies for their ability to reduce costs and improve the quality of its services.

Concerning our recommendations to improve the Federal Reserve's control and oversight mechanisms, the Board did not agree with our characterization of the System's budget process as one that assumed continuous growth. The Board also did not agree that the independence of its internal oversight would be strengthened by expanding the authority of the Board's OIG to the Reserve Banks. The Board believed that the current audit process ensured adequate independence and that expanding the OIG's authority could integrally involve the inspector general in the Board's oversight process and raise questions about the inspector general's "arm's length" ability to audit such processes. The Board did not comment on our recommendation to institutionalize an annual external audit of the combined financial statements of the Reserve Banks.

Finally, the Board did not agree with our suggestion that Congress may want to consider requiring the Federal Reserve to charge for bank examinations. The Board noted that, currently, the states charge examination fees that, on average, are approximately half of those charged by OCC for national bank examinations. The Board believed that if the Federal Reserve and FDIC were to charge for their examinations of state-chartered banks, such fees could tip the scales toward national charters and call into question the long-term viability of a valuable dual banking system.

We continue to believe that the major technological and marketplace developments that are currently affecting the financial services industry have profound implications for the activities and operations of the Federal Reserve and require the System to have a strong, systemwide strategic management process. We acknowledge that the Federal Reserve has a range of strategic planning processes and programs in place or under development. And we recognize and commend the Federal Reserve's efforts to provide a more systemwide focus for its strategic planning efforts through the recent creation of the Federal Reserve System Strategic Planning Coordination Group. However, we are concerned that these strategic planning efforts are not sufficiently integrated and thus may be too limited and insufficient to effectively address the major challenges the Federal Reserve is facing, given the potential implications of these developments for the Federal Reserve's business lines and organizational structure.

Leading private and public institutions have found that truly significant savings often come only when, as a part of a comprehensive strategic planning process, they have rethought their basic missions and lines of business and reengineered their work processes to streamline operations. The Federal Reserve's plans to consolidate some of its operations in financial services, while commendable, fall far short of the broad rethinking that we believe is necessary if the Federal Reserve is to be as efficient and cost effective as it can be in fulfilling its critical role as our nation's central bank.

As a part of this broad rethinking, we also believe the Federal Reserve should consider consolidating some Reserve Banks and branches. We agree with the Board that such consolidation would result in transition costs but we believe that these costs could be offset by longer-term savings. We also note that consolidating banks and branches is not without precedent among central banks. For example, before the reunification of the former East and West Germany, the German central bank, the Deutsche Bundesbank (which was established by the Allies after World War II and modeled on the Federal Reserve System), had a presence in the form of Landesbanks in each of the 11 West German states. If it chose to keep intact the same structure after reunification, the Bundesbank was faced with the possibility of establishing five additional Landesbanks, one in each of the states of the former East Germany. Instead, the German government reduced the total number of Landesbanks serving the reunified 16 states to 9 Landesbanks and significantly reduced the number of central bank branches as well. The chief reasons given for these consolidation efforts were to promote efficiency and cost savings. Between January 1, 1995, and January 1, 1996, the Bundesbank reported that it was able to reduce its staff by 6 percent.

Our recommendation that the Federal Reserve consider alternatives to the current way it delivers priced services to depository institutions is another example of the broad rethinking of mission and lines of business that we believe the Federal Reserve should undertake. When institutions carefully reexamine their missions and lines of business, they often determine that some lines of business are no longer profitable or no longer fit with the strategic direction they wish to take. For example, observers in the private sector have questioned whether it is appropriate for the Federal Reserve to continue to be both a provider and regulator of priced services, particularly in light of the growth of private-sector service providers. Some top officials within the Federal Reserve have, in the past, also suggested alternative ways to provide these services, such as by establishing a separate corporation.

Regarding the use of technology to streamline work processes, our reviews of leading organizations that have sought to improve performance through strategic information management and technology have shown that accomplishing order-of-magnitude improvements in performance nearly always requires streamlining or redesigning critical work processes.[7] Consequently, we believe information systems initiatives must be focused on process improvement. Using business process reengineering to drive information systems initiatives can lead to these order-of-magnitude savings, rather than the marginal efficiency gains normally associated with initiatives that use technology to do the same work, the same way, only faster. We acknowledged in several sections in this report that the Federal Reserve's automation consolidation efforts (under the FRAS system) were designed to promote more efficient operations and to ensure increased security in the nation's payments system. However, we are concerned that the Federal Reserve's automation consolidation efforts may not have involved sufficient reengineering of existing work processes. Because of the size of the information technology investment and the potential that such technology holds for providing higher quality services faster and at lower cost, we believe that it is critical that the Federal Reserve ensures that its strategic information technology planning is an integral part of its strategic and business planning processes.

We continue to believe that the concerns we raised about the Federal Reserve's oversight and control mechanisms are valid. Although the Federal Reserve does not view its budget process as having a built-in assumption of annual growth, we note that, for each year from 1988 to 1994 and for each Reserve Bank, annual budget targets have been expressed as percentage increases from the previous year's budgets. The budget did not reflect a decrease in budget authority in any year for any Reserve Bank despite the fact that during this period many Reserve Banks

[7]See GAO/AIMD-94-115, May 1994.

consolidated their savings bonds programs and mainframe computer operations.

With regard to expanding the OIG's authority to directly audit the Reserve Banks, we believe the inspector general can perform these functions while also retaining the ability to provide arm's length reviews of the Board's oversight processes. In an increasingly consolidated Federal Reserve System, retaining the Reserve Banks' general auditors to do systemwide reviews seems increasingly inappropriate. And reliance on DRBOPS to do such reviews leads to questions about the independent nature of such reviews, particularly since this division also sets policy for the Reserve Banks and has approval authority over certain Reserve Bank purchases and decisions. Such problems and questions could be resolved by expanding the OIG's authority and by taking steps to better ensure the independence of the Federal Reserve's internal audit function. In addition, centralizing reviews of Reserve Bank programs would make more apparent any overlapping and redundant reviews and would more clearly highlight areas receiving insufficient audit attention.

Finally, we found no reason to suggest that having the Federal Reserve charge for its bank examinations would threaten our valuable dual banking system. Currently, the Federal Reserve is the only one of five federal regulators of depository institutions where taxpayers, and not the industry, bear the cost of supervision. As we noted in this report, the Federal Reserve supervises less than 1,000 state-member banks, or about 9 percent of all banks, and evidence from recent mergers indicates that state charters are being considered more desirable than national charters. The Federal Reserve could also take steps through arrangements with state banking regulators to reduce any undue competitive effects of charging for bank examinations. In addition, our recommendation is not meant to be limited to charging state-member banks. The Federal Reserve's response does not address charging for its other examinations—those for foreign banks and bank-holding companies—where the possibility of charter switching is not an issue.

Detailed Statement of Conditions of All Federal Reserve Banks Combined, December 31, 1994

1. Detailed Statement of Condition of All Federal Reserve Banks Combined, December 31, 1994

Thousands of dollars

ASSETS

Gold certificate account				**11,050,635**
Special drawing rights certificate account				**8,018,000**
Coin				**320,320**
Loans and securities				
Loans to depository institutions			**222,876**	
Federal agency obligations				
Bought outright			**3,636,705**	
Held under repurchase agreement			**1,025,000**	
U.S. Treasury securities				
Bought outright				
Bills	**177,378,390**			
Notes	**144,143,313**			
Bonds	**42,997,536**			
Total bought outright		**364,519,239**		
Held under repurchase agreement		**9,565,000**		
Total securities			**374,084,239**	
Total loans and securities				**378,968,820**
Items in process of collection				
Transit items			4,109,320	
Other items in process of collection			1,089,912	
Total items in process of collection				**5,199,231**
Bank premises				
Land			167,320	
Buildings (including vaults)	878,056			
Building machinery and equipment	234,938			
Construction account	64,378			
Total bank premises		1,177,371		
Less depreciation allowance		268,258	909,114	
Bank premises, net				**1,076,434**
Other assets				
Furniture and equipment		1,136,824		
Less depreciation		654,735		
Total furniture and equipment, net			482,088	
Denominated in foreign currencies[1]			22,031,496	
Interest accrued			3,841,600	
Premium on securities			4,476,244	
Overdrafts			318,716	
Prepaid expenses			716,595	
Suspense account			33,847	
Real estate acquired for banking-house purposes			25,360	
Other			336,556	
Total other assets				**32,262,501**
Total assets				**436,895,941**

1.—Continued

LIABILITIES		
Federal Reserve Notes		
Outstanding (issued to Federal Reserve Banks)	454,642,232	
Less held by Federal Reserve Banks	−73,137,090	
Total Federal Reserve notes, net		**381,505,142**
Deposits		
Depository institutions		**30,788,596**
U.S. Treasury, general account		**7,161,095**
Foreign, official accounts		**250,119**
Other deposits		
Officers' and certified checks	25,737	
International organizations	101,899	
Other[2]	645,963	
Total other deposits		**773,600**
Deferred credit items		**4,458,817**
Other liabilities		
Discount on securities	3,842,323	
Sundry items payable	85,285	
Suspense account	29,022	
All other	635,289	
Total other liabilities		**4,591,919**
Total liabilities		**429,529,287**
CAPITAL ACCOUNTS		
Capital paid in		**3,683,327**
Surplus		**3,683,327**
Other capital accounts[3]		**0**
Total liabilities and capital accounts		**436,895,941**

NOTE. Amounts in boldface type indicate items in the Board's weekly statement of condition of the Federal Reserve Banks.

1. Of this amount $9,165.9 million was invested in securities issued by foreign governments, and the balance was invested with foreign central banks and the Bank for International Settlements.

2. In closing out the other capital accounts at year-end, the Reserve Bank earnings that are payable to the Treasury are included in this account pending payment.

3. During the year, includes undistributed net income, which is closed out on December 31.

Income and Expenses of Federal Reserve Banks, 1994

2. Statement of Condition of Each Federal Reserve Bank, December 31, 1994 and 1993

Millions of dollars

Item	Total 1994	Total 1993	Boston 1994	Boston 1993
ASSETS				
Gold certificate account	11,051	11,053	553	660
Special drawing rights certificate account	8,018	8,018	511	511
Coin	320	372	15	10
Loans				
To depository institutions	223	94	6	4
Other	0	0	0	0
Acceptances held under repurchase agreements	0	0	0	0
Federal agency obligations				
Bought outright	3,637	4,638	190	274
Held under repurchase agreements	1,025	1,025	0	0
U.S. Treasury securities				
Bought outright[1]	364,519	332,015	19,082	19,592
Held under repurchase agreements	9,565	12,187	0	0
Total loans and securities	378,969	349,960	19,278	19,870
Items in process of collection	5,199	7,173	293	353
Bank premises	1,076	1,055	93	91
Other assets				
Denominated in foreign currencies[2]	22,031	22,339	797	793
All other	10,231	10,000	450	460
Interdistrict Settlement Account	0	0	−2,202	−2,195
Total assets	**436,896**	**409,971**	**19,788**	**20,553**
LIABILITIES				
Federal Reserve notes	381,505	343,925	17,747	17,254
Deposits				
Depository institutions	30,789	34,951	1,214	2,555
U.S. Treasury, general account	7,161	14,809	0	0
Foreign, official accounts	250	386	5	5
Other	774	397	31	15
Total deposits	38,973	50,543	1,250	2,575
Deferred credit items	4,459	6,210	284	326
Other liabilities and accrued dividends[3]	4,592	2,489	228	152
Total liabilities	**429,529**	**403,168**	**19,509**	**20,307**
CAPITAL ACCOUNTS				
Capital paid in	3,683	3,401	139	123
Surplus	3,683	3,401	139	123
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	**436,896**	**409,971**	**19,788**	**20,553**
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding (issued to Bank)	454,642	409,265	22,868	19,706
Less: Held by Bank	73,137	65,339	5,121	2,452
Federal Reserve notes, net	**381,505**	**343,925**	**17,747**	**17,254**
Collateral for Federal Reserve notes				
Gold certificate account	11,051	11,053	...	...
Special drawing rights certificate account	8,018	8,018	...	...
Other eligible assets	0	0	...	...
U.S. Treasury and federal agency securities	362,437	324,854	...	...
Total collateral	**381,505**	**343,925**	...	...

For notes see end of table.

2.—Continued

New York		Philadelphia		Cleveland		Richmond	
1994	1993	1994	1993	1994	1993	1994	1993
4,134	3,753	393	399	660	701	902	899
2,808	2,808	303	303	556	556	652	652
19	11	19	15	17	21	56	67
0	9	17	8	0	0	0	65
0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0
1,344	1,602	142	176	229	312	291	362
1,025	1,025	0	0	0	0	0	0
134,693	114,654	14,256	12,583	22,978	22,303	29,138	25,898
9,565	12,187	0	0	0	0	0	0
146,627	129,477	14,416	12,766	23,207	22,614	29,428	26,325
649	789	332	445	269	275	392	502
137	140	47	47	46	37	134	139
6,267	6,474	737	858	1,449	1,289	1,481	1,537
4,160	4,529	353	306	529	512	902	835
5,853	12,726	2,232	921	−1,332	−3,321	−867	598
170,653	**160,707**	**18,833**	**16,060**	**25,400**	**22,684**	**33,080**	**31,553**
151,608	134,964	16,733	13,026	22,542	20,161	28,847	28,035
7,105	6,969	1,491	2,248	1,814	1,556	2,782	2,357
7,161	14,809	0	0	0	0	0	0
149	288	5	5	9	8	9	10
261	196	26	7	41	14	70	32
14,677	22,261	1,523	2,261	1,864	1,578	2,862	2,398
551	747	32	432	222	340	447	477
1,843	798	183	114	257	158	332	186
168,678	**158,769**	**18,511**	**15,832**	**24,885**	**22,237**	**32,487**	**31,096**
988	969	161	114	258	224	296	229
988	969	161	114	258	224	296	229
0	0	0	0	0	0	0	0
170,653	**160,707**	**18,833**	**16,060**	**25,400**	**22,684**	**33,080**	**31,553**
174,495	157,408	18,463	14,472	26,124	23,474	35,331	34,012
22,888	22,444	1,690	1,446	3,581	3,313	6,484	5,978
151,608	**134,964**	**16,773**	**13,026**	**22,542**	**20,161**	**28,847**	**28,035**
...	...	...	...	...	...	...	...
...	...	...	...	...	...	...	...
...	...	...	...	...	...	...	...
...	...	...	...	...	...	...	...
...	...	...	...	...	...	...	...

2. Statement of Condition of Each Federal Reserve Bank, December 31, 1994 and 1993—Continued

Millions of dollars

Item	Atlanta 1994	Atlanta 1993	Chicago 1994	Chicago 1993
ASSETS				
Gold certificate account	542	509	1,217	1,186
Special drawing rights certificate account	318	318	1,036	1,036
Coin	46	55	23	32
Loans				
To depository institutions	28	1	18	1
Other	0	0	0	0
Acceptances held under repurchase agreements	0	0	0	0
Federal agency obligations				
Bought outright	163	189	417	539
Held under repurchase agreements	0	0	0	0
U.S. Treasury securities				
Bought outright[1]	16,293	13,507	41,758	38,585
Held under repurchase agreements	0	0	0	0
Total loans and securities	16,484	13,697	42,193	39,124
Items in process of collection	753	775	509	674
Bank premises	64	61	112	113
Other assets				
Denominated in foreign currencies[2]	2,073	2,120	2,527	2,531
All other	423	380	1,069	960
Interdistrict Settlement Account	1,871	2,185	−1,048	1,743
Total assets	**22,573**	**20,101**	**47,638**	**47,400**
LIABILITIES				
Federal Reserve notes	18,053	14,960	42,265	41,541
Deposits				
Depository institutions	3,018	3,617	3,397	4,022
U.S. Treasury, general account	0	0	0	0
Foreign, official accounts	13	13	16	16
Other	29	2	148	81
Total deposits	3,060	3,632	3,561	4,118
Deferred credit items	561	736	496	679
Other liabilities and accrued dividends[3]	217	132	479	282
Total liabilities	**21,891**	**19,461**	**46,800**	**46,620**
CAPITAL ACCOUNTS				
Capital paid in	341	320	419	390
Surplus	341	320	419	390
Other capital accounts	0	0	0	0
Total liabilities and capital accounts	**22,573**	**20,101**	**47,638**	**47,400**
FEDERAL RESERVE NOTE STATEMENT				
Federal Reserve notes outstanding (issued to Bank)	23,368	19,797	48,257	45,621
Less: Held by Bank	5,315	4,837	5,992	4,081
Federal Reserve notes, net	**18,053**	**14,960**	**42,265**	**41,541**

NOTE. Components may not sum to totals because of rounding.

1. Includes securities loaned—fully guaranteed by U.S. Treasury securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions.

2. Valued monthly at market exchange rates.

3. Includes exchange-translation account reflecting the monthly revaluation at market exchange rates of foreign-exchange commitments.

2.—Continued

St. Louis		Minneapolis		Kansas City		Dallas		San Francisco	
1994	1993	1994	1993	1994	1993	1994	1993	1994	1993
429	392	230	243	436	409	453	510	1,102	1,392
168	168	186	186	199	199	377	377	904	904
23	22	21	15	22	21	28	42	33	61
89	1	11	4	20	1	0	0	33	0
0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0
145	164	80	106	156	176	138	199	343	542
0	0	0	0	0	0	0	0	0	0
14,497	11,723	8,028	7,600	15,637	12,592	13,786	14,219	34,373	38,761
0	0	0	0	0	0	0	0	0	0
14,731	11,888	8,119	7,710	15,813	12,769	13,924	14,418	34,749	39,303
195	246	380	465	370	583	513	511	544	1,555
30	31	46	35	54	51	157	158	156	151
481	512	589	585	830	795	1,594	1,550	3,207	3,295
334	271	196	181	361	292	343	380	1,111	895
4,308	1,857	−1,897	−1,004	−1,929	1,442	−1,303	−2,831	−3,685	−12,122
20,698	**15,387**	**7,870**	**8,418**	**16,154**	**16,561**	**16,086**	**15,115**	**38,122**	**35,433**
19,229	14,006	6,553	7,048	13,948	14,511	12,917	12,097	31,024	26,323
941	907	612	677	1,336	1,233	2,140	2,021	4,938	6,791
0	0	0	0	0	0	0	0	0	0
3	3	4	4	5	5	10	10	21	21
22	9	15	5	23	11	26	4	80	21
966	919	631	686	1,365	1,249	2,176	2,034	5,039	6,833
158	215	380	435	358	427	332	381	640	1,016
175	99	110	67	205	118	168	112	395	272
20,528	**15,238**	**7,673**	**8,236**	**15,876**	**16,305**	**15,592**	**14,623**	**37,098**	**34,443**
85	74	98	91	139	128	247	246	512	495
85	74	98	91	139	128	247	246	512	495
0	0	0	0	0	0	0	0	0	0
20,698	**15,387**	**7,870**	**8,418**	**16,154**	**16,561**	**16,086**	**15,115**	**38,122**	**35,433**
21,908	16,735	8,043	8,219	15,280	16,022	16,819	16,082	43,685	37,716
2,679	2,729	1,491	1,171	1,333	1,511	3,902	3,986	12,662	11,393
19,229	**14,006**	**6,553**	**7,048**	**13,948**	**14,511**	**12,917**	**12,097**	**31,024**	**26,323**

Personnel Compensation Information for the Federal Reserve System

This appendix includes information on personnel compensation within the Federal Reserve. Where appropriate, we also compared the Federal Reserve's personnel practices to other federal agencies with analogous regulatory responsibilities. Table III.1 shows the number and title of Federal Reserve employees who earned more than the Board Chairman during 1994. Tables III.2 through III.5 contain 1994 salary information for personnel at various levels within the Federal Reserve. Table III.6 shows the percentage of health insurance subsidies paid in 1993 by the Reserve Banks, the Board, and other regulatory agencies. Table III.7 shows the 1993 employee annual and sick leave eligibility levels for the Reserve Banks, the Board, and other regulatory agencies.

In addition, this appendix includes a description of the several benefit programs offered to Federal Reserve employees that, in many cases, were not provided to employees of the Securities and Exchange Commission (SEC), FDIC, or OCC. These benefits included dental insurance; a subsidized employee cafeteria; premium conversion accounts; flexible spending accounts; matching contributions for savings accounts; and separate leave categories for bereavement, marriage, and family care.

Table III.1: Federal Reserve Officials Earning More Than the Board Chairman During 1994

Salary range ($000 omitted)	Number of Federal Reserve Board employees	Typical Federal Reserve Board titles	Number of Federal Reserve Bank employees	Typical Federal Reserve Bank titles
>133.6 to 140	9	Associate director	15	First VP, Senior VP
>140 to 150	11	Associate director, Deputy director	24	First VP, Senior VP
>150 to 160	4	Deputy director	23	President, First VP, Senior VP
>160 to 170	12	Director	8	President, First VP, Executive VP, Senior VP
>170 to 180	0	N/A	3	President, Executive VP
>180 to 190	0	N/A	4	President, Executive VP
>190 to 200	0	N/A	3	President, Executive VP
>200 to 210	0	N/A	1	President
>210 to 220	0	N/A	1	President
>220 to 230	0	N/A	2	President
Total	**36**	**N/A**	**84**	**N/A**

Legend:

> = Greater than
N/A = Not applicable
VP = Vice president

Source: Federal Reserve Board.

Table III.2: 1994 Reserve Bank President and Federal Reserve Board Chairman and Members' Salaries

Reserve Bank and Board	Salary
Atlanta	$212,000
Boston	177,600
Chicago	221,700
Cleveland	165,500
Dallas	161,500
Kansas City	159,800
Minneapolis	175,200
New York	205,000
Philadelphia	184,500
Richmond	159,600
St. Louis	190,900
San Francisco	229,600
Board Chairman	133,600
Board members	123,100

Source: Federal Reserve Board.

Table III.3: 1994 Federal Reserve Bank First Vice President Salary Scale Ranges

Reserve Bank	Minimum salary	Maximum salary
New York	$140,500	$224,500
San Francisco	130,500	209,500
Atlanta	121,500	194,500
Chicago	121,500	194,500
All other Reserve Banks	110,000	176,000

Source: Federal Reserve Board.

Table III.4: 1994 Federal Reserve Bank and Board Officer Salary Scale Ranges

Reserve Bank and Board	Minimum salary	Maximum salary
Atlanta	$57,500	$157,000
Boston	57,500	157,000
Chicago	57,500	157,000
Cleveland	52,500	151,000
Dallas	57,500	157,000
Kansas City	52,500	151,000
Minneapolis	57,500	157,000
New York	63,500	204,000
Philadelphia	57,500	157,000
Richmond	52,500	151,000
St. Louis	52,500	151,000
San Francisco	66,500	175,000
Federal Reserve Board	63,500	161,800

Note: This table excludes president and first vice president salaries.

Source: Federal Reserve Board.

Table III.5: 1994 Bank and Board Nonofficer Salary Scale Ranges

Reserve Bank and Board	Minimum salary	Maximum salary
Atlanta	$11,000	$83,600
Boston	9,530	87,980
Chicago	13,585	79,580
Cleveland	12,340	81,600
Dallas	11,900	82,900
Kansas City	11,964	82,116
Minneapolis	11,000	80,700
New York	12,475	103,800
Philadelphia	9,770	81,600
Richmond	12,300	76,068
St. Louis	10,700	75,200
San Francisco	13,500	88,700
Federal Reserve Board	15,380	123,470

Note: The time frame during 1994 in which these ranges were in effect varied. For example, one bank's 1994 salary scale was effective from October 1, 1993, to September 30, 1994.

Source: Federal Reserve Board.

Table III.6: Percentage of 1993 Health Insurance Subsidies

Entity	Percentage of premiums paid by entity
Atlanta	76 - 94
Boston	70
Chicago	75 - 90
Cleveland	78
Dallas	72
Kansas City	80
Minneapolis	81 - 87
New York	85
Philadelphia	83 - 90
Richmond	67 - 90
St. Louis	75 - 90
San Francisco	80
Federal Reserve Board	60 - 75
FDIC	85
OCC	74 - 76
SEC	60 - 75

Sources: Federal Reserve Board; 12 Federal Reserve Banks; and the headquarters of FDIC, OCC, and SEC.

Table III.7: 1993 Employee Annual and Sick Leave Eligibility Levels

Entity	Annual leave (in days)	Sick leave (in days)
Atlanta	10 - 32	15
Boston	10 - 25	18 at full pay and 18 at half pay
Chicago	11 - 23	10
Cleveland	10 - 28	12
Dallas	10 - 23	12
Kansas City	10 - 30	12 to 260, depending on length of service
Minneapolis	10 - 27	8-1/4
New York	10 - 30	10 full pay and 120 60-percent pay during first year to 260 full pay, depending on length of service
Philadelphia	10 - 25	12
Richmond	10 - 27	20 - 75, depending on length of service
St. Louis	10 - 25	18
San Francisco	10 - 25	9 - 12, depending on length of service
Federal Reserve Board	13 - 26	13
FDIC	13 - 26	13
OCC	13 - 26	13
SEC	13 - 26	13

Sources: The Federal Reserve Board; 12 Federal Reserve Banks; and the headquarters of FDIC, OCC, and SEC.

A Number of Federal Reserve Benefits Were Not Available to Civil Service Employees

The Federal Reserve offered benefits that are not generally offered to civil service employees, although many of the benefits are available to employees of FDIC and OCC. These benefits included separate dental insurance, subsidized employee cafeterias, premium conversion accounts, flexible spending accounts, matching contributions for savings accounts, and mass transit subsidies. In addition, some banks offered marriage, bereavement, parental care, and floating holiday leave.

Subsidized Cafeterias

The Board and the Reserve Banks pay a subsidy to reduce the cost of employee cafeteria meals. The Board offers subsidized employee meals in its cafeteria, seven dining rooms, and three meeting rooms. The Board's subsidy in 1993 was 45 percent and cost about $741,000. Each of the Reserve Banks also have subsidized cafeterias, but the level of subsidies and number of cafeterias and dining rooms differed. As shown in table I.7, in 1993, the total cost of cafeteria subsidies for the 12 Reserve Banks was about $8.4 million. Most Reserve Bank cafeterias were privately run, with the Reserve Bank paying subsidies ranging from 19 to 55 percent. FDIC and OCC provided cafeteria subsidies of 40 and 19 percent, respectively; SEC did not have a cafeteria.

Table III.8: 1993 Cafeteria and Dining Room Subsidies for the Federal Reserve System, FDIC, OCC, and SEC

Entity	Total subsidy cost	Percentage subsidized[a]
Atlanta	$632,747	45
Boston	680,729	52
Chicago	1,101,062	49
Cleveland	280,773	50
Dallas	651,928	43
Kansas City	500,808	50
Minneapolis	321,644	37
New York	2,500,000	55
Philadelphia	519,108	40
Richmond	545,457	52
St. Louis	445,603	45
San Francisco	174,866	19
Federal Reserve Board	740,900	45
FDIC[b]	246,420	40
OCC[c]	83,322	19
SEC	n/a	n/a

Legend: n/a = not applicable.

[a]When separate percentages were provided for the cafeteria and dining room subsidies, we combined the employee cafeteria and executive dining room subsidy cost and divided by the total cost for both facilities to calculate the percentage subsidized. Percentages were rounded to the nearest whole number.

[b]Information is for the 12-month period from June 1, 1993, to May 31, 1994.

[c]OCC indicated that its cafeteria contractor is expected to operate on a break-even basis. However, in 1993 the contractor experienced a loss of $83,322, which was subsidized by OCC.

Sources: The Federal Reserve Board; Federal Reserve District Banks; and the headquarters of FDIC, OCC, and SEC.

Dental Insurance

While the Federal Employees Health Benefits Program does not offer employees separate subsidized dental insurance, the Board subsidizes its employees' dental plan, paying approximately 80 percent of the premium. Reserve Bank subsidies ranged from 65 to 95 percent. In 1993, the dental subsidy cost the Board about $518,000 and the 12 Reserve Banks, a total of more than $6.8 million. To reduce this cost, one Reserve Bank negotiated a new dental plan that froze premiums for 1993 and 1994. Officials estimated that this would save the Reserve Bank $200,000 over those 2 years. FDIC and OCC pay the full cost of their employee dental insurance. In keeping with the Federal Employees Health Benefits Program, SEC does not offer this benefit.

Marriage, Bereavement, Family Care, and Floating Holiday Leave

In addition to annual and sick leave, many Reserve Banks offered separate leave categories for bereavement, marriage, family care, and floating holidays that are not generally offered to civil service employees. The Board, FDIC, OCC, and SEC do not offer any of these four leave programs. Their employees must use their annual or sick leave, in lieu of these other leave benefits. Table III.9 shows the number of banks offering these leave categories and the number of days offered.

Table III.9: Marriage, Bereavement, Family Care, and Floating Holiday Leave

Leave category	Number of banks offering benefit	Number of days offered
Bereavement	11	3 - 7
Marriage	4	1 - 5
Family care	3	0 - 5
Floating holidays	10	1 - 2

Source: Federal Reserve Banks.

Bereavement leave provides extra days off for an employee to grieve the loss of a family member. In 1993, 2 of the 11 banks that offered bereavement leave did not keep records of the number of days provided. The remaining nine banks granted a total of about 4,200 days for bereavement leave. The cost to one bank that granted about 1,500 days of bereavement leave was $245,000.

Marriage leave is provided to employees who are marrying. One of the four banks that granted such leave in 1993 did not track the number of days provided. The other three banks granted a total of 546 days for marriage leave. The cost to one bank granting 394 days of such leave was about $64,000.

Family care leave is provided to employees to care for sick family members. Three banks offered paid family care leave and granted a total of about 2,900 days in 1993. We did not determine the cost of family care leave. Floating holidays are given to employees to use to take care of personal matters.

Mass Transit Subsidy

Four of the 12 Reserve Banks offered employees a monthly mass transit subsidy. Some restricted the subsidy to employees who did not use the Reserve Banks' parking facilities. The subsidies ranged from $4 in Kansas City to $30 in St. Louis. Both the Board and SEC offer employees up to $21 in monthly mass transit subsidies, while FDIC and OCC do not offer this benefit.[1] Under section 629 of the Treasury, Postal Service and General Government Appropriations Act of 1991, Public Law 101-509, federal government agencies may offer monthly mass transit subsidies to their employees.

Home Security Systems

Home security systems are provided to the Chairman of the Board, eight Reserve Bank presidents, five first vice presidents, one executive vice president, and one senior vice president. We were told that the Board Chairman's system cost approximately $2,500, and the cost to install four of the Reserve Bank Presidents' systems ranged from $2,500 to $8,000. FDIC, OCC, and SEC do not provide home security systems for officers or employees.

Home-to-Work Transportation

At the Board, only the Chairman regularly receives home-to-work transportation authorized under Public Law 99-550.[2] At the Reserve Banks, six other Reserve Bank presidents drive themselves from home to work in Federal Reserve-owned vehicles. In addition, 47 other Reserve Bank personnel use bank vehicles to travel from home to work, and some can also use the cars for personal reasons, although they must claim a taxable benefit. As of January 1996, three banks indicated they will limit the use of bank-owned vehicles for home-to-work transportation to presidents and first vice presidents. This will result in about 12 fewer employees' using these vehicles for home-to-work travel. The FDIC, OCC, and SEC Washington, D.C., offices do not regularly provide home-to-work transportation to their officials.

[1]At the time our survey, the Board was unable to provide us information about the total cost of the mass transit subsidy.

[2]The Chairman is the only Board member who is assigned a chauffeured vehicle. The 6 remaining Board members have access to a motor pool of 14 vehicles that is used for business-related trips.

Procurement Practices Differ and Effective Controls Are Often Missing

As discussed in chapter 3, despite the Federal Reserve's attempt to provide a framework for uniform procurement policies, Reserve Banks have differing procurement practices. Although the guidance used by each Reserve Bank is intended, among other things, to ensure fair and equitable treatment of prospective sources, Reserve Bank practices appear to favor certain sources over others. We found that some Reserve Banks comply closely with Uniform Acquisition Guidelines (UAG), while others use practices that limit competition. At some Reserve Banks, new bidders were not provided an equal opportunity to bid for large procurements, and bidders lists at three Reserve Banks were limited to sources with which the Reserve Banks traditionally have done business, although other equally qualified sources were available and interested.

Some practices/procedures at individual Reserve Banks are commendable, yet noteworthy procedures were not being disseminated among the Reserve Banks. None of the Reserve Banks uses commendable procedures in every area. For instance, although the procurement process at one Reserve Bank appeared to be in compliance with the intent of the UAGs, it lacked appropriate controls over its voucher payment function for major construction contracts. Moreover, some Reserve Banks use practices that restrict full and open competition, by limiting bidders lists to sources with which the Reserve Bank traditionally does business, although we were told that other sources were available and interested.

Certain Bidders Favored in Source Selection

According to the UAGs, invitations to bid and requests for proposals should be sent to as many interested suppliers as possible to ensure competition. Interested suppliers should not be excluded from receiving a solicitation, unless they are clearly unable to fulfill the basic requirements of the solicitation. Yet, new sources were excluded from receiving awards for large, complex, and costly procurements at most of the Reserve Banks we visited, since Reserve Banks restricted lists of potential bidders to sources with which they have had previous experience, giving new sources smaller, less complex orders. Furthermore, several Reserve Banks restricted the number of potential bidders by forwarding invitations to bid and requests for proposals to a limited number of bidders. For example, the building department at one Reserve Bank selected the sources and limited the number of sources to a maximum of five bidders for construction/building alteration projects.

In contrast, another Reserve Bank solicited bids/proposals from a large number of sources. To prepare for the award of its travel contract, the

Reserve Bank combined information from a list of the top travel agencies in the area with names from their vendor database to identify potential sources. The Reserve Bank invited a total of 14 sources to a meeting to discuss Reserve Bank requirements. The Reserve Bank also forwarded copies of questions and answers from the meeting to the 11 firms attending the meeting. Proposals were subsequently received from six firms. The successful firm was selected on the basis of the best overall financial cost to the Reserve Bank.

Contract Extension Precludes Competition

The UAGS encourage competition and restrict the use of sole/single source awards to situations where (1) no other source of supply is available, (2) the urgency of the Reserve Bank's need does not permit the delay involved in using more formal methods of acquisition, or (3) senior officials deem it necessary. However, two of the four Reserve Banks we reviewed have retained incumbent cafeteria contractors for years without recompeting the award, thus precluding other firms from competing for those services. Officials at one of the Reserve Banks were unable to locate documentation in support of the last contract competition, which they believed occurred in the late 1980s. Furthermore, at the other Reserve Bank, records indicated that the cafeteria contract was last competed in 1986, about 10 years ago. In contrast, two Reserve Banks competed their cafeteria contract awards within the last 2 years. One Reserve Bank invited six firms to submit bids for cafeteria operations and performed an extensive analysis of the four bids received to determine which firm should receive the award, including an analysis of the possibility of using one source to operate the Reserve Bank's cafeteria, as well as the cafeterias at each branch office. Our review showed that the other Reserve Bank invited 14 firms to submit bids and performed an extensive analysis of the 11 bids received to select the firm to operate the cafeteria.

Wide Discretion in Negotiations

In addition to competitive bidding, in which the award goes to the low bidder after the bids are opened, the UAGS provide for the use of competitive proposals. The competitive proposal method permits discussions with offerors after proposals have been opened to allow clarification and changes in proposals. However, adequate precautions are to be taken to treat each offeror fairly and to ensure that information gleaned from competing proposals is not disclosed to other offerors.

Our work indicated that wide discretion exists among Reserve Banks in the latitude under which they negotiate with competitive sources. For example, in negotiating the competitive award of a network server and peripherals at one of the four Reserve Banks, negotiations were conducted only with the low bidder after bid opening, despite the fact that the system configuration (i.e., type, size, and sophistication of server) had been totally changed. Other firms were not given the opportunity to offer competing bids. In contrast, when a design change occurred after bid opening, one Reserve Bank's legal department required that the contract be recompeted and did not allow negotiations with bidders.

Bid Evaluation Delegated Outside the Reserve Bank

Although the UAGS prohibit disclosure of specific information contained in bids or proposals to anyone except Reserve Bank personnel directly involved in the selection process, two Reserve Banks transferred most functions associated with the award of major construction/building alteration contracts to architecture and engineering (A&E) firms. Both Reserve Banks used A&E firms for source selection, receipt and evaluation of bids, and selection of the successful bidder. The amount of responsibility passed from the hands of Reserve Bank personnel to the A&E firm is demonstrated by the fact that the Reserve Bank officials at one of the two Reserve Banks were not aware that the award may not have been given to the low bidder. The department vice president assured us that he was certain that the A&E firm could justify the award to the selected source.

In contrast, one Reserve Bank building department's vice president cautioned against delegating bid evaluation functions to A&E firms, commenting that the larger the role the A&E firm plays, the greater the potential for favoritism. At another Reserve Bank, personnel also retained source selection functions for large construction contracts. Moreover, they told us they found that the process of evaluating cost information provided by potential sources leads to a better understanding of the sources' knowledge of the area and their technical capability. An official from the Reserve Bank summarized the benefits of evaluating proposals as follows: challenging the bids/proposals from construction contractors results in improved understanding of what is required, better quality, and lower prices.

Independent Checks and Reconciliation Lacking

Although the UAGS do not address payments, the American Institute of Certified Public Accountants defines a desirable control environment as one in which duties should be segregated to reduce opportunities for any person to be in a position to perpetuate or conceal errors or irregularities in the normal course of his or her duties. Therefore, different people/organizations should have the responsibility for authorizing transactions, recording transactions, etc. Another control procedure is ensuring that the procedures contain independent checks and reconciliations.

Two Reserve Banks had a system of internal checks over the voucher payment process for progress payments associated with construction contracts. The organization responsible for the paying of invoices at each Reserve Bank maintained a separate clerical check/reconciliation system to ensure that contract dollar amounts were not exceeded. However, two other Reserve Banks did not have systems that ensured separation of duties or independent checks. The individual responsible for the payment function at one Reserve Bank explained that when an authorization to pay an invoice for a progress payment is received from the building department, it is paid. At the other Reserve Bank, officials responsible for the payment function explained that, while they tracked payments to each source by year, they did not track progress payments on each contract.

In contrast, at another Reserve Bank, payments to construction contractors were closely controlled. As a control mechanism for the payment authorization from the Building Department, another department tracked progress payments using a spreadsheet. When a payment authorization was received, the spreadsheet maintained for each construction contract was updated to accumulate a running total. This practice ensured that construction contractors did not receive more funds than the Reserve Bank was obligated to pay. This control system served as an independent check and reconciliation.

Comments From the Board of Governors of the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN

April 11, 1996

Mr. James L. Bothwell
Director, Financial Institutions
and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Re: Draft report of the General Accounting Office entitled "Federal Reserve System: Current and Future Challenges Require Systemwide Attention," prepared pursuant to the request of Senators Harry Reid and Byron Dorgan.

Dear Mr. Bothwell:

The Board of Governors takes exception to the broad implication of the draft report that the Federal Reserve has not exercised appropriate budget constraint and that it has not adequately addressed the changing technological and financial environment within which it operates.

We at the Federal Reserve recognize that expending taxpayers' funds outside of the appropriations process places a special obligation on us to be particularly diligent in the use and application of such funds. We believe our diligence has resulted in a level of cost effectiveness and performance that equals that of the most efficient public and private sector institutions.

See comment 1.

In order to fulfill its mandates, the Federal Reserve has had to undertake significant and often costly new initiatives since 1988 (the starting point of the GAO analysis). Among others, these have included the expanded supervision of U.S. operations of foreign banks and a major upgrading of our computer systems and personnel to adapt our surveillance and payment technologies to the major changes that have occurred in private financial markets. This upgrade involved significant consolidation within the Federal Reserve System, but it also enhanced our ability to ensure the smooth functioning of our financial markets, even during periods of financial or operational disruptions. To hold the risk of systemic crises to acceptably low levels for both U.S. markets, and U.S. dollar markets abroad, requires some redundancy of resources. We believe that the

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benefits of this redundancy far exceed the associated incremental costs. In light of these initiatives, as well as others required by the Financial Institutions Reform, Recovery and Enhancement Act (1989) and the Federal Deposit Insurance Corporation Improvement Act (1991), we believe the control of our operating costs has been very effective.

Federal government non-defense discretionary expenditures, which the GAO draft report employs, is particularly useful as a rough standard of comparison, as these expenditures have been subject to increasing Congressional restraint in recent years. During the fiscal years 1988 to 1994, these costs increased 50.9 percent. Over the same years, despite the very considerable expansion of the Federal Reserve's role, our costs (on a calendar-year basis) increased 47.6 percent. Similarly, over this period, non-defense executive branch civilian employment grew by 5.5 percent compared to an increase in total employment at the Federal Reserve of 3.7 percent.

See comment 2.

As further evidence of effective cost control, the Federal Reserve's provision of financial services to depository institutions in a competitive market (accounting for about one-third of Federal Reserve costs) has consistently earned money for the Treasury by recovering not only its direct and indirect costs, but also a rate of return and imputed taxes commensurate with our competitors in the private sector.

Nonetheless, the Board recognizes that the Federal Reserve System, like any organization, can be made more efficient and effective. The GAO draft report does include some specific recommendations regarding the management of certain costs that we consider potentially quite helpful and that we will evaluate and implement where appropriate. We will also continue to identify other opportunities to contain costs, while endeavoring to carry out our mission in a effective manner.

One difficult issue that has and will confront the Board in our oversight of the System is the appropriate degree of consolidation of various activities. Certain Systemwide activities do appear to be more cost effective if consolidated. But it is also evident that the element of autonomy that is accorded to the Reserve Banks has created a competitive environment within the Federal Reserve that attracts highly qualified staff who contribute importantly to the effectiveness and efficiency of the Federal Reserve System over the long run. The advantages of this environment must be balanced against the expected savings from consolidation.

See comment 3.

Our responses to a number of the specific GAO recommendations and observations are included in an enclosure to this letter.

Sincerely,

Enclosure

Board of Governors of the Federal Reserve System
Comments on GAO Draft Report
"Federal Reserve System: Current and Future Challenges Require Systemwide Attention"

The Federal Reserve's Role in Providing Financial Services

The draft report recommends that the Board undertake a fundamental review of the Federal Reserve's role in providing financial services to banks and government agencies.

See comment 4.

Such reviews are an ongoing and integral part of our oversight of the Federal Reserve System. Moreover, it is important to recognize that the Federal Reserve's financial services and, in particular, its priced services, are continually tested by the marketplace. Institutions choose payments service providers based on the cost and quality of the alternative services available to them. The Federal Reserve Banks have been successful in providing services that are attractive to their customers by controlling costs while maintaining high quality standards.

See comment 5.

The Federal Reserve fully recovers its cost of providing services to depository institutions over the long run. The Monetary Control Act (1980) requires that the Federal Reserve set fees for priced services to recover not only all direct and indirect costs incurred in providing the services, but also imputed costs, such as taxes that would have been paid, and the return on capital that would have been earned, had the services been provided by a private business firm. Over the past ten years, 1986 through 1995, the Federal Reserve Banks have recovered 101 percent of their total costs of providing priced services, including the targeted return on equity and other imputed costs.

Because the revenue from the Reserve Banks' priced services recovers imputed costs that are not actually incurred, the Federal Reserve's provision of priced services has consistently had a positive effect on the level of earnings transferred by the Federal Reserve to the Treasury. Over the past ten years, priced services revenues have exceeded operating costs by more than $872 million. Priced services revenues exceeded operating costs by more than $570 million during the period 1988 through 1994 reviewed for this draft report. This net revenue contributes to the amount transferred to the Treasury.

As acknowledged in the draft report, the Federal Reserve has a strategic focus for its financial services activities. The mission of the Federal Reserve in the payments system is to foster the integrity, efficiency, and accessibility of U.S. dollar payments and settlement systems in support of U.S. financial stability and economic growth in a global context. The Federal Reserve pursues this mission through a combination of the financial services provided by the Reserve Banks, the policies and rules adopted by the Board, and the leadership in financial markets exerted by the Federal Reserve on a variety of payments-related matters.

See comment 6.

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This strategic focus includes an ongoing assessment of the appropriate operational role of the Federal Reserve in the payments system. The Board has adopted guidelines to evaluate both the Reserve Banks' introduction of new services and their withdrawal from existing services. The Federal Reserve's ability to recover the costs of providing priced services over the long run is an important consideration in assessing its future operating role. For example, in 1993 the Reserve Banks withdrew from the priced definitive securities safekeeping service, which had been subject to rapidly declining volumes due to the issuance of new securities in book-entry rather than physical form and the banking industry's increasing use of private depositories.

The Reserve Banks' check service has also been subject to volume declines. These declines are attributable largely to the same-day settlement rule adopted by the Board. This rule improves payments system efficiency by increasing the legal rights of correspondent banks that compete with the Reserve Banks in the check collection business. Although the Board anticipated that the rule would erode the Reserve Banks' check volume, it adopted it as being in the best interest of the payments system. The Reserve Banks have taken steps to reduce substantially their operating costs during the past several years in response to these volume declines. For example, during the 1993 through 1995 period, the Reserve Banks reduced check staffing levels by almost 600 employees, or by more than 10 percent. Additional staff reductions are planned for 1996. It is reasonable to expect that reductions in Reserve Bank resource levels would follow, rather than be contemporaneous with, significant volume declines.

The Federal Reserve's strategic focus has also resulted in the re-engineering of the manner in which it provides many of its financial services and the implementation of other productivity improvements. For example, the Reserve Banks are centralizing the processing of their electronic payment services; centralization of Fedwire funds transfer processing is substantially completed and centralization of the ACH and Fedwire book-entry securities transfer applications is underway. As part of this initiative, the Federal Reserve has significantly enhanced the level of contingency backup of its critical applications, including Fedwire. High operational reliability of the Fedwire applications is especially critical to the continued smooth functioning of the financial markets due to the value of transfers processed, which is currently $1.5 trillion per day.

The Reserve Banks have also sought ways to improve the efficiency of their paper-based services. They have consolidated processing of their noncash collection service for maturing coupons and bonds from 27 to 2 sites, and also have consolidated their savings bond operations by reducing the number of sites from 24 to 5. Moreover, they have sought to improve the efficiency of the check collection process by promoting electronic check presentment and have significantly improved the efficiency of their ACH service by accepting ACH transactions from, and delivering transactions to, all depository institution endpoints electronically. Finally, the Federal Reserve, working with the Treasury, has introduced automated processing to the previously paper-based Treasury auction system, improving the accessibility, integrity, and timeliness of the Treasury securities auction process. The Reserve Banks are currently consolidating the handling of commercial tenders from 13 to 3 sites using this automated system.

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These and other changes have improved the reliability and security of many Federal Reserve services and have enabled the Reserve Banks to respond more quickly to changes in business requirements. At the same time, many of the initiatives described above have resulted in one-time transition costs. Nevertheless, the Reserve Banks have been able to contain the aggregate unit cost of providing financial services. While the quality of Federal Reserve services has improved, the cost per transaction of providing all of these services has increased far less than the rate of inflation. Moreover, we expect the unit cost of our electronic payment services to decline as transition to the centralized environment is completed.

The draft report recommends that the Federal Reserve's review of its role in providing financial services include its role in providing services to the government. As fiscal agents of the United States, the Reserve Banks do not dictate the scope of their role in providing fiscal and depository services to the federal government. Instead, the Reserve Banks provide financial services to the government at the direction of the Treasury and other federal agencies. We endeavor to provide high-quality, cost-effective services to the federal government and work in concert with the Treasury and other federal agencies to achieve this objective. Several of the examples noted above illustrate some of the efficiency and quality initiatives undertaken by the Federal Reserve in its role as fiscal agent. We are also continuing to work closely with the Treasury to determine how the federal government can best meet its future payments and debt processing needs.

Management Structure and Consolidation of Operations

The draft report recommends that the Board assess the cost saving opportunities that could result from streamlining the Federal Reserve's existing management structure and consolidating operations, including the possible merger of some of the 12 Reserve Banks and 25 branches.

We agree that it is important that the Federal Reserve assess how it can best fulfill its mission, particularly given the evolution in technology, banking structure, and consumer demand for financial services. As discussed above, the Federal Reserve has consolidated or is planning to centralize or consolidate the provision of many of its financial services. In addition, System staff is currently evaluating possible infrastructure changes that may have the potential to increase the efficiency of the Reserve Banks' check and cash services. Our analyses suggest that significant scale economies exist in electronic payment functions, with much more modest economies of scale apparent in paper-based systems. Further, as long as currency or checks are physically transported to and from depository institutions, proximate physical location will continue to be important in providing these services.

While the location and territory of some of the 12 Federal Reserve Bank head offices and their 25 branches would likely be different if they were established today, relocation of facilities or substantial realignment of office territories generally is very costly, and the long-term savings would have to be substantial to offset the transition costs.

The Use of Technology to Streamline Work Processes

The draft report recommends that the Board assess the potential for technology to support streamlined work processes in the Reserve Banks, reduce costs, and improve quality.

We agree that an ongoing assessment of technologies is essential in identifying possible means of improving operations; the Federal Reserve has a long-standing position of leadership in developing and applying technology in the financial sector. We routinely assess technologies for their ability to reduce costs and improve quality, reliability, contingency backup, security, risk control, and customer service.

To advance these goals, some initiatives taken during the period covered by the draft report include the consolidation of Reserve Bank mainframe processing at Federal Reserve Automation Services (FRAS), the implementation of a new unified communications network, Fednet, which connects the Federal Reserve offices and approximately 13,000 depository institution endpoints, and the development and implementation of the National Information Center (NIC), a central repository for bank structure, financial, and supervisory information on all domestic and foreign banking organizations with a U.S. presence. The NIC facilitates the monitoring and analysis of individual organizations as well as of the banking industry as a whole and helps us streamline and enhance the effectiveness of our supervisory activities. Although expenses have been incurred exclusively by the Federal Reserve, the NIC system is available to other federal regulators and to state banking agencies.

In addition, the Federal Reserve provided the research and development that was critical to the development of high-speed check image capture capability. Moreover, together with the Treasury, the Federal Reserve has developed and implemented sophisticated currency counterfeit-detection processes and systems. The Federal Reserve has also implemented FED-Mail, which provides a more cost-effective and timely electronic delivery mechanism for the dissemination of information to depository institutions.

These are but a few examples of the Federal Reserve's application of technology to improve the security, quality, and cost effectiveness of its operations.

Control and Oversight Mechanisms

The draft report concludes that the combination of the Board's general supervisory responsibilities for Reserve Bank operations and the autonomy of the Reserve Banks has resulted in oversight that, in some cases, appears fragmented, inefficient, or lacking in independence. The draft report indicates that the GAO found issues that were either not adequately covered or were reviewed by both the Board's and the Reserve Banks' oversight organizations.

The Federal Reserve's audit structure has long proven to be very effective. Audit coverage for Federal Reserve Banks is multi-faceted and appropriately reflects the structure of the Federal Reserve System and the statutory roles of the various entities and their respective auditors. The different audit approaches result in a thorough and balanced perspective of the entire Federal Reserve environment. Each of the responsible entities (Federal Reserve Banks and Board of Governors) has its own independent auditing function reporting to its respective board.

The Reserve Banks have adopted and follow the Institute of Internal Auditors Standards for the Professional Practice of Internal Auditing, the world-wide standard for the internal auditing profession. The internal auditors of each Reserve Bank report to the audit committee of that Bank's board of directors. Consistent with current business practice, all audit committee members (in fact, all members of the boards of directors) are outside directors who are independent of management. The audit committee selects the Bank's General Auditor, approves the annual audit plan, budget, and staffing level, and evaluates the General Auditor's performance. In addition, the General Auditors provide information about audits and miscellaneous items to the Board of Governors at least quarterly.

The draft report notes potential overlap of audit coverage, citing the audit attention to FRAS as an example. The FRAS auditing for the System is overseen by the Conference of General Auditors (COGA), which is comprised of the General Auditor of each Reserve Bank and a Board liaison, and is administered by the Richmond General Auditor, because FRAS is part of the Richmond Federal Reserve Bank. While audits are performed by Richmond's internal audit function and by the Board's financial examiners, each party carefully plans its audit work to avoid unnecessary duplication. The Board's Inspector General (IG) also reviewed the effectiveness of the Board's oversight in this area.

Moreover, each Reserve Bank is also examined by the Board's financial examiners, who report to the Board of Governors. The financial examination program is an essential part of the statutory scheme for the oversight structure of the Board of Governors for the Reserve Banks. The Board is responsible for assessing financial, operating, and procedural controls as well as reviewing the efficiency of Reserve Banks and the quality of their services. This Board-based examination program provides a centralized focus. The Board also engages an outside audit firm to conduct audits and certify the combined financial statements of the Reserve Banks, a step that the GAO draft report commends.

The GAO draft report recommendations for addressing its concerns in this area include taking steps to better assure the independence of its internal audit function, and extending the IG's authority to include responsibility for auditing Reserve Bank and Systemwide projects. We believe that the audit process described above, including the use of outside audit firms, assures adequate independence. We believe that extending the IG's authority would not improve the audit focus and would be less desirable than the current audit approach. For example, if the IG becomes an integral part of the Board's oversight process, it would lose its "arms length" ability to audit such processes.

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Budget Process

The draft report indicates that the Federal Reserve's budget process has weaknesses in that it uses a current services approach that assumes that existing functions would be retained and continued through incremental budgetary growth. The draft report also indicates that this approach provides inadequate support to top management in constraining costs and imposing internal self-discipline necessary for the Federal Reserve to respond effectively to future priorities.

The Federal Reserve's budget process does not use a current services approach. The Reserve Bank and Board budgets are strategy-driven and reflect a decision-making process that focuses on priority setting, continual re-examination of the need for existing programs, and phasing out activities and processes as appropriate. As previously discussed, many changes have occurred in Reserve Bank operations during the period covered by this draft report. In addition, the Federal Reserve has actively engaged in improving the efficiency of its output services as well as its support and overhead activities. Moreover, as the GAO correctly states, a significant portion of the increase in Federal Reserve expenses has been the result of legislative mandates in the supervision and regulation area, such as the Financial Institutions Reform, Recovery and Enhancement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act, including the Foreign Bank Supervision Enhancement Act, which have had a major impact on Federal Reserve System expenses.

The budget process used by the Federal Reserve System focuses on a number of factors, including workloads associated with volume projections, the effect of legislation on the scope of the Federal Reserve's responsibilities, the use of technology, and projected changes to pay, benefits, rents, travel, and other costs. This process is reflected in the variations among the individual Reserve Bank and Board budgets and the significant re-engineering of work processes and downsizing of selected functions that has taken place. As noted earlier in our response, some functions have been eliminated or consolidated to improve quality, consistency, and efficiency. Such downsizing and re-engineering is not indicative of a current services budgeting approach.

Finally, it should be noted that the Federal Reserve budget process is but one part of a larger process. The System engages in strategic planning; the strategic plans are reviewed each year with a view to ascertaining whether the strategic directions are still appropriate. Strategic plans are then implemented through action plans and annual objectives. Our, or any other, strategic planning process can be continually improved, and we are in the process of doing that, as is discussed below. But we believe that this forward-looking planning process helps ensure that our activities, be they monetary policy, bank supervision, or financial services, will continue to best serve the public's needs.

Federal Reserve Pay and Benefit Levels

The draft report recommends that the Board review pay and benefits levels at the Board and the Federal Reserve Banks to determine if current levels can continue to be justified in today's environment of increased governmental and private-sector cost containment. It also recommends that the Board assess whether managing the System's health care coverage on a Systemwide basis could reduce health care costs.

In order to acquire and maintain personnel with the degree of skills necessary to accomplish our mandate, the Federal Reserve strives to provide salaries and benefits competitive with local private-sector markets. We use a number of approaches to evaluate our compensation programs, including participating in local and national salary surveys, contracting with compensation consultants, and using published wage data. Our analysis of this information indicates that Federal Reserve System base pay generally is competitive at non-officer employee levels with the average base pay of comparable positions in our local labor markets. Base pay lags the market, however, for certain positions, including Federal Reserve System senior level officers and, in terms of total compensation (i.e., base pay plus other forms of cash including bonus and incentives), most Federal Reserve officer levels lag the market, some very significantly. Our presumption is that for our officers the nonmonetary rewards of working in the Federal Reserve System compensate for the often significantly higher monetary compensation available in the private sector.

See comment 7.

The draft report indicates that the increase in Federal Reserve benefits from 1988 to 1994 was significantly higher than that of the federal government. This does not appear to be the case. As noted in the draft report, the Reserve Banks monitor and control costs computed on an accrual basis rather than the cash basis used by the federal government. Particularly as it relates to retiree benefits, the cash basis of accounting is clearly an inferior accounting methodology to the accrual basis. Because we are unable to adjust federal government benefits to an accrual basis, in an effort to facilitate a comparison, we have reversed the most significant accruals in the Federal Reserve accounts.[1]

After adjusting for these accruals, the cost of benefits per employee for the Federal Reserve and the federal government increased by approximately the same percentage during the 1988 to 1994 period; i.e., 64 percent and 62 percent, respectively. Based on this adjustment, the increase in total compensation per employee for the Federal Reserve also appears to be similar to that of the federal government for the period reviewed in the draft report.

The Federal Reserve continually assesses Federal Reserve benefits to identify benefit design, cost containment, and productivity enhancements. As a result of these and other efforts, we have implemented effective cost containment techniques, such as managed care medical programs, which were introduced some years ago. As part of this ongoing effort, we will continue to explore whether managing some parts of our health care programs on a Systemwide

[1]Specifically, we reversed the effects of Financial Accounting Standards (FAS) 87 and FAS 106 on the Federal Reserve's calculated cost of benefits.

basis, as the GAO draft report suggests, would improve efficiency and reduce costs, while retaining the quality of these benefits.

The draft report also states that "a few Federal Reserve benefits are more generous than those available to the OCC and FDIC and many are more generous than civil service benefits, such as those available to SEC." We believe that the comparison of overall benefit costs cited above is more meaningful. Nevertheless, with respect to specific benefits, the FDIC pays more for health insurance premiums per capita than the Federal Reserve; the FDIC and OCC provide greater dental insurance subsidies; and the OCC and FDIC contribute more to employees' savings plans.

In addition, the draft report highlights six Federal Reserve benefits as being more generous than civil service benefits, but we believe several of these comparisons are misleading. The Federal Reserve contributes less to its employees' savings plan than the Federal government under FERS, and many federal agencies also offer mass transit subsidies to their employees. Although the Federal Reserve offers premium conversion accounts and flexible spending accounts, the contributions to these accounts are made by employees and the Federal Reserve incurs only a small administrative cost in providing the services.

Surplus Account

The draft report states that a reduction in the Federal Reserve's surplus account would have a positive effect on the federal budget by increasing the amount returned to the Treasury in the years the reductions occur. Therefore, the report recommends that the Board assess whether there is any compelling need for the surplus account, and whether the size of the account can be safely reduced.

We agree that the appropriate level of the Federal Reserve surplus is open to debate. But consideration of the surplus should recognize that its transfer to the Treasury would have no meaningful effect on the gap between receipts from, and outlays to, the general public -- that is, it would have no economically relevant meaning for the federal budget deficit in this context. Moreover, reducing the Federal Reserve surplus to very low levels or eliminating it could have certain disadvantages.

To be sure, transferring the approximately $4 billion surplus to the Treasury would increase "unified receipts" and reduce the "unified budget" deficit, as these measures have been defined for budget accounting purposes. The Treasury would have $4 billion less in debt outstanding, and its gross interest payments would drop by the interest on that debt. But this is an artifact of an accounting convention, and does not represent a change in the government's true economic and financial position. These are intra-governmental transfers. The Federal Reserve holds government securities as the asset counterpart to the surplus in its capital accounts, interest on which it returns to the Treasury. If the Federal Reserve decreases its surplus by $4 billion it would have to decrease its government security holdings by the same $4 billion. Consequently, the Federal Reserve's payment to the Treasury would decline into the indefinite future by the amount of interest on the $4 billion, exactly offsetting the Treasury's savings on gross interest payments. The debt in the hands of the public (excluding the Federal Reserve) and consequently the net interest cost to the Treasury of financing that debt would be unchanged.

Thus, transferring the surplus to the Treasury, to repeat, would be only an exchange of intra-governmental claims involving no net transactions with the public. Recognizing the anomaly between the accounting in the unified deficit and financial reality, Congress instructed the Congressional Budget Office not to count any transfer of Federal Reserve surplus as real deficit reduction for budget scoring purposes for FY 1996.

Moreover, using Federal Reserve surplus to finance government expenditures would have potential disadvantages. By law, Federal Reserve notes must be collateralized by specified types of assets, including gold, U.S. government securities, foreign currencies, and certain other instruments (though the Federal Reserve has raised questions about the economic rationale for this law). The margin of available collateral has shrunk over the years, partly reflecting the declining volume of reserve balances and the associated drop in Treasury securities corresponding to those balances. By reducing the Federal Reserve's holdings of government securities, a transfer of surplus would further narrow the margin of excess collateral. A sizable increase in any assets not eligible to serve as collateral -- such as loans to a troubled bank secured by the bank's loans -- could require the use of foreign currencies, which have seldom been used for this purpose in the past. In an extreme case, the Federal Reserve could have difficulty complying with the collateral requirement while conducting an appropriate monetary policy.

Finally, elimination of the surplus would increase the risk that a loss of asset value could seriously impair capital that has been paid in by member banks and possibly result in a negative capital position for the Federal Reserve. Although the Federal Reserve has never had an annual loss, it has had on many occasions short-run losses that have necessitated temporary withdrawals from surplus. The Federal Reserve publishes its balance sheet weekly, and therefore temporary capital impairment would be publicly known. The Federal Reserve's earnings would remain quite substantial, permitting its capital to be rebuilt fairly quickly, and, in principle, low or temporarily negative capital should have no adverse effects on the Federal Reserve's ability to meet its financial or public policy obligations. Nonetheless, such a situation could prompt questions in the minds of some investors in dollar assets, including holders of Federal Reserve notes, about the continued ability of the central bank to conduct a sound monetary policy. Even though such concerns would have little merit, if investors acted on them, real economic effects would be felt.

Charges for Bank Examinations

The draft report recommends that the Board reconsider its policy of not charging for bank examinations.

Although state examination fees are currently approximately half those of the OCC on average, the fact that there has been little shifting to state charters in recent years reinforces the view that national charters have superior franchise value for some banks. Interstate banking may increase this disparity. Accordingly, additional fees imposed by the Federal Reserve on state member banks, and presumably by the FDIC on state nonmember banks, could tip the scales further toward national charters, thus calling into question the long-term viability of a valuable dual banking system.

Contracting and Procurement Practices

The draft report states that the Reserve Banks could better ensure the purchase of goods and services at reasonable cost through increased compliance with their uniform acquisition guidelines and adoption of best practices in procurement and contracting.

We agree that Reserve Bank contracting and procurement practices should be reviewed to ensure that they are consistent with Federal Reserve policy and result in cost-effective contracts and we will strengthen our oversight in this area. While informal communications between Reserve Bank officials currently provide for the sharing of information on best practices in procurement and contracting, we will encourage the Reserve Banks to establish a more formal forum for exchanging this information.

Travel Policies

The draft report states that the Board's general policy directive for Reserve Bank travel expenditures allows for variations in Bank reimbursement procedures, which can result in unnecessary expenditures.

A recent Board survey indicates that, for the most part, the Federal Reserve Banks' and the Board's travel rules are consistent with General Services Administration travel rules. The Board's practice is to provide guidance to the Reserve Banks in areas such as travel, without providing rules on every detail of the Reserve Banks' operations. The Board requires that each Reserve Bank have a written policy regarding permissible expenditures for travel, including purpose, method, and class of travel. Travel policies may provide for a daily per diem allowance, for reimbursement of actual expenses, or a combination of the two. When provision is made for reimbursement of actual expenses, the provision should be in line with sound business judgment, community standards, and applicable Internal Revenue Code provisions. Explanations of any unusual and extenuating circumstances are required. Both the Reserve Banks' internal auditors and the Board's financial examiners review expenditures for their propriety and conformance with Bank and Board guidelines. We will review Reserve Bank travel policies to determine whether modifications indicated by the GAO draft report, or any other modifications, are warranted.

Management of Reserve Bank Building Projects

The draft report states that opportunities were overlooked to reduce the costs of the new Dallas Head Office building project and cited as examples the sizes of the overall building, the lobby, the computer facilities space, and the land on which the building is sited.

This building project was completed on time and $15 million under its original budget. This result was achieved in spite of the fact that the overall size of the building increased by approximately 35,000 square feet from the initial program to the final design approved by the Federal Reserve Board. The increase was due primarily to the need to enclose the delivery courts inside the building. The City of Dallas would not permit delivery trucks to maneuver on a city street and required that the maneuvering space be provided on the Bank's property. Because the building's floor plate occupied most of the 6.2 acre portion of the site dedicated to the building, the delivery courts were relocated inside the building.

The main lobby and exhibit space on the first floor comprise 6,671 square feet of floor area, which is less than the 7,800 square feet included in the initial program. The GAO also appears to be referring to the second floor corridor or hallway as lobby space. The second floor "lobby" is provided for employees entering the building from the parking garage and serves as a controlled entry and corridor to the building's elevators. This corridor leads from the elevators along the meeting rooms and assembly room to the cafeteria. As the design evolved, the corridor was widened, at a very low cost, to function as the main breakout area for the meeting and assembly rooms; this enabled the Bank to avoid building a dedicated reception area to accommodate large numbers of people.

See comment 8.

During the planning and design phase of the building, the decision to consolidate Federal Reserve mainframe automation had not been made and the details on space needs were unknown. Although the initial program identified approximately 70,000 square feet of floor area for the Bank's computer services function, additional space was identified within the overall space program for the possible installation of a consolidated data center. This was accomplished by providing raised flooring on an additional floor to accommodate easy conversion of that space from office to data center space. When the building was later modified for one of the FRAS computer centers, that space was easily converted at a cost significantly lower than would have been the case otherwise.

Although the building plan was based on a site requirement of approximately 6.2 acres, parcels were not available in the configuration needed to develop the site. Therefore, it was necessary to acquire approximately 8.0 acres in order to obtain the necessary acreage. Siting of the building was carefully planned so that, in the future, if the property is not needed, it can be sold.

See comment 9.

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Systemwide Strategic Management Process

The draft report indicates that, if the Federal Reserve is to meet the challenges it faces and streamline operations effectively, the Board and the Reserve Banks must work together to plan strategically for the future.

The Federal Reserve System has engaged in strategic planning efforts for many years. As a result of plans and strategies developed from these planning efforts, we have successfully met significant challenges in supervision, financial services, and monetary policy. More recently, the Board established a System Strategic Planning Coordination Group consisting of selected members of the Board, Reserve Bank Presidents, and staff. As the name implies, the group provides a Systemwide focus for coordinating the forces affecting how the Federal Reserve can carry out legislated mandates and the most effective and efficient ways of meeting its public policy objectives into the twenty-first century. This group has a broad mandate, but it is important to note that it is only the latest manifestation of an ongoing process in the Federal Reserve.

The following are GAO's comments on the Board of Governors of the Federal Reserve System's letter dated April 11, 1996.

GAO Comments

1. The Federal Reserve Board commented that the cost increases we reported were related to a number of new initiatives in expanded supervision and technology and personnel enhancements necessary to keep pace with developments in private financial markets. The Board also commented that some redundancy of resources was necessary to limit the risk of systemic crises. We acknowledge that the growth in Federal Reserve expenses that occurred during 1988 to 1994 was caused, at least partially, by significant increases in expenses for bank supervision and regulation, personnel compensation, and an extensive automation modernization and consolidation effort. However, we note that bank supervision accounted for only about 20 percent of total Reserve Bank expenses in 1994. We also note that the Federal Reserve's computer hardware and software expenses are largely capitalized, with their costs being spread out over many years through charges to depreciation. Finally, we note that the rapid rise in personnel compensation costs, which affected all lines of business and accounted for about two-thirds of total Federal Reserve operating costs in 1994, was by far the most significant contributor to the Federal Reserve's cost increases during the 1988 to 1994 period, representing over 70 percent of the total growth in the System's operating expenses.

2. The Board commented that the overall growth in their costs during the 1988 to 1994 period was lower than the comparable growth in federal nondefense discretionary expenditures. We used three different baselines as standards of comparison in this report. As the Board noted, the growth in the Federal Reserve's operating costs was somewhat less than the growth in federal nondefense discretionary expenditures over the 1988 to 1994 period. However, it was substantially greater than both the amount of inflation and the increase in total federal discretionary expenditures that occurred over these same years. We also noted in this report that Federal Reserve employment increased approximately 4 percent during the 1988 to 1994 period. To compensate for differences in changes in employment levels, we computed personnel costs on a per capita basis. These calculations showed that the 39-percent increase in the per employee cost of Federal Reserve salaries was slightly higher than the 36-percent increase in the per capita salary cost in the federal government. However, the increase in the per employee cost of Federal Reserve benefits

(96 percent) was substantially higher than the increase for the federal government (62 percent).

3. The Board commented that, while some opportunities for consolidation of activities may exist, the benefits of the autonomy and competitiveness of the Reserve Banks in attracting highly qualified staff must be balanced against the expected savings from consolidation. We agree that a competitive, internal environment can help attract highly qualified staff. However, our findings raise questions about the extent to which the Federal Reserve is able to capture the benefits of internal competition. One measure of effective competition within a cost-conscious, decentralized organization would be the extent to which proven or potential cost-saving strategies developed by one or more of the autonomous units is shared with, and embraced by, the others. We found mixed evidence of this at the Federal Reserve. For example, we noted that the systemwide automation consolidation effort began as a proposal by several Reserve Banks that they consolidate their mainframe processing. This effort led the Board to establish a committee to study the feasibility of consolidation for the Federal Reserve as a whole. However, in other activities—such as contracting and procurement and management of health care benefits—we identified cost-saving strategies that had not been shared, at least formally, among the Reserve Banks. Furthermore, we do not believe that consolidating activities is necessarily inconsistent with maintaining a competitive, internal environment. For example, a systemwide activity performed by fewer than 12 Reserve Banks could still provide opportunities for internal competition.

4. The Board noted that its financial services, especially its priced services, are competitively tested by the marketplace. We noted in the report that private sector competition is increasing in payments services. Still, in many areas, competition is limited and many financial institutions have no alternative to the Federal Reserve for some services. For example, private check clearinghouses often only cover certain geographical areas or handle only certain types of payments, such as those for large dollar amounts.

5. The Board commented that the Federal Reserve fully recovers its costs of providing services to depository institutions in the long run. The Board noted that, from 1986 through 1995, it recovered 101 percent of its costs, including a targeted return on equity and other imputed costs. We noted that the most recent data showed a trend of Federal Reserve expenses for providing priced services rising much faster than the revenues received.

For example, from 1990 to 1994, Federal Reserve revenues from check clearing actually declined by 0.2 percent, while expenses increased 13.8 percent. Similarly, automated clearinghouse revenues increased during the period by 22 percent, while expenses increased 41.1 percent. Thus, we continue to believe that the Board should undertake a review of the Federal Reserve's provision of these services.

6. The Board noted that the decline in the Reserve Banks' check volume was largely attributable to the Board's adopting a same day settlement rule, and that staffing reductions were made to adjust to those declines in volume. We noted in this report that the growth in expenses for priced services to financial institutions was the smallest for any line of business during the 1988 to 1994 period. However, we also noted that the Federal Reserve has a significant incentive to restrain increases in these costs because the System competes with the private sector in providing these services and is legally required to charge fees that recover its costs. We also noted that, in other service areas not subject to these constraints, Federal Reserve staffing and expenses have increased despite Systemwide efforts to consolidate and increase efficiency. For example, in the savings bonds program, Treasury directed the Federal Reserve to consolidate its savings bonds operations from 12 to 5 locations. Despite this consolidation, staffing in the program increased slightly. When Treasury announced the selection of the 5 Reserve Bank locations in June 1992, there were 913 employees in the savings bonds departments of the Reserve Banks and branches. In 1994, there were 918 employees. Automation costs for the program also increased, from $6.7 million in 1992 to $12.7 million in 1994.

7. The Board stated that our finding that the increase in Federal Reserve benefits from 1988 to 1994 was significantly higher than benefit increases for the federal government did not appear to be correct. They calculated the benefit increase to be 64 percent for the Federal Reserve, comparable to our reported increase in the federal government's benefits of 62 percent. Their calculation was based on a different methodology than ours.

Although there are several ways to present the increases in the cost of benefits for the Federal Reserve, we believe our methodology is the best way to facilitate comparison with the federal government. The Board's annual reports, which are done on an accrual basis, showed a 176-percent increase in per capita benefits over this period. However, to facilitate comparison with the federal government, it was necessary to take out certain accruals because the federal government accounts are done primarily on a cash basis. In our calculations, we (1) reduced the Board's reported amounts by a measure of the accrual for additional postretirement benefit expenses; (2) increased these amounts by a measure of the accrual for the Federal Reserve's overfunded pension fund; and (3) added back in amounts representing payments for the Federal Reserve's early retirements in 1988, 1989, and 1994. In calculating its 64-percent estimate, the Federal Reserve has made the first two adjustments, but not the third. As a result, the Federal Reserve numbers do not include early retirement payments, but these costs are included in the federal government's benefits costs and are clearly a cost incurred by the Federal Reserve. We believe that comparability would be more properly maintained by including these costs in the Federal Reserve measures as well.

8. The Board noted that the planning and design phase of the Dallas Federal Reserve Bank building predated certain decisions concerning computer facility consolidation, but included sufficient flexibility in design to accommodate the decision made later to house a consolidated data center. While recognizing the need for some flexibility to accommodate changes in function or design, we continue to believe that such major construction projects may offer opportunities to reduce costs. Such opportunities appear to have been available in the Dallas Reserve Bank building and some could still be available if, as the Federal Reserve suggests, they were to sell off unneeded land. In addition, after making what turned out to be overestimates of staffing growth for the Dallas Reserve Bank building, the Federal Reserve has subsequently made more conservative projections in connection with a new bank building and a major renovation of an existing bank building.

9. The Board stated that the Federal Reserve System has engaged in a variety of strategic planning efforts for many years. In addition, the Board noted that it had recently established a Federal Reserve System Strategic Planning Coordination Group (SPCG) to coordinate various strategic planning efforts within the System.

We acknowledged that the Federal Reserve had established SPCG, which includes representatives from the Reserve Banks and the Board of Governors. SPCG is to provide a common framework for the development and refinement of the many individual strategic plans and action plans within the Federal Reserve. According to Federal Reserve planning documents, several Board members and Reserve Bank presidents believed that the discrete strategic planning processes within the Federal Reserve would benefit from greater coherence, especially in terms of assumptions about the future environment and interrelationships among functions. In our report, we characterized the establishment of SPCG as a positive step for the Federal Reserve, but we expressed concern that its scope of responsibility and authority may be too limited. While doing the bold strategic planning we envision may be difficult to accomplish in a system of shared responsibilities, we continue to believe it is essential for the Federal Reserve to adopt such an approach to effectively meet the challenges of the future.

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