BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: December 8, 2000

To: Board of Governors

From: Edward W. Kelley, Jr.

Subject: 2001 Reserve Bank Budgets

The Committee on Federal Reserve Bank Affairs has reviewed staff's recommendation that the Board approve the Reserve Bank budgets for 2001. In aggregate, the 2001 Reserve Bank budgets total $2,442.2 million, an increase of $144.4 million or 6.3 percent over 2000 estimated expenses. This includes Reserve Bank operating budgets totaling $2,425.8 million and a special project totaling $16.4 million. The staff memorandum is attached.

Attachment

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS

Date: December 8, 2000

To: Board of Governors

From: Stuart Sperry, Cathie Austin, Dorothy LaChapelle, Paul Bettge

Subject: 2001 Final Reserve Bank Budgets

ACTION REQUESTED

Staff requests Board approval of the 2001 Reserve Bank budgets totaling $2,442.2 million, an increase of $144.4 million or 6.3 percent over 2000 estimated expenses.[1] This includes Reserve Bank operating budgets totaling $2,425.8 million and a special project budget totaling $16.4 million.[2] The 2001 budget is $28.5 million lower than the Reserve Bank Budget Outlook projection of $2,470.7 million provided to the Board in June.

Staff also requests Board approval of the 2001 Reserve Bank and Federal Reserve Information Technology (FRIT) capital budgets totaling $361.3 million, a decrease of $106.0 million from 2000 estimated capital outlays. The capital budgets are approved with the understanding that approval for actual capital outlays will be in accordance with the Board's Policies and Guidelines Concerning Reserve Bank Operations (S-2597).

[1] These expenses include those budgeted by Federal Reserve Information Technology (FRIT) and the Office of Employee Benefits (OEB). Expenses from these entities have been charged to the Reserve Banks, as appropriate, and included in their budgets. OEB's staffing level of 29 ANP is not discussed further in this memorandum. Unless otherwise noted, expenses also include costs associated with the check standardization special project. Special project costs are estimated to be $6.7 million in 2000 and are projected to be $16.4 million in 2001.

[2] Special projects are major efforts having Systemwide significance that are outside the budgets of the individual Reserve Banks. The only special project currently in effect reflects certain costs associated with the check standardization initiative.

TOTAL EXPENSE AND EMPLOYMENT SUMMARY

The Reserve Banks' 2001 total budget of $2,442.2 million is $116.3 million or 5.0 percent above the 2000 approved budget. This rate of increase is lower than the 6.2 percent increase that was anticipated at the time the Reserve Bank Budget Outlook (RBBO) was developed earlier this year. The current year budget underrun of $28.1 million is explained in the 2000 Budget Performance section.

Approximately 52 percent of Reserve Bank expenses in the 2001 budget are offset by priced service revenues (40 percent) and reimbursable claims for services provided to the U.S. Treasury and other agencies (12 percent). Priced service revenues are budgeted to increase 6.7 percent primarily due to projected volume increases in ACH, slight increases in check volume, check fee increases and the introduction of new priced check products. Reimbursable claims will decrease 6.5 percent, primarily as a result of consolidation of the Treasury Tax & Loan and *TreasuryDirect* servicing functions.

Table 1
Change in Net Expenses
(dollars in millions)

Expenses	2000 Budget	2000 Estimate	2001 Budget	Percent Change 00B-01B	Percent Change 00E-01B
Reserve Banks	$2,325.9	$2,297.8	$2,442.2	5.0%	6.3%
Less:					
Priced service revenue	925.5	916.1	977.8	5.7%	6.7%
Reimbursable claims	315.6	310.2	290.1	-8.1%	-6.5%
Net expense	$1,084.8	$1,071.5	$1,174.3	8.2%	9.6%

Individual Reserve Bank 2001 budget changes from 2000 estimated expenses vary from a decrease of 4.2 percent to a 19.3 percent increase, as depicted in Table 1 of the statistical appendix. The wide swing is directly related to recent Reserve Bank accounting changes that resulted in cost shifts among Reserve Banks and between cost centers.[3] The total Reserve Bank increase of $144.4 million provides funding for each District's salary administration and benefit programs, local operations, nationally-provided support services, and consolidated operations.

Total 2001 projected employment for the Reserve Banks and FRIT is 23,458 average number of personnel (ANP), an increase of 68 ANP or 0.3 percent from 2000 estimated staff

Table 2
Employment

	2000 Estimate	2001 Budget	Change ANP	Change Percent
Reserve Banks	22,721	22,760	38	0.2%
FRIT	668	698	30	4.5%
Total	23,389	23,458	68	0.3%

[3] Cost shifts among Reserve Banks and within cost centers result from the adoption of recommendations made in three studies concerning the accounting practices of Federal Reserve Banks. These studies are the Accountability, Integrity, Decision-making, and Efficiency (AIDE) Report, the Treatment of National Costs and Revenues Study, and a capitalization threshold change proposal. The cost shifts limit budget comparability with previous years' data. An overview of the accounting changes and the corresponding effects on the 2001 budget has been included with this memorandum as Attachment 1.

levels. Reserve Bank employment is expected to increase 38 ANP or 0.2 percent, largely due to the full-year effect of 2000 staff additions and, to a lesser extent, initiatives planned for 2001. FRIT employment is expected to increase 30 ANP or 4.5 percent resulting from several initiatives, including FEDNET modernization, the image services system (ISS) and check standardization projects, and new distributed processing services. Tables 1 through 4 in the statistical appendix provide more detail on expense and ANP changes by district and service line.

2000 BUDGET PERFORMANCE

The Reserve Banks estimate that 2000 expenses will be $2,297.8 million, which represents a decrease of $28.1 million or 1.2 percent from the approved 2000 budget of $2,325.9 million. The 2000 estimate is $104.0 million or 4.5 percent higher than 1999 actual expenses. ANP is estimated at 23,389, a decrease of 362 ANP or 1.5 percent from the approved 2000 level. Staffing is 22 ANP below 1999 actual levels.

Eight of the twelve Banks are experiencing underruns compared to the approved 2000 budget, ranging from 0.1 percent in Kansas City to 3.0 percent in New York. The remaining four Banks are over their approved budgets, ranging from 0.1 percent in Atlanta to 2.5 percent in Richmond. Tables 5 and 6 in the statistical appendix provide district-by-district detail of current year performance.

As could be expected by the substantial underrun in ANP, Reserve Banks experiencing below-budgeted staffing levels are projecting a correlated underrun in officer and employee salaries. Reserve Bank officer and employee salaries are $16.4 million under budget. The Banks have reported common themes to explain the variances, primarily turnover and delays in planned additions to staff due to tight labor markets and productivity improvements. In addition, over half of the Banks have identified lower-than-anticipated retirement and other benefits costs because of savings associated with postretirement benefits plan (FAS 106) changes ($3.3 million). A variety of district-specific factors add to and offset the underrun. Initiatives in several of the outlying Banks, however, are key drivers of the 2000 estimate.

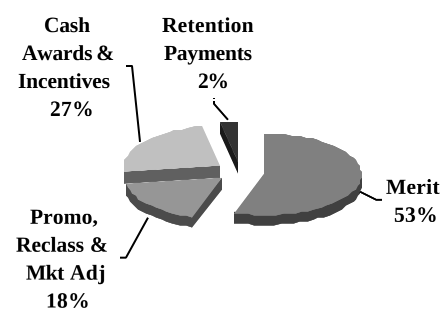
New York’s budget underrun of $13.7 million is largely the result of the Bank’s staffing underrun of 84 ANP, creating an associated personnel cost underrun of $7.4 million. The ANP underrun is partially the result of under staffing at the beginning of 2000 that continued to widen throughout the year. Staffing levels in the Second District have declined dramatically since 1998 primarily because of productivity improvement and operating efficiency initiatives both at the Bank and also through System consolidation efforts. Chicago's 2000 budget estimate is 1.8 percent or $4.2 million lower than its approved budget due primarily to the expense effect of deferred or cancelled capital projects ($2.3 million) and a postretirement benefits plan change ($1.0 million). Other key factors in the System underrun include San Francisco's decision to move to the ISS platform rather than upgrade an existing system ($1.0 million) and declining check volume and check productivity initiatives in Atlanta ($3.1 million).

The Fifth District's overrun of $4.5 million has been partly attributed to unanticipated work associated with two Treasury projects ($1.1 million) and increased costs for an upgrade to the Bank's purchasing, accounts payable, and asset management system ($0.7 million). Other substantial increases over planned expenditures are in the Retail Payments Office (RPO), which is accounted for in Atlanta's budget. The RPO projects an increase of $3.8 million associated with higher-than-anticipated fuel costs for Check Relay and an additional $2.7 million for the creation of a check modernization implementation team. Other unbudgeted expenses include the establishment of a payment card research center at the Philadelphia Bank ($0.7 million) and the accelerated purchase of check processing equipment in Kansas City ($0.7 million) because of the check standardization conversion schedule.

FACTORS AFFECTING THE 2001 BUDGET

Personnel expenses, which include both salaries and benefits, represent 63.3 percent of Reserve Bank expenses and are the major driver of the year-over-year budget increase. Reserve Bank budgets include $88.7 million to fund salary administration programs for officers and employees.[4] The budgets include average merit increases of 4.5 percent for officers and 4.3 percent for employees, totaling $48.9 million, or 52.9 percent of the total salary administration budget. Promotions, reclassifications, and market adjustments represent $16.1 million; retention payments represent $2.1 million; and officer and employee

Figure 1
Components of Salary Administration

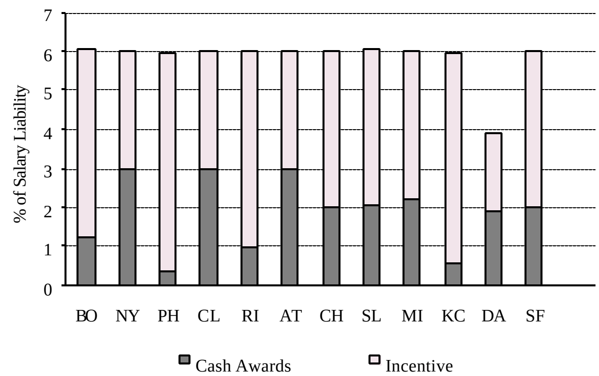


[4] Salary administration represents the budgeted funds that are available to increase compensation to officers and employees in the upcoming year. It does not include adjustments for changes in staffing levels, turnover and lag in hiring, and overtime.

cash awards and incentive payments represent $23.6 million. Merit and other salary related expenses are in line with public and private sector trends.

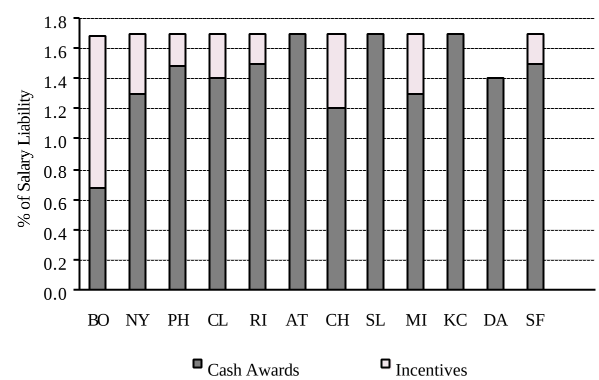
Officer incentive payments and cash awards total $7.9 million or 5.8 percent of officer salary liability. For 2001, the officer variable pay threshold increased to 6.0 percent of salary liability. As shown in figure 3, only the Dallas Bank did not fund the officer incentive/cash award program to the 6.0 percent maximum.

Figure 2
Officer Incentive and Cash Awards



Employee incentive payments and cash award funds total $16.6 million or 1.7 percent of employee salary liability. The employee variable pay threshold increased to 1.7 percent in 2001. Again, only the Dallas Bank did not budget the full amount. The mix between incentive and cash awards in the employee category is heavily weighted toward cash awards.

Figure 3
Employee Incentive and Cash Awards



Officer turnover (including retirements) in 2001 is projected to remain stable at 4.0 percent, ranging from 0.0 percent (Dallas) to 16.0 percent (San Francisco). Similarly, employee turnover in 2001 is also projected to remain stable at 13.1 percent, ranging from 8.1 percent (Richmond) to 16.2 percent (San Francisco). Banks are reporting higher turnover in checks and some professional and technical areas. In 2001, continuing market pressures will increase the risk of losing employees with critical skills. As a result, the Banks plan to maximize variable pay, retention incentives, and other monetary and non-monetary rewards for key officers and employees.

Retirement and other benefit expenses, which account for 14.0 percent of Reserve Bank budgets, are anticipated to increase by $23.5 million or 7.4 percent in 2001. The primary factors driving the higher costs include increases in salary-related benefits such as Social Security and Thrift Plan contributions, which are directly related to the increased number of

ANP. Other contributing factors include higher postretirement (Financial Accounting Standard 106) and postemployment (Financial Accounting Standard 112) valuations, which are directly related to changes in actuarial assumptions. The increases in employer contributions for health benefits average 5.6 percent for non-HMO plans, 8.5 percent for HMOs, and 6.4 percent for dental plans.

In addition to salary administration and benefit costs, other major factors affecting the 2001 budget are shown in Table 3 and discussed below.

Table 3
Major Factors Impacting the 2001 Budget
(dollars in millions)

	2000 Estimate	2001 Budget	Variance Amount	Variance Percent	Incremental ANP
Total System Budget	$2,297.8	$2,442.2	$144.4	6.3%	68
Major Factors				**Percent Contribution**	
Affecting Priced Services					
Check Modernization	27.3	84.1	56.8	2.5%	223
Other Check Initiatives	48.6	52.3	3.7	0.2%	-33
Affecting Reimbursable Services					
Treasury Direct Consolidation	19.5	15.9	-3.6	-0.2%	-53
Treasury Tax & Loan Consolidation	4.1	1.4	-2.7	-0.1%	-30
Affecting Central Bank Services					
Cash Initiatives	22.5	30.0	7.5	0.3%	53
Supervision and Regulation	27.3	29.7	2.4	0.1%	26
Affecting Cross-Functional Areas					
Infrastructure Initiatives	39.0	58.8	19.9	0.9%	25
FRIT Initiatives	11.7	24.2	12.5	0.5%	73
Capitalization Thresholds	0.0	12.9	12.9	0.6%	NA
Total Major Factors	$199.9	$309.4	$109.5	4.8%	285

FACTORS AFFECTING FEE-BASED SERVICES TO FINANCIAL INSTITUTIONS

Check Modernization: The Federal Reserve Banks, under the leadership of the Retail Payments Office, have undertaken four major projects, collectively referred to as check modernization. The four projects – check standardization, enterprise wide adjustments, image services system, and electronic access and delivery – will standardize the check function's operating platform across all forty-five check processing sites. The primary objectives of this effort will be to reduce the time to market for new check products, improve consistency, uniformity, flexibility and quality of check services, facilitate the transition to electronic check presentment, and reduce the ongoing costs of providing check services. The 2001 budget for the Reserve Banks includes $84.1 million for the overall project, which is a $56.8 million and 223 ANP increase over 2000 estimates. The check standardization special project accounts for $16.4 million and 14 ANP of the total 2001 project budget. The multi-year check modernization projections estimated 2001 expenses would total $75.2 million. Increased spending projections in 2001 are due to expense shifts from 2000 and accelerated spending from the out years of the check modernization projects. The budgetary effect of each of the check modernization projects is described below.

Check Standardization: Six districts have identified Nationally Provided Support Service (NPSS) costs associated with the project totaling $29.0 million, FRIT has budgeted $7.4 million for data processing support, and an additional $9.2 million has been included by the Banks for local incremental costs to implement the project. The check standardization project budget also includes $16.4 million in special project costs. Costs vary significantly by district and are determined by the timing of each office's conversion in the forty-five month implementation schedule.

Enterprise Wide Adjustments (EWA) System: The Twelfth District is the host Bank for the development and implementation of the EWA system. The 2001 budget includes $7.4 million for this project, which represents a $2.4 million increase over the 2000 estimate. Project plans call for the conversion of twenty-five offices to the system by year-end 2000, fourteen sites converting in 2001, and the remaining six sites converting in 2002.

Imaging Services System (ISS): Boston will provide project management for the implementation and deployment of ISS to the four regional archive sites . . .

The 2001 budget includes $17.0 million for this project. Upon deployment of the first "point of presence" in January 2001, Boston will establish a Central Business Application Function (CBAF). Thirty-two offices currently are scheduled to convert to regional sites in 2001, with the remaining offices converting in 2002.

Check Electronic Access and Delivery (EA&D): The Dallas Bank has been assigned responsibility for development of this application. Initially, EA&D will develop web-based interfaces for check services currently offered through FedLine. The 2001 budget includes $5.1 million for the project. Software is scheduled to be available to Reserve Banks in March 2001. An implementation schedule currently is being developed.

Five Districts have included costs in their budgets totaling $52.3 million to support **other local check initiatives.** These initiatives include the Utica RCPC check image effort, increased staff to process volume increases, and additional equipment (personal computers, high-speed and medium-speed reader/sorters, and replacement of image capture systems) needed in 2001 to accommodate accelerated check modernization project schedules.

FACTORS AFFECTING REIMBURSABLE SERVICES

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

Treasury Tax and Loan Consolidation (TT&L): The implementation of the Treasury Investment Program (TIP) and the Paper Tax System (PATAX) operations at the St. Louis Reserve Bank has replaced the existing TT&L software and staff at all Reserve Banks. All Reserve Banks transitioned to this new system on October 23, 2000. The 2001 budget includes a net decrease in Reserve Bank costs of $2.7 million and 30 ANP. Minimal staff will be retained in the other Reserve Banks for collateral processing.

FACTORS AFFECTING CENTRAL BANK SERVICES

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

Supervision and Regulation: Three factors contribute to staffing increases in Supervision and Regulation: growth in state member banks, the Large Complex Banking Organization initiative, and development of the Risk Management Information System. These initiatives are adding $2.4 million and 26 ANP in 2001.

FACTORS AFFECTING CROSS-FUNCTIONAL AREAS

Infrastructure Initiatives: The 2001 projection includes an expense increase of $12.0 million for new buildings, leased space, and security enhancements in five districts.

Reserve Bank automation initiatives add another $7.9 million, of which about $2.5 million is for efforts directly tied to System initiatives (electronic access projects, the Internet firewall, and Groupware Leadership Center). The remaining expenses address a variety of needs, including support for Treasury-related projects, Human Resource Information Systems, and information security.

FRIT Initiatives: Customer-driven projects at FRIT to support web access and centralized distributed processing applications are projected to increase costs $8.2 million above 2000 estimates. Infrastructure improvements, primarily for distributed computing and FEDNET modernization, add $4.3 million to costs.

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

RISKS IN THE 2001 BUDGET

Reserve Banks have noted several common risks associated with the 2001 budgets. First, issues and problems relating to the check modernization projects could divert significant resources, including management attention, as complex implementation schedules have the potential for costly delays. Additionally, the 2001 budget is based on current check modernization project plans. As these plans are refined and the projects progress, actual expenses may vary significantly from the 2001 budget. Second, most Banks have projected flat volume growth in check and only moderate increases in cash for 2001. Volatility in production volumes could create capacity problems and affect the System’s ability to meet cost performance expectations.

In addition, the passage of the Gramm-Leach-Bliley financial modernization act (GLBA) is expected to have significant implications for the bank supervision and regulation function. As this brings the Federal Reserve broad financial holding company oversight responsibilities as the umbrella supervisor, resource implications on the supervisory function remain unclear at this time.

Finally, some Banks are experiencing difficulty in attracting and retaining key staff due to tight labor markets. Turnover poses a significant risk when compounded by the resource demands necessary to implement check modernization and recent regulatory changes in bank supervision and regulation. Initiatives that are contingent upon successful staffing efforts present additional uncertainties in the 2001 budget.

2001 CAPITAL PLAN

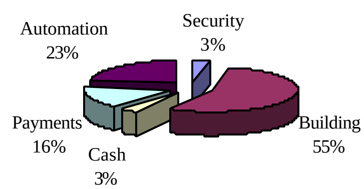
The 2001 capital budget submitted by the Reserve Banks and FRIT totals $361.3 million, which represents a $106.0 million decrease from the 2000 estimated levels. The budget includes $323.0 million for the Banks and $38.3 million for FRIT. The substantial decrease in 2001 outlays from the 2000 estimate is due in part to the conclusion or near completion of several major building projects, including the Birmingham new branch building project ($22.7 million decrease in 2001 outlays), Atlanta’s new building project ($21.1 million decrease), and the Phoenix currency operations center ($12.8 million decrease). After the land purchase in 2000, outlays for the Houston new branch building project will decrease significantly in 2001 ($24.2 million). Capital for software and equipment acquisitions at FRIT for the check standardization and ISS projects is $13.1 million lower in the 2001 budget than has been estimated in 2000. Other factors causing the reduction in capital outlays include the non-renewal of software licenses and maintenance contracts associated with check standardization, outlays for check processing equipment moved from future years into 2000 because of the check standardization project schedule, the completion of various building renovation and software development projects, and the shift of funds from capital to expense caused by the capitalization threshold changes. Tables 8 and 9 in the statistical appendix provide detail of capital expenditures by district and asset classification.

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

The proposed capital budget includes an estimated $197.9 million for **building-**

related projects and facility improvements. These projects are geared toward renovation, modernization or replacement of physical facilities and replacement or upgrading of critical systems. Of the total building-related capital, $101.1 million (51.1 percent) is attributable to seven initiatives with budgets greater than $4.0 million. These include the Second District's floor-by-floor Head Office modernization program, the Sixth District's new Atlanta building project, plans to relocate the Seventh District's Detroit Branch and the Chicago check function, major floor renovations in the Chicago Bank, the Houston Branch building project, and the check department renovation in the St. Louis Head Office. In addition to the larger projects described, funding is also provided for the replacement of routine building-related equipment, as well as furniture and fixture replacements.

Figure 4
Major Capital



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

Of the total automation-related outlays, FRIT projects and acquisitions account for $26.7 million. FRIT's 2001 capital plan includes outlays for FEDNET modernization ($8.7 million), virtual tape server implementation ($1.8 million), and various software and hardware upgrades and enhancements. Aside from FRIT, major automation-related projects include $2.3 million for continued development of New York's Transaction Processing System; $1.9 million for enhancements to the Statistics and Reserves (STAR) System; $1.3 million for development of the Account Management Information (AMI) gateway; $1.3 million for upgrades to the System's internet and directory services (IDS) competency center; and $1.1 million for the Sixth District's ethernet conversion project.

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

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

The capital budget includes two additional major categories of planned spending in 2001; **Bank security enhancements and cash services initiatives.** Capital spending for Bank security projects is projected to total $11.6 million in 2001. Over half of this funding ($5.8 million) is for the Richmond Bank's security enhancement project. Outlays of $12.4 million have been included in the capital budget for cash services initiatives. Sixth District initiatives account for $5.9 million of the total, including the Atlanta Bank's cash vault automation and currency disposal systems ($4.2 million) and new currency processing machines for the Atlanta and Jacksonville offices ($1.7 million).

Attachments

Federal Reserve Bank Cost Accounting
Summary of Changes Affecting the 2001 Budget

In late 1999 and early 2000, the Conference of First Vice Presidents approved recommendations made in three studies concerning the accounting practices of Federal Reserve Banks. These studies are the AIDE Report, the Treatment of National Costs and Revenues Study, and the Phase Two Materiality Report. The implementation of these recommendations limits comparability of budget and expense data across Districts and functions in 2001. A summary of the accounting changes is provided below.

Summary of Key Enhancements

AIDE

In March 2000, the Conference approved changes in Reserve Bank cost accounting practices following an extensive review of the Federal Reserve's Planning and Control System (PACS) and private industry practices. The goal of the review was to seek opportunities to incorporate private industry "best practices" into the Reserve Bank cost accounting framework wherever possible, while ensuring the system maintained accountability, integrity, decision-making, and efficiency (AIDE).

The AIDE concepts result in new methods to assign costs to the appropriate activity, a shift of some activities among service lines, the creation of two new service lines, and a change in management responsibility related to statistical data. These changes will be implemented in PACS while maintaining the system's full costing foundation. The new processes and structure changes should create opportunities for efficiency gains by reducing some of the burden currently inherent in the PACS system. Key enhancements are summarized below.

Assigning department costs to benefiting activities – In today's PACS, numerous surveys are required to charge direct expenses to the appropriate benefiting activities. Each employee completes an individual time survey, which is then used to charge many costs related to that individual, such as salary, benefits, travel, and computer equipment. For other types of expense, a usage survey is employed to determine the appropriate activities to charge. For example, to charge maintenance and depreciation costs associated with a department's copier, Bank staff would survey the usage of the machine to determine percentages for allocating costs to activities. AIDE methodology calls for each department to develop annually a Department Distribution Table (DDT) to distribute costs to activities. The DDTs are based on a compilation of each department's time surveys (amount of time each employee charges to various activities) and adjusted for anticipated staff changes. The DDT will become the basis for charging most direct expenses, eliminating the need for many of the time-consuming surveys. In the aforementioned example, the DDT would be used to distribute expenses for salary, benefits, travel, and equipment, including copiers.

Moving activities to more appropriate service lines – All activities were reviewed to ensure that they were aligned with the most appropriate service line. Some activities were moved to different service lines to reflect more accurately the functions performed. Most notably, the Other Check and the Postal Money Order and Processing activities will be moved from the Financial Institutions and Public service line to the U.S. Treasury and Government Agencies service line. This change will allow the Treasury and Government Agency service line to reflect a clearer picture of reimbursable activities. In addition, all priced services were moved to a new service line, "Fee-Based Services To Financial Institutions," and support activities considered national were moved to a new service line entitled "Nationally Provided Support Services" (NPSS). The creation of NPSS will organize the cost of System projects, centralized business administration functions (CBAFs), product offices, etc. under one service line by responsibility center. The current PACS structure organizes national services by the type of function performed, thereby reporting costs in more than one service line.

Shifting most overhead activities to support and creating two types of internal support – Comparisons between Federal Reserve practices and those of the private sector revealed that Federal Reserve overhead costs account for 20 to 30 percent more of total costs than that of private sector companies. Each overhead activity was reviewed to determine if it would be more appropriately classified in another service line. The result of this review was the movement of all but four overhead activities to other service lines, primarily to the support service line. The rationale for these shifts is based on: 1) the principle that overhead should be limited to activities that benefit the entire organization and can only be charged back to other activities in a general manner; and 2) the principle that, as support activities, all users of the service can be charged. For example, as support activities, human resource functions will charge all activities, but as an overhead, only the four output service lines would be charged. The increased number of support activities will also provide increased accountability and scrutiny of costs.

Two categories of local support were developed. "Services bought and sold," where costs are transferred to the activity acquiring the services (bought) from the service provider (sold), is charged based on service usage measures at a rate calculated during the budget process. An example of this type of support would be printing services. The other support category, "operations sustaining," contains the general business support functions and is transferred to activities based on predetermined usage assumptions. Examples of this type of support include human resources, audit, and legal.

The private sector limits overhead to areas that support the entire organization and should not be charged to specific departments or activities. To be more consistent with this definition, overhead will be renamed "Corporate Overhead," and consist of the following activities: Corporate Administration, Expense Accounting, General Ledger, and Budget and Control. Consistent with the general nature of these functions, all costs in these activities will be charged using the dollar (expense) ratio method.

Treatment of National Costs and Revenues

In October 1999, the Conference approved recommendations to eliminate geographic sharing of costs for all services and operations that are provided centrally to all Reserve Banks.[5] Under this new approach, the Reserve Banks report the associated expenses where the costs are incurred. To ensure consistent implementation, these recommendations are being addressed in conjunction with the structure changes, such as service line enhancements previously discussed in this memorandum.

Over the past several years, the System has consolidated the development, processing, and management responsibilities of many operations. Cost accounting rules have not kept pace with this shift. System projects have been shared out to Reserve Banks as defined in PACS through shared costs distributed and shared costs received. For example, the costs of operating the Support Function Office (SFO) are incurred by the San Francisco Reserve Bank and shared with all other Reserve Banks so that each Bank's bottom line reflects one-twelfth of the costs of operating the SFO. The sharing of these costs reduces accountability, confuses responsibility, and complicates monthly accounting processes. In the 2001 budget, the Reserve Banks have eliminated geographic sharing of costs for all services and operations that are

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

provided centrally to all Reserve Banks. These costs are now reported in the Districts where the activities are provided.

Based on the accounting change described above, Banks that distributed more costs than they received in 2000 generally have the largest year-over-year increases in 2001. In Table 1, Banks are grouped by net distributors and net receivers. With the elimination of cost sharing in 2001, Banks have retained in their budgets the national service costs previously shared. Conversely, Banks that were net receivers have not included these national expenses in their budgets. Not factored into the table are FRIT expenses associated with these national services that also have been retained by the Bank providing the service. For example, in addition to national costs retained in 2001, Minneapolis has included in its budget all of the FRIT charges related to its national application.

Table 1

2000 Net Distributor/Receiver
(dollars in thousands)

Banks	Shared costs distributed	Shared costs received	Net Distributed
Net Distributors			
Atlanta	24,937.6	13,814.3	11,123.3
New York	22,084.1	13,734.5	8,349.6
Minneapolis	15,875.6	8,217.2	7,658.4
San Francisco	19,078.2	12,064.4	7,013.8
Boston	11,681.3	8,109.0	3,572.3
Net Receivers			
Philadelphia	6,782.6	7,339.5	-556.9
Richmond	6,768.2	10,904.9	-4,136.7
Dallas	4,936.6	9,164.8	-4,228.2
Cleveland	4,782.5	9,112.0	-4,329.5
Kansas City	3,582.9	9,115.2	-5,532.3
Chicago	3,267.7	11,802.9	-8,535.2
St. Louis	11.0	10,199.6	-10,188.6

Materiality Thresholds for Capitalization

In March 2000, the Conference supported an increase in materiality thresholds for capitalization, accruals, and prepaid expenses. By adopting the new thresholds, Reserve Banks will reduce the total number of transactions booked and items tracked by accounting staff. This should allow management to reduce the average number of personnel devoted to these tasks and reallocate staff to more value-added activities. Minimal risk is associated with raising the thresholds, and those approved are similar to thresholds established in the private sector.

Of the threshold increases, those relating to capitalization requirements have the greatest effect on the 2001 budgets; specifically, changes to the personal computer and other equipment thresholds. Currently, the Financial Accounting Manual requires that all personal computers and any “other equipment” costing over $1,500 be capitalized. The Conference approved combining the data processing and other equipment categories and increasing the capitalization threshold to $5,000. This change virtually eliminates the capitalization of personal computers. Reserve Banks project that the materiality threshold changes will create a one-time expense increase of $12.9 million, which reflects a shifting of costs from capital to expense and not unplanned or increased spending.

ATTACHMENT 2

TO THE PRESIDENT OF EACH FEDERAL RESERVE BANK

Dear __________:

The Board of Governors has approved the Federal Reserve Bank of __________ 2001 expense budget of $__________. The Board has also approved your District's 2001 capital budget of $__________ with the understanding that approval of actual outlays for building and equipment purchases will be in accordance with the Board's Policies and Guidelines Concerning Reserve Bank Operations (S-2597).

The Board approved a 2001 budget for all Reserve Banks totaling $2,442.2 million, a 6.3 percent increase over 2000 estimated expenses. The budget includes $16.4 million for the check standardization special project.

The Board recognizes the difficult decisions that each Reserve Bank has made this year. The Board also recognizes that each Reserve Bank has been challenged to make trade-offs so that continued improvements in productivity can be achieved in 2001 and beyond.

As in the past, you are asked to keep the Board informed of any major changes anticipated in the spending plans for 2001. Please notify us as soon as possible should any major changes occur that affect your resource needs.

Very truly yours,

Jennifer J. Johnson
Secretary

ATTACHMENT 3

TO THE DIRECTOR OF FEDERAL RESERVE INFORMATION TECHNOLOGY

Dear Mr. Summers:

The Board of Governors has approved the FRIT 2001 expense budget of $194.8 million and special project budget totaling $7.3 million. The Board has also approved your 2001 capital budget of $38.3 million, with the understanding that approval of actual outlays for building and equipment purchases will be in accordance with the Board's Policies and Guidelines Concerning Reserve Bank Operations (S-2597).

The Board approved a 2001 budget for all Reserve Banks totaling $2,442.2 million, a 6.3 percent increase over 2000 estimated expenses. The budget includes $16.4 million for the check standardization special project.

As in the past, you are asked to keep the Board informed of any major changes anticipated in the spending plans for 2001. Please notify us as soon as possible should any major changes occur that affect your resource needs.

Very truly yours,

Jennifer J. Johnson
Secretary

ATTACHMENT 4

TO THE EXECUTIVE DIRECTOR OF THE OFFICE OF EMPLOYEE BENEFITS

Dear Mr. Donovan:

The Board of Governors has approved the Office of Employee Benefits' 2001 expense budget of $34.9 million. The Board approved a 2001 budget for all Reserve Banks totaling $2,442.2 million, a 6.3 percent increase over 2000 estimated expenses.

As in the past, you are asked to keep the Board informed of any major changes anticipated in the spending plans for 2001. Please notify us as soon as possible should any major changes occur that affect your resource needs.

Very truly yours,

Jennifer J. Johnson
Secretary

STATISTICAL APPENDIX

Note: In the following tables, components may not add to totals because of rounding. Table-to-table comparisons may also differ due to rounding.

Table 1

2001 Final Budget

TOTAL EXPENSES OF THE FEDERAL RESERVE BANKS,
by District, 2000 and 2001
(Dollars in Thousands)

District	2000 Estimate	2001 Budget	Change Amount	Change Percent
Boston	124,720	144,041	19,321	15.5%
New York	448,572	484,358	35,787	8.0%
Philadelphia	118,499	121,597	3,098	2.6%
Cleveland	130,515	131,778	1,262	1.0%
Richmond	185,498	188,288	2,790	1.5%
Atlanta	270,542	297,629	27,087	10.0%
Chicago	231,029	226,869	-4,160	-1.8%
St. Louis	130,048	123,780	-6,268	-4.8%
Minneapolis	115,978	138,828	22,850	19.7%
Kansas City	143,418	150,806	7,388	5.2%
Dallas	143,997	144,597	600	0.4%
San Francisco	248,236	273,246	25,010	10.1%
Subtotal	**2,291,051**	**2,425,817**	**134,766**	**5.9%**
Special Projects	6,735	16,392	9,657	143.4%
Total, All Districts	**2,297,786**	**2,442,209**	**144,423**	**6.3%**

Table 2

2001 Final Budget

TOTAL EMPLOYMENT OF THE FEDERAL RESERVE BANKS,
by District, 2000 and 2001

District	2000 Estimate	2001 Budget	Change Amount	Change Percent
Boston	1,287	1,285	-3	-0.2%
New York	3,570	3,431	-139	-3.9%
Philadelphia	1,272	1,287	15	1.2%
Cleveland	1,340	1,392	52	3.9%
Richmond	2,186	2,205	19	0.9%
Atlanta	2,644	2,666	22	0.8%
Chicago	2,134	2,111	-23	-1.1%
St. Louis	1,324	1,318	-6	-0.5%
Minneapolis	1,265	1,289	24	1.9%
Kansas City	1,602	1,678	76	4.7%
Dallas	1,608	1,600	-8	-0.5%
San Francisco	2,489	2,499	10	0.4%
Total, All Districts	22,721	22,760	38	0.2%
FRIT	659	684	24	3.7%
Special Project	9	14	6	64.4%
Total, All Districts	**23,389**	**23,458**	**68**	**0.3%**

Table 3

2001 Final Budget

TOTAL EXPENSES OF THE FEDERAL RESERVE BANKS,[1]
by Service Line, 1996-2001
(Dollars in Thousands)

Year	Total	Monetary and Economic Policy	Services to U.S. Treasury and Gov't Agencies	Services to Financial Institutions and the Public	Supervision and Regulation
1996	1,956,104	138,649	215,609	1,177,444	424,402
1997	2,002,643	144,103	207,079	1,215,069	436,392
1998	2,075,256	152,580	223,414	1,247,404	451,859
1999	2,193,772	168,177	223,756	1,325,052	476,788
2000 Est	2,291,051	176,820	237,367	1,374,377	502,487
2001 Bud	2,425,817	229,340	264,406	1,486,907	445,164
AAGR 1996-2000 Estimate [2]	**4.0%**	**6.3%**	**2.4%**	**3.9%**	**4.3%**

[1] Service line expenses and the average annual growth rate exclude costs associated with special projects.

[2] Average annual growth rates are only shown through the 2000 estimate, as 2001 budget data is not comparable to prior periods due to the accounting changes described in attachment 1.

Table 4

2001 Final Budget

TOTAL EMPLOYMENT OF THE FEDERAL RESERVE BANKS,[1]

by Service Line, 1996-2001

(Average Number of Personnel)

Year	Total	Monetary and Economic Policy	Services to U.S. Treasury and Gov't Agencies	Services to Financial Institutions and the Public	Supervision and Regulation	Support and Overhead
1996	22,909	734	1,543	8,083	3,111	9,439
1997	22,483	718	1,438	7,954	2,980	9,393
1998	22,396	712	1,410	8,106	2,886	9,283
1999	22,769	729	1,322	8,385	2,933	9,401
2000 Est	22,721	909	1,530	8,392	2,545	9,345
2001 Bud	22,760	890	1,422	8,230	2,575	9,643

[1] Service line employment and the average annual growth rate exclude FRIT and special project Average Number of Personnel. Estimated 2000 and budgeted 2001 ANP are not comparable due to the accounting changes described in attachment 1.

Table 5

2001 Final Budget

TOTAL CURRENT YEAR EXPENSES OF THE FEDERAL RESERVE BANKS,
by District, 2000 Budget and 2000 Estimate
(Dollars in Thousands)

District	2000 Budget	2000 Estimate	Change Amount	Change Percent
Boston	125,597	124,720	-876	-0.7%
New York	462,234	448,572	-13,663	-3.0%
Philadelphia	119,350	118,499	-851	-0.7%
Cleveland	132,514	130,515	-1,999	-1.5%
Richmond	181,017	185,498	4,481	2.5%
Atlanta	270,313	270,542	228	0.1%
Chicago	235,202	231,029	-4,173	-1.8%
St. Louis	129,353	130,048	695	0.5%
Minneapolis	117,876	115,978	-1,899	-1.6%
Kansas City	143,542	143,418	-124	-0.1%
Dallas	143,654	143,997	343	0.2%
San Francisco	251,258	248,236	-3,022	-1.2%
Subtotal	**2,311,910**	**2,291,051**	**-20,860**	**-0.9%**
Special Projects	13,995	6,735	-7,260	-51.9%
Total, All Districts	**2,325,905**	**2,297,786**	**-28,119**	**-1.2%**

Table 6

2001 Final Budget

TOTAL CURRENT YEAR EMPLOYMENT OF THE FEDERAL RESERVE BANKS,
by District, 2000 Budget and 2000 Estimate

District	2000 Budget	2000 Estimate	Change Amount	Change Percent
Boston	1,308	1,287	-21	-1.6%
New York	3,654	3,570	-84	-2.3%
Philadelphia	1,287	1,272	-16	-1.2%
Cleveland	1,381	1,340	-41	-3.0%
Richmond	2,195	2,186	-9	-0.4%
Atlanta	2,762	2,644	-117	-4.2%
Chicago	2,163	2,134	-28	-1.3%
St. Louis	1,324	1,324	1	0.1%
Minneapolis	1,270	1,265	-5	-0.4%
Kansas City	1,614	1,602	-12	-0.8%
Dallas	1,635	1,608	-27	-1.7%
San Francisco	2,515	2,489	-26	-1.0%
Subtotal	**23,107**	**22,721**	**-386**	**-1.7%**
FRIT	644	659	15	2.3%
Special Project	0	9	9	NA
Total, All Districts	**23,751**	**23,389**	**-362**	**-1.5%**

Table 7

2001 Final Budget

SALARY ADMINISTRATION EXPENSES OF THE FEDERAL RESERVE BANKS,

Officers and Employees by District, 2001
(Dollars in Thousands)

District	Merit	Promo & Reclass	Market Adjustment	Cash Awards	Incentive Payments	Retention Payments	Total	Percent[1]
Boston	2,558	914	85	490	970	-	5,018	6.9%
New York	10,224	2,905	1,350	3,506	1,893	120	19,997	8.2%
Philadelphia	2,297	454	299	774	472	-	4,295	6.6%
Cleveland	1,943	238	227	593	481	45	3,528	5.6%
Richmond	4,017	1,150	835	1,370	697	-	8,070	7.7%
Atlanta	5,029	1,055	543	2,072	329	155	9,183	7.3%
Chicago	4,393	1,600	500	1,359	913	38	8,804	7.6%
St. Louis	2,535	324	114	854	326	177	4,329	7.1%
Minneapolis	2,561	309	125	778	306	17	4,097	6.8%
Kansas City	3,168	998	462	1,131	584	60	6,405	7.9%
Dallas	2,840	240	32	979	144	53	4,288	5.7%
San Francisco	5,340	782	577	1,902	676	1,424	10,700	7.2%
FRIT	2,022	230	-	243	652	1,090	4,237	8.2%
Total	48,928	11,200	5,149	16,052	8,443	3,179	92,950	7.0%

Merit: the amount of budgeted salary expense that reflects the cumulative impact of planned salary increases based on performance.
Promo & Reclass: the amount of budgeted salary expense that reflects the cumulative impact of salary increases for individuals as a result of grade promotions and reclassifications.
Market Adjustment: the amount of budgeted salary expense to bring individual salaries to the minimum of a grade range or to better align salaries with the market.
Cash Awards: the amount of other personnel expense that represents payments for awards in recognition of exceptional achievements.
Incentive Payments: the amount of other personnel expense that represent payments for the achievement of pre-determined goals.
Retention Payments: the amount of other personnel expense that represent payments to employees based upon contractual agreement with the Bank. Generally used to retain staff in "hot market" jobs, or positions critical to the success of the Bank.

[1] Percent represents the total of the stated payments as a percentage of salary expense.

Table 8

2001 Final Budget

CAPITAL OUTLAYS OF THE FEDERAL RESERVE BANKS,
by District, 2000 and 2001
(Dollars in Thousands)

District	2000 Estimate	2001 Budget	Change	
			Amount	Percent
Boston	18,692	12,025	-6,667	-35.7%
New York	50,759	53,766	3,007	5.9%
Philadelphia	10,259	7,037	-3,222	-31.4%
Cleveland	40,171	17,726	-22,444	-55.9%
Richmond	20,779	22,880	2,101	10.1%
Atlanta	132,367	85,608	-46,758	-35.3%
Chicago	22,346	46,590	24,244	108.5%
St. Louis	13,292	20,449	7,158	53.9%
Minneapolis	4,081	4,012	-69	-1.7%
Kansas City	16,766	16,258	-508	-3.0%
Dallas	38,671	10,431	-28,240	-73.0%
San Francisco	43,257	26,252	-17,005	-39.3%
Total, All Districts	411,438	323,034	-88,404	-21.5%
FRIT	55,917	38,272	-17,645	-31.6%
Total, System	467,355	361,306	-106,049	-22.7%

Table 9

2001 Final Budget

CAPITAL OUTLAYS OF THE FEDERAL RESERVE BANKS,[1]

by Asset Classification, 2001 and 2001

(Dollars in Thousands)

Asset Classification	2000 Estimate	2001 Budget	Change	
			Amount	Percent
Equipment	142,087	129,489	-12,598	-8.9%
Furniture & Fixtures	26,888	34,503	7,615	28.3%
Land & Other Real Estate	36,006	11,956	-24,050	-66.8%
Buildings	164,708	113,571	-51,137	-31.0%
Building Machinery & Equipment	20,867	24,745	3,879	18.6%
Leashold Improvements	4,176	8,064	3,889	93.1%
Software	72,624	38,977	-33,647	-46.3%
TOTAL, SYSTEM	**467,355**	**361,306**	**-106,049**	**-22.7%**

[1] Capital outlays for the Federal Reserve System include the twelve Reserve Districts and FRIT.