



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

DATE: December 14, 2005
TO: Board of Governors
VIA: Governor Mark W. Olson and Stephen R. Malphrus
FROM: H. Fay Peters, Stephen J. Clark and Carol A. Sanders
SUBJECT: 2006–07 Proposed Budget

ACTIONS REQUESTED

Approval of the 2006–07 Board operations and capital budgets as itemized below:

1. An operating budget of \$609.5 million. This figure represents an operating budget increase of \$70.9 million for the biennium, or 6.4 percent annually. The budget includes 1,976 positions, a net increase of 18 positions.¹
2. A capital budget of \$31.4 million (see page 5).

OVERVIEW OF THE BUDGET

Process

Every two years, the Board and its senior staff undertake a process that produces a four-year strategic plan and a biennial budget. For the 2006–09 planning period and the 2006–07 budget period, the Committee on Board Affairs (CBA), assisted by a senior-level Staff Planning Group (SPG) chaired by Messrs. Malphrus and Stockton, and staff in the Planning and Budget Section of the Management Division, guided the process, which resulted in a budget objective of \$609.6 million for operations which was approved by the Board in September.

Planning Issues

The SPG reviewed the planning materials submitted by the Board's divisions and offices and identified the following major issues that will have a significant effect on Boardwide operations over the planning period:

- the full two-year cost of current initiatives such as reorganizations in the Division of Consumer and Community Affairs and the Management Division, creation of the

¹ These figures do not include funding or positions for the Office of Inspector General or funding for currency purchased from the Bureau of Engraving and Printing.

Quantitative Unit in Banking Supervision and Regulation, and the Monetary and Financial Studies Section in Monetary Affairs

- legislative and executive mandates for a number of activities, including physical and information security and electronic government initiatives
- the need to attract and retain high quality staff
- the need in the biennium to address office space

These issues are reflected in the resource-allocation decisions of the Committee on Board Affairs, which form the basis of the approved budget. They will also serve as the basis for the 2006–07 Performance Budget prepared as part of the Board’s voluntary compliance with the Government Performance and Results Act.

Major Initiatives

To address these major planning issues, the approved budget includes the following initiatives and projects for the 2006–07 period.

- *Attract and retain high quality staff.* Initiatives to improve the Board’s ability to attract and retain staff include enhancements to the cash award program for staff and to the variable-pay program for economists, attorneys, and officers; a 3.8 percent merit increase for 2006 and a placeholder of 3.8 percent for the 2007 merit increase; a compensation study; and actions to enhance productivity and meet new requirements, such as improved information technology equipment, access to enhanced data sets, and a slight increase in staffing to assist with current analysis.
- *Information technology (IT).* Funding is provided for the Board to comply with e-government initiatives such as improved public access to data, Federal information security management, and section 508 compliance.
- *Workload.* A small increase in the number of positions, a reallocation of positions to meet higher-priority requirements, and the filling of a number of vacant positions are necessary in order to comply with new laws that effect Board operations, such as our expanded role relative to the Reserve Banks in the implementation of the Sarbanes-Oxley Act (SOX), Board implementation of the Committee on Sponsoring Organizations (COSO) framework and compliance with SOX, and preparation for Basel II and other key initiatives.
- *Security and continuity of operations.* Several factors, have contributed to a significant increase in the budget for security and continuity of operations. These include market pressures in the security field as Washington agencies continue to expand security staff, coverage of additional security posts due to on-going perimeter construction leading to a slight increase in overtime, some new overtime payments to keep competitive in the market place, and other actions to enhance employee safety and the Board’s ability to operate in a contingency environment.
- *Facilities.* In line with the Board’s strategic plan, capital investments are planned for the three Board facilities, as discussed in the capital budget section below. Additional noncapital improvements are also planned at all three facilities.

Areas of Risk

Despite a careful and coordinated planning effort, future developments could require resources beyond what is currently approved, such as the following:

- a merit increase greater than the 3.8 percent for 2007 or a higher rate of increase in health insurance costs
- assumptions of turnover due to demographics and the estimated salaries of successors
- pressure in key areas requiring additional salary or benefit packages to remain competitive
- significant changes in or shocks to the economy or financial system that create a material increase in workload
- terrorist activity requiring additional security and contingency enhancements
- new workload created by laws or decisions to expand or modify central bank operations
- changes to the position-vacancy-rate assumptions used in developing the salary budget and the need for more office space if the staff increases
- issues such as changes that may result from the appointment of a new Chairman

Operations Budget by Division and Account Classification

Details of the Board's overall operations budget are provided by division in table I and by account classification in table II. Merit pay increases and COSO-SOX are the largest factors in the 6.4 percent annual increase in Board expenses. Without these two components, the budget increase would have been 3.31 percent annually.

Personnel costs dominate the Board's budget, and most of the increase in the 2006–07 budget is in this area. The proposed budget for personnel services (salaries, retirement, and insurance) is \$447.3 million, or \$58.0 million greater than the 2004–05 base. Merit pay (\$26.4 million), promotions and reclassifications (\$2.3 million), and higher benefit costs (\$9.4 million) are large components of this increase. Incremental salary costs for positions added during the current biennium amounted to \$8.5 million for positions added in the Division of Consumer and Community Affairs, the Management Division, and the Division of Banking Supervision and Regulation, and \$0.8 million for COSO-SOX positions. The remainder of the increase is caused by a lower position-vacancy rate in certain divisions and a net increase of eighteen positions in the budget.

The 2006–07 budget for goods and services is \$162.2 million, which is \$12.9 million greater than the 2004–05 base (an average annual increase of 4.2 percent per year). Much of this increase is attributable to the increase related to the Board's funding of an attestation of management's assertions for the Reserve Banks' internal controls. Expenses by account classification are discussed in more detail beginning on page 16.

The increases discussed above would have been greater without programmatic reductions and improved efficiency in areas throughout the Board. These include discontinuance of the compilation of the M3 series, reductions for contractual services, actions to contain utilities costs, and better management of travel.

Operations Budget by Operational Areas

The Board's operations budget supports four broadly defined operational areas: monetary and economic policy, supervision and regulation, services to financial institutions and the public, and Federal Reserve System policy direction and oversight. Following is a summary discussion of the resources, including support and overhead, budgeted for each area for 2006–07.

Monetary and Economic Policy

The 2006–07 budget for the monetary and economic policy function is \$243.6 million, an increase of \$21.1 million, or an average of 4.6 percent per year.

As the financial markets change, the monetary and economic policy function continues to evolve in order to develop effective monetary policy through open market operations, discount rates and the administration of the discount window, and reserve requirements. The Board has been evaluating the data used in crafting monetary policy and plans to make changes in the 2006–07 biennium. Initiatives will be taken to expand surveys and gather new data sets related to industrial output and commercial activity and consumer and mortgage credit. At the same time, other data, such as those gathered for the M3 series, which are serving a less-valuable purpose, will be discontinued.

A continuing challenge in this area is recruiting and retaining qualified staff. However, implementation of new compensation policies, such as variable pay, has been helpful.

Supervision and Regulation

The 2006–07 budget for the supervision and regulation function is \$247.0 million, an increase of \$31.1 million, or an average of 7.0 percent per year.

The U.S. banking system has evolved into a sector with a small number of large complex banking organizations operating across wide geographic regions, and numerous smaller institutions focused on local communities or regional areas. The Division of Consumer and Community Affairs and the Division of Banking Supervision and Regulation have realigned their structures in response to these changes by creating Large Financial Institutions/Large Complex Banking Organization units within their organizations. The changes will help the Board enhance the quality and consistency of supervision across a select group of important institutions by promoting a more explicit portfolio-management approach. A number of significant automation projects supporting this work are included in the capital budget.

During the 2006–07 budget period, this function will also devote resources to the implementation of the Basel II capital accord and will lead the development of E-Apps, an electronic filing application to be used throughout the Federal Reserve System.

Services to Financial Institutions and the Public

The 2006–07 budget for oversight of Reserve Bank services to financial institutions and the public is \$11.7 million, an increase of \$1.6 million, or an average of 7.7 percent per year.

A portion of the increase is attributable to enhancements to the CASH Statistical Data System and resolution of production problems. Additional funds were also provided for the administration of a survey to assess the effect of the Check Clearing for the 21st Century Act (Check 21) on various aspects of check processing.

The Board expects its workload to comprise, among other things, ongoing assessment of the Reserve Banks' (1) business strategies addressing long-term check services viability and check infrastructure, (2) cash infrastructure study, and (3) implementation of major Reserve Bank technological projects.

System Policy Direction and Oversight

The 2006–07 budget for System policy direction and oversight is \$107.2 million, an increase of \$17.0 million, or an average of 9.0 percent per year. The increase would have been 3.2 percent year, but is 9.0 percent because the budget for the audit of the Reserve Bank audits was moved from Special Projects to the division to better manage the budget.

This budget reflects increased funding for personnel costs, transfer of the Reserve Bank external auditor contract, increases in foreign travel and software requirements, significant growth in the use of the System interchange program by other Board divisions, and rate changes for services provided by the Division of Information Technology.

The Board expects that the workload in this area will continue to be influenced primarily by the key strategic, technological, environmental, and infrastructure changes affecting the Reserve Banks' payment services, fiscal agency activities, and major support functions. In addition, staff will continue to participate on work groups and perform analysis in support of the Board's international work on payments systems.

Capital Budget

The Board's proposed 2006–07 capital budget is \$31.4 million. Of this total, \$18.6 million supports continued security enhancements and large building projects. Major facility projects include the perimeter security enhancements, installing sprinklers in the Martin Building and in the data center, renovating the main cafeteria and replacing the sanitary risers in the Eccles/Martin complex, and installing vehicle barriers at all three buildings.

Information technology projects of \$4.1 million include computer server replacements, network infrastructure, and data security enhancements. Software and other office automation-related expenses of \$7.2 million include projects such as the Shared National Credit Program and the National Information Center Rearchitecture. The Division of Banking Supervision and Regulation plans to upgrade the Shared National Credit Program by developing an interagency central repository, standardizing the process of collecting data from external sources, and enhancing security. The division will also modify the infrastructure of the National Information Center to reduce redundant processes and simplify the system for end users.

The remaining \$1.5 million is for non-automation-related expenses, such as purchases of furniture and office equipment.

Positions

For the 2006–2007 budget period, staffing requests resulted in a net increase of eighteen positions in the Board’s position authorization, bringing the total to 1,976 positions (see table IV).

The Management Division requested a net increase of eleven positions to meet the demands of an increasing workload. During the planning process, a full-time carpenter and an apprentice were approved to handle office reconfigurations, thus reducing contractual services. To meet the Board’s COSO/SOX requirements, three additional analyst positions were also approved and offsets were identified. Five positions (four mail clerks and one technician) were approved for conversion to higher-level positions, to assist with workload saturation. In addition, the division is creating four permanent positions to allow it to eliminate four dual occupancies in the procurement, training, health, and travel functions. Beyond these position increases, the division plans to self-fund five positions in the compensation, administration, information systems, and workers’ compensation area. Some of these positions are offset by the abolishment of two positions (in program direction and planning and budget) and some of the funding will be from outside the personnel services area.

The Division of Consumer and Community Affairs had a net increase of five positions, one of which will be for information systems development support previously provided by the Division of Information Technology and four of which will be for the new Large Financial Institutions/Large Complex Banking Organizations (LFI/LCBO) Section.

In the Division of Monetary Affairs, an additional economist position was added in the Monetary Studies Section because of the increasing applicability of academic research to the framework for monetary policy strategies and to the formulation, implementation, and communication of monetary policy, as well as potential changes to analytical elements of the Bluebook

**Operating Budget
by Division, Office, and Special Account**

Table I

Division	2004-05 Base	2006-07 Budget Request	Difference	Annual Percent Change
Office of Board Members	\$ 25,065,749	\$ 26,399,048	\$ 1,333,299	2.6%
Office of the Secretary	11,520,591	12,403,391	882,800	3.8%
Office of Staff Director for Management	16,105,000	16,783,354	678,354	2.1%
Division of Research and Statistics	75,803,370	82,689,776	6,886,406	4.4%
Division of International Finance	28,162,536	32,005,674	3,843,138	6.6%
Division of Monetary Affairs	23,055,615	28,441,083	5,385,468	11.1%
Division of Banking Supervision and Regulation	84,381,803	99,481,186	15,049,383	8.6%
Division of Consumer and Community Affairs	24,300,000	29,514,814	5,214,814	10.2%
Legal Division	23,846,317	26,083,160	2,236,843	4.6%
Division of Reserve Bank Operations and Payment Systems	38,100,000	51,357,441	13,257,441	16.1% ¹
Division of Information Technology	90,831,970	91,154,747	322,777	0.2%
Management Division	106,200,000	122,213,541	16,013,541	7.3%
IRM Income	(39,306,406)	(39,783,595)	(477,189)	0.6%
Residual Retirement and Insurance Benefits	7,147,642	9,816,982	2,669,340	17.2%
Special Projects	13,355,910	11,964,170	(1,391,740)	-5.4%
Extraordinary Items	10,000,000	9,000,000	(1,000,000)	-5.1%
Total Board	\$ 538,570,097	\$ 609,474,772	\$ 70,904,675	6.4%

¹ Without the increase for SOX, the division's increase would be 3.6 percent.

**Operating Budget
by Account Classification**

Table II

Division	2004-05 Base	2006-07 Budget Request	Difference	Annual Percent Change
<i>Personnel services</i>				
Salaries	\$ 331,649,881	\$ 380,220,046	\$ 48,570,165	7.1%
Retirement	29,026,068	35,725,206	6,699,138	10.9%
Insurance	28,605,006	31,352,362	2,747,356	4.7%
<i>Subtotal</i>	<u>\$ 389,280,955</u>	<u>\$ 447,297,614</u>	<u>\$ 58,016,659</u>	7.2%
<i>Goods and services</i>				
Travel	\$ 13,808,314	\$ 15,703,307	\$ 1,894,993	6.6%
Postage and expressage	1,176,000	976,448	(199,552)	-8.9%
Telecommunications	10,575,656	10,799,398	223,742	1.1%
Printing and binding	2,963,000	2,690,500	(272,500)	-4.7%
Publications	1,380,710	1,230,192	(150,518)	-5.6%
Stationery and supplies	2,291,693	2,315,184	23,491	0.5%
Software	14,538,573	14,643,249	104,676	0.4%
Furniture and equipment	9,212,101	7,517,207	(1,694,894)	-9.7%
Rentals	747,944	1,199,248	451,304	26.6%
Books and subscriptions	2,004,813	1,988,593	(16,220)	-0.4%
Utilities	5,916,391	7,800,000	1,883,609	14.8%
Building repairs and alterations	5,860,700	4,646,000	(1,214,700)	-11.0%
Furniture repairs and maintenance	3,568,614	2,475,129	(1,093,485)	-16.7%
ARC expense/R&S-MA	1,576,221	1,605,120	28,899	0.9%
ARC income/R&S-MA	(1,576,220)	(1,605,120)	(28,900)	0.9%
Contingency processing center expenses	895,750	1,700,000	804,250	37.8%
Contractual professional services	51,437,486	62,848,336	11,410,850	10.5%
Interest expense	180,985	85,651	(95,334)	-31.2%
Tuition/registration and membership fees	4,405,061	4,833,513	428,452	4.8%
Subsidies and contributions	1,285,233	1,338,434	53,201	2.0%
All other	5,272,799	4,991,489	(281,310)	-2.7%
Depreciation	26,609,427	28,825,570	2,216,143	4.1%
Income	(14,803,097)	(16,391,822)	(1,588,725)	5.2%
IRM user charge	39,267,394	39,745,127	477,733	0.6%
IRM income	(39,306,406)	(39,783,595)	(477,189)	0.6%
<i>Subtotal</i>	<u>\$ 149,289,142</u>	<u>\$ 162,177,158</u>	<u>\$ 12,888,016</u>	4.2%
Total Board	\$ 538,570,097	\$ 609,474,772	\$ 70,904,675	6.4%

Capital Budget
by Division, Office, and Special Account

Table III

Division	2004-05	2006-07	Difference
	Base	Budget Request	
Office of Board Members	\$ 459,060	\$ 127,610	\$ (331,450)
Office of the Secretary	30,000	30,000	-
Office of Staff Director for Management	550,000	365,000	(185,000)
Division of Research and Statistics	600,000	600,000	-
Division of International Finance	102,000	-	(102,000)
Division of Monetary Affairs	-	-	-
Division of Banking Supervision and Regulation	-	4,480,380	4,480,380
Division of Consumer and Community Affairs	-	-	-
Legal Division	-	-	-
Division of Reserve Bank Operations and Payment Systems	-	-	-
Division of Information Technology	7,800,000	5,775,000	(2,025,000)
Management Division	18,913,388	20,018,000	1,104,612
IRM Income	-	-	-
Residual Retirement and Insurance Benefits	-	-	-
Special Projects	-	-	-
Total Board	\$ 28,454,448	\$ 31,395,990	\$ 2,941,542

Position Summary
by Division, Office, and Special Account

Table IV

Division	2004-05	2006-07	Difference
	Authorization	Proposed	
Office of Board Members	77	78	1
Office of the Secretary	50	50	-
Office of Staff Director for Management	45	45	-
Division of Research and Statistics	275	275	-
Division of International Finance	116	116	-
Division of Monetary Affairs	74	75	1
Division of Banking Supervision and Regulation	254	254	-
Division of Consumer and Community Affairs	89	94	5
Legal Division	80	80	-
Division of Reserve Bank Operations and Payment Systems	139	139	-
Division of Information Technology	301	301	-
Management Division	458	469	11
Total Board	1,958	1,976	18

APPENDIX—SUPPLEMENTAL INFORMATION

Planning and Budgeting Process

The Board's budget covers a two-year period. As part of the planning process, the Board's divisions examine their operations and look for any adjustments to their mission, priorities, activities, and associated resources that might improve the efficiency and effectiveness of the Board's operations.

The management of each division discusses with the appropriate Board oversight committee the issues that result from its planning review. After any adjustment, the results are given to the Staff Planning Group, a small group of senior managers with a Boardwide perspective, for use in their analysis of the Board's budget options.

After consulting with the Board-level Committee on Board Affairs for final guidance, the Staff Planning Group updates the Board's strategic plan and uses the plan as an input to prepare a preliminary budget objective that identifies the level and allocation of resources needed in the budget. As part of this process, individual division budget objectives are prepared on the basis of Boardwide priorities and planning assumptions. The Committee on Board Affairs reviews the plan and preliminary budget objective, clarifies outstanding planning issues with the Staff Planning Group and division directors, and submits the budget objective to the Board for its consideration. The divisions use the budget objective approved by the Board to complete their budgeting under the approved plan.

2004–05 Budget Performance

During the 2004–05 budget period, although the operating budget remained unchanged, a number of divisions reallocated funds to higher-priority projects, such as development of a web-enabled Check 21 survey. Final expenses for Board operations are expected to be close to the \$538.6 million budget.

Average employment during the 2004–05 biennium was approximately 1,819. This is 84 employees (4.8 percent) higher than the 2002–03 average of 1,735. The majority of additions are related to completing the hiring of security staff positions approved in the prior budget cycle. In addition, the variable-pay program, which was created to increase recruitment and retention of economists, attorneys, and officers, has been successful in decreasing turnover and will continue as a Board program.

The largest contributing factor in the increase in goods and services is utilities. During the 2004–05 budget cycle, steam prices increased multiple times, and the General Services Administration, which provides steam, has told its customers that prices will again rise dramatically in the near future because the price of the natural gas used to generate steam continues to escalate.

2006–07 Operations Budget by Division

Key projects and initiatives associated with each division's budget are discussed below.

Office of Board Members

The Office of Board Members will continue to articulate the Board's public policy role and describe how those responsibilities are fulfilled. The Board of Governors will provide overview, direction, and supervision for System goals, objectives, and projects.

During the 2006–07 budget period, the appointment of a new Chairman and two new Board members may result in staffing and other changes that are difficult to predict. Some of the major initiatives the division will focus on include development of a sales inventory management system, the upgrade of the Correspondence Control System to a web interface, and additional assistance for the section 508 compliance help desk.

Office of the Secretary

The Federal Reserve Integrated Records Management Architecture (FIRMA) will continue to evolve in the 2006–07 budget period while ensuring that it is in compliance with federal law and Board policy. New features will make the system more user-friendly and increase the number of document formats the system will accept electronically.

The Office of the Secretary will also participate in E-Apps, the electronic application and filing system to be implemented throughout the Federal Reserve System. Comments on applications will be provided to Board staff electronically through a distribution system managed by the Clearing Section. The Freedom of Information Office will develop the capacity to make applications and comments available on, and to receive comments from, the Board's public website. In addition, FIRMA will be modified to receive E-Apps records directly.

Office of the Staff Director for Management

The Office of Staff Director for Management will oversee the Board's management and operations functions. During the budget period, the office will continue to improve management processes, comply with the increasing workload related to requests from OMB and GAO and enhance resiliency and continuity of critical central bank and financial sector functions. A review of the Board's compensation system and long-term space needs will also be conducted. Significant progress will also be made in implementing the Board's decision to implement the Sarbanes-Oxley Act and the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework. This activity will have major governance effects throughout the Board.

Division of Research and Statistics

In the next biennium, the Division of Research and Statistics will continue to carry out its responsibility for developing and presenting domestic economic and financial information for use by the Board, the Federal Open Market Committee, and other System groups in the conduct of monetary, regulatory, and supervisory policies. The division has reviewed data currently gathered in surveys and has identified several new initiatives to purchase and develop data. During this time, the survey of plant capacity will be expanded, two new data sets relating to computing/information technology will be purchased, and the credit data purchased in the

previous biennium will be updated. In conjunction with the Division of Information Technology, Research and Statistics will develop the Financial Institutions Research and Market Analysis Tool (FIRMAT). This system will be used to help the Federal Reserve System understand the impact of bank mergers on competition, community reinvestment, and related areas.

The division faces similar challenges as those of other Board divisions that compete in a very competitive labor market to attract and retain a highly educated workforce. The competition for job applicants continues to place pressure on the division's budget; however, the new compensation policies enacted in recent years, such as variable pay, are beginning to have positive results. Turnover has been reduced, especially among top-performing employees. This alone, however, will probably not be enough to enable the division to meet all of its human capital objectives. To remain competitive, the division will have to continue to evolve and adapt by improving research work opportunities, compensation policies, and lifestyle-related options.

Division of International Finance

During the next biennium, the Division of International Finance will continue to meet its obligations to the Board and FOMC by providing high quality analyses on a wide range of international economic and financial issues and developments. The division will provide analyses on the U.S. current and capital accounts, foreign exchange markets, international financial intermediation, and foreign industrial and emerging economies. The division will continue to make contributions to fundamental economic research, including the further development of econometric models, which are important for the division's forecasting responsibilities. In addition, the division will provide support to the Chairman and other Board members in order to support their participation in various international meetings, including meetings associated with the G-7, G-10, G-20, BIS, IMF, and OECD.

The Board's compensation policies, including variable pay and hiring premiums, will be a critical factor in the division's ability to attract and retain qualified Ph.D.s in economics and finance. The Board's recent action to allow certain staff members who are not U.S. citizens access to sensitive information under certain circumstances will also help the division to hire and retain highly qualified Ph.D. economists.

Division of Monetary Affairs

The Division of Monetary Affairs is responsible for assisting the Board and the FOMC in developing monetary policy. A significant amount of staff time will be devoted to formulating the statements released to the public regarding the Federal Reserve's monetary policy. The division will also monitor the markets' responses to the statements. This monitoring will be enhanced by research into the behavior of money and credit, reserve, and government securities markets. FOMC statements are closely scrutinized by the public, which requires the division to gather and analyze data and to discuss the text used in the statements. Monetary Affairs also faces uncertainty about the direction a new Chairman may want to take in developing monetary policy in the next biennium.

Division of Banking Supervision and Regulation

With the consolidation of the banking industry into a small number of complex, geographically dispersed organizations, the Division of Banking Supervision and Regulation continues to enhance its program for the oversight of large financial institutions (LFIs) and is updating its risk

expertise, incorporating an enterprise-wide approach to the supervision of LFIs. As needed, the division will continue to revise the programs currently in place to monitor large complex banking organizations (LCBOs), foreign banking organizations (FBOs), and community and regional banking organizations. Corporate governance has become an area of concern within the financial markets; therefore the division will focus efforts to encourage bank disclosure, provide input on proposed Financial Accounting Standards Board (FASB) rules, and participate in developing stronger international accounting guidelines.

During the 2006–07 budget period, the division will initiate E-Apps, an electronic application that will enable banking organizations to file documents electronically. E-Apps is planned to be used throughout the Federal Reserve System. Significant division resources will be expended on Basel II in the next biennium. A new section, Quantitative Risk Management, has been created to support our supervision around quantitative risk management practices and Basel II. Banking Supervision and Regulation will also support the development of guidance and procedures for examiners and the industry regarding the implementation of Basel II and the revisions to Basel I.

The division, in conjunction with the Federal Reserve Bank of New York and the Federal Reserve Bank of Dallas, will undertake an initiative to rearchitecture the National Information Center to make the system more user-friendly and reduce redundant data and redundant project costs. The Shared National Credit Program's technology will also be upgraded in the next few years. The planned upgrades include developing an interagency central repository, standardizing the process of collecting data from external sources, and enhancing security.

Banking Supervision and Regulation anticipates that the U.S. banking system will continue to evolve, with a small number of large complex banking organizations operating globally and numerous smaller institutions focusing on local communities or regions. The nature of banking risks has become more complex, creating the need for more effective and robust systems for identifying, measuring, monitoring, and controlling risks. Supervision of community and regional banking organizations will also continue to be important, given the risk that these banks can pose to the Federal Deposit Insurance Company's Bank Insurance Fund.

Division of Consumer and Community Affairs

The division has restructured for the 2006–07 budget period to better manage its consumer compliance responsibilities as an umbrella supervisor of large complex banking organizations and large financial institutions. As the banking industry consolidates into a small number of large complex banking organizations operating across wide geographic regions, the division has determined that, in order to meet its objectives, it will need to develop an enterprise-wide compliance program.

In 2006–07, the division plans to develop a unit with enhanced expertise for dealing with complex consumer compliance regulatory and policy issues associated with LFIs and LCBOs. Staff in this unit will work closely with Reserve Bank staff in the supervision of these critical institutions. Financial institutions' continuous innovation in developing fee-based products such as stored-value cards and bounced-check protection services will require the division to devote resources to rule writing, compliance supervision, and other efforts related to consumer protection. Many of these products and their associated costs and fees, while not unlawful or otherwise regulated by federal law, are the subject of significant public complaint and criticism, which is placing increased pressure on the Board to take supervisory or regulatory action

The division will be working on disclosures for Regulation Z (Truth in Lending) and Regulation E (Electronic Fund Transfers) that meet the requirements of the regulations and that effectively assist consumers in understanding the terms and risks of financial service products and their rights and responsibilities under the law. The division will contract for professional services to assist in research, development, and consumer testing measuring the utility and effectiveness of the redesigned disclosures.

Legal Division

During 2006–07, the Legal Division will continue to work on ongoing initiatives, such as the domestic implementation of Basel II and Basel I-A, the review of bank, nonbank and foreign bank expansion applications and notices, and the mandated 10-year review of all of the Board's regulations required by the Economic Growth and Regulatory Paperwork Reduction Act, including the preparation of a report to Congress in 2006. Other major projects include ongoing work in connection with a variety of legislative projects, supervisory-information-sharing arrangements with a number of countries and the EU, and participation in the Treasury-led US-EU Financial Markets Regulatory Dialogue. The Law Library and Legal Records Section began a project to make the historical and ongoing Legal Records files more accessible to division staff through the use of scanning technology. This project will intensify during this budget cycle as scanning and indexing technology becomes less expensive.

In the upcoming budget period, resources will also be devoted to new initiatives, including the implementation of the E-Apps project (electronic filing of applications), and to revisions of Regulations Y (Bank Holding Companies and Change in Bank Control) and K (International Banking Operations). The division will be engaged in a major project with the Management Division to review the federal laws with which the Board must comply, as part of the Management Division's efforts to implement COSO and comply with the spirit of the Sarbanes-Oxley Act. Increased resources will also be devoted to reviewing and updating the Board's systems of records under the Privacy Act.

Division of Reserve Bank Operations and Payment Systems

The division's budget reflects a strategy of focusing on three broad areas: Reserve Bank oversight, policy and regulation development and payment system oversight, and payments research. To achieve its goals in these areas, the division will continue to produce high-quality assessments of Federal Reserve System strategies, projects, and operations that assist System management to foster and strengthen sound internal control systems; develop sound, effective policies and regulations to foster payment system integrity, efficiency, and accessibility; and conduct research and analysis to enhance policy development and promote an understanding of payment system dynamics and risk.

The division will continue its work on payment system policy issues in domestic and international arenas, and will focus its research agenda on topics in the retail and cash payments arenas. It will also continue to respond in a timely fashion to inquiries from Congress, private-sector organizations, foreign central banks, and the public regarding the Federal Reserve's payment policies and service.

Division of Information Technology

The Division of Information Technology is supporting a number of high-priority client initiatives during the 2006–07 budget period. The initiatives are the result of requests from customers and necessary enhancements to the Board's infrastructure and security environment. The major projects include incorporating managed public key infrastructure (PKI) from a federal PKI shared service provider, and implementing E-Apps and FISMA compliance across Reserve Banks. The division will continue to focus on improving information security, replacing servers, upgrading data storage, and enhancing network infrastructure.

Management Division

The Management Division will continue to face considerable strategic challenges during the 2006–07 budget period. The Board's space needs have increased dramatically over the past four years as a result of security issues as well as new legislation and regulations. Because all space at the Board is now occupied and additional demands are certain, the division will complete its comprehensive review of options and develop a strategic plan that addresses both short- and long-term space needs. Some funding has also been included in the budget to lease a small amount of space for a portion of the cycle to meet immediate demands.

In the financial reporting area, efforts to implement a more formal internal control structure are underway and will require substantial investment during the planning period. In other areas, work is ongoing to ensure that the Board is in compliance with all relevant laws, policies, and regulations. Security is another area in which ongoing challenges require considerable attention to ensure readiness and responsiveness. The division must also devote significant resources to ensuring that the Board continues to attract, retain, and develop the staff necessary to complete its mission and that it will be able to replace approximately one-third of the Board's management staff who will be eligible for retirement during the planning period.

Special Projects

This budget, administered by the Management Division, provides funds for projects that do not appropriately fall within the realm of the Board's divisions or other special accounts. In 2006–07, varied projects are funded for Board operations in this budget, such as two salary-related initiatives, the employee relocation program, and the transportation subsidy. Other items included in this budget are the Enhanced Foreign Economic Analysis Program, the Board's Van Pool Program, and the Board's share of Federal Financial Institutions Examination Council expenses.

Extraordinary Items

The Board's extraordinary items budget for 2006–07 provides funds of \$9.0 million for the Survey of Small Business Finances (\$0.5 million) and the Survey of Consumer Finances (\$8.5 million). These surveys, which gather information on the economic behavior of households and the financial health of small businesses in the U.S., will improve the quality of economic data produced by the Board.

Operations Budget by Account Classification

Following is a brief discussion of each account classification with major changes between budget periods.

Travel (6.6 percent annual increase)

This increase is the result of several factors. In anticipation of filling Board vacancies with applicants from around the System, additional funds were allocated to support the Board's relocation program. Increased foreign travel is projected to support payments-related initiatives, Basel II, risk, compliance, and enhanced economic activity in the coming biennium. Divisions have increased their use of the System interchange program as well as academic participants' travel to the Bellagio conference. Finally, the appointment of a new Chairman in 2006 is expected to result in greater travel by the Chairman and his support staff.

Furniture and Equipment (9.7 percent annual decrease)

The completion of the contingency effort reduced the funds needed for furniture, contingency laptop computers, hardware, and software. Also reflected in this reduction is lower-than-expected costs for replacement Blackberries. Since some divisions recently replaced laser printers and computer monitors, less funding for those items will be needed during the 2006–07 cycle.

Utilities (14.8 percent annual increase)

During the 2004–05 budget cycle, steam prices increased multiple times, and the General Services Administration, which provides steam, has told its customers that prices will again rise dramatically during 2006 because the price of the natural gas used to generate steam is continuing to escalate. For emergency purposes, the Board purchased and installed hot water heaters to provide heat for the Eccles/Martin complex if service from GSA is cut off. Board staff subsequently determined that it could use the hot water to provide heat to the building on a daily basis at a lower cost than purchasing steam from GSA. During 2005, the Board began using the hot water heaters for the majority of the complex, and the switchover from GSA should be complete by the end of 2005. Although this change will require increased funding for electricity, it should result in lower total utility costs than if the Board had continued using steam provided by GSA.

Building Repairs and Alterations (11.0 percent annual decrease)

The decrease primarily reflects the cyclical nature of the work coded to these accounts (the change between the 02-03 and the 04-05 cycles was an increase of 9.4 percent). Fewer projects will be required in the 06-07 cycle, and due to the large volume of capital projects, staff in the Design & Construction area will not have time to focus on lower priority operating projects, allowing for some of the reduced funding in this cycle. A permanent reduction in this account is the support for furniture and installation and small office reconfigurations as that work will now be performed by new in-house staff at an overall lower cost.

Furniture Repairs and Maintenance (16.7 percent annual decrease)

The largest factor in the decrease is a reduction in equipment needed for data processing, which is a result of the completion of the Board's contingency sites. Boardwide there was a reduction in the budget for reupholstering furniture and for audio/visual repairs. These reductions have been partially offset by the increase in the Security Systems Unit for anticipated maintenance contract fees for x-ray machines, the fire arms training system, and the electronic security system.

Contractual Professional Services (10.5 percent annual increase)

Various factors are contributing to the significant increase in funding in this area. The largest single factor is the additional funding required for the Reserve Bank external audit contract as a result of significant consulting assistance for COSO/SOX activities. Additional funding is also required to expand the survey of plant capacity and to purchase networking equipment reports. Renewal or granting of contracts for services such as the employee shuttle, building cleaning, and the medical director has resulted in higher costs. Finally, the Board will begin making monthly payments to the food service provider to operate the New York Avenue cafeteria.

Depreciation (4.1 percent annual increase)

The depreciation account balance is a direct result of large capital projects completed during the 2004–05 budget cycle. Such projects included the software development project (Banking Organization National Database), the replacement of the Eccles roof, and the New York Avenue security enhancements. The account also captures the depreciation for projects to be completed in 2006–07. For example, the perimeter security project, Martin sprinkler project, New York Avenue electrical switchgear replacement, and the relocation of Martin air intakes.

Income (5.2 percent annual increase)

The Board expects to receive income for full two years of the *International Journal of Central Banking* and reimbursement for FFIEC projects. The majority of the increase, however, is attributable to the two years' worth of rental income the Board will receive from the Richmond relocation site.

Trends in Expenses and Employment

The rate of increase within the 2006–07 budget is 6.4 percent per year, which is less than the 6.4 percent projected average annual rate of increase since the 1996–97 biennium. The increase over this period is mainly attributable to security initiatives, strategic human capital initiatives, and the increasing complexity of Board work over this period. The increased complexity required a net increase in positions and higher average grades, higher salaries, and increasingly sophisticated automation systems to manage ever-increasing volumes of data. More recently, the Board has experienced sharply higher security costs mainly attributable to additional personnel.

Approximately three-fourths of the Board's operating expense is for personnel; consequently, analysis of trends is heavily tied to staffing levels. From 1996 to 2007, the number of authorized positions for Board operations rose from 1,733 to 1,976, a net increase of 243, or 14.0 percent. However, over 60 percent of this increase in positions is for security precautions. Reflecting the growing complexity of the Board's work, the average grade for professional staff rose from 25 to 26.

During the ten-year period, changes in financial services, many associated with automation enhancements, increased the complexity of supervisory safety-and-soundness activities. To adequately perform these activities and to increase attention on consumer issues, including collection and analysis of data collected under the Home Mortgage Disclosure Act and Community Reinvestment Act, a net of thirty-four positions were added. (Many positions associated with lower-priority work were eliminated to offset the cost of the new work.) The increasing complexity of monetary policy issues resulted in an increase of twenty-five positions. There have been substantial changes in the overall Reserve Bank environment, including

consolidation of check processing and related changes to the governance process. As a result of these changes, as well as increased interest in private-sector clearing and settlement, nineteen positions were added. Over a hundred security-related positions have been added. Implementation of the Sarbanes-Oxley Act has resulted in the addition of three positions dedicated to ensure compliance with internal control requirements. Finally, a net decrease of seven administrative and support positions resulted from the Board's efforts to outsource where feasible; without these efforts, the number of administrative and support positions would have increased because of enhanced security and the acquisition of office space.

While the number of positions at the Board has fluctuated during the 1996–2007 period, the salary budget (not including retirement and insurance benefits) has remained relatively stable at roughly 63 percent of operating expenses. The portion of operating expenses devoted to retirement and insurance has increased approximately 1 percentage point over the period as a result of significant increases in health insurance premiums and administrative actions to enhance benefits such as the Thrift Plan.

Over the 1996–2007 period, the average annual increase in expenses for goods and services has been 6.4 percent. The largest increase has been in contractual professional services. This growth resulted primarily from four factors: (1) increased use of contracting services in the divisions of Information Technology, Management, and Banking Supervision and Regulation; (2) significant increases in the amount and cost of data acquired from third parties; (3) procurement of outside legal services; and (4) development and implementation of software and office automation tools. Partially offsetting the overall increase is the rental income received from New York Avenue and the Richmond relocation site.