FEDERAL RESERVE BANK OF DALLAS

2200 N. PEARL ST.

DALLAS, TX 75201-2272

HELEN E. HOLCOMB
FIRST VICE PRESIDENT AND
CHIEF OPERATING OFFICER

October 17, 2003

Notice 03-59

TO: The Chief Operating Officer of each financial institution using cash services in the Eleventh Federal Reserve District

SUBJECT

Proposed Changes to the Board's Cash Services Policy

DETAILS

On October 8, 2003, the Board of Governors of the Federal Reserve System issued a request for comment on proposed changes to its cash services policy. In brief, the Board proposes revising its policy by adding two elements:

1) A custodial inventory program that provides an incentive to depository institutions (DIs) to hold currency in their vaults to meet customers' demand, and

2) A fee charged to DIs that deposit currency to and order currency from Reserve Banks within the same week, instead of recirculating currency deposited with them among their customers.

The proposed policy will change the way certain DIs interact with Reserve Banks in the area of currency services. Based on *current* behavior, approximately 100 Federal Reserve System cash customers—out of approximately 8,000—may incur fees under the proposed policy. Within a week, potentially affected institutions will receive a letter from the Federal Reserve, with an order and deposit activity report that shows the probable fee impact on the DI nationally.

If you do not receive an order and deposit activity report, your organization is not *currently* ordering and depositing currency in a way that would cause you to incur fees. However, if you would like to receive an electronic report, please go to **www.frbservices.org/Cash/index.cfm** and provide your contact information. After your request is received and authenticated, a copy of the report for your organization will be sent via e-mail within 10 business days.

Reason for Change

The Board of Governors believes that current cash handling practices have led to overuse of public sector resources. As the central bank, the Federal Reserve accepts deposits from institutions with a surplus of currency and provides currency to institutions with a shortfall; these "middleman" services are provided free of charge. Since the mid-1990s, however, an increasing number of DIs have used the Fed's services to keep their own inventories and associated costs as low as possible. Rather than continuing to supply commercial customers, ATMs, and branches with currency obtained from customer deposits throughout the week, these DIs have transported—sometimes on a daily basis—their customers' deposits to the Fed and filled their customers' orders with currency received from the Fed. This practice, known as "cross-shipping," has expanded the scope of the Federal Reserve's services beyond those implied by its central bank role. This expansion imposes a real cost on society. In 2002, the Federal Reserve spent approximately $35 million to process nearly seven billion cross-shipped $5s, $10s, and $20s.

Goal of the Policy

The goal of the policy change, therefore, is to improve efficiency and reduce the total costs associated with cash handling nationwide by encouraging DIs to reduce their overuse of free Federal Reserve Bank cash services.

Proposed Policy Components

The proposed policy has two components. First, the policy establishes a "Custodial Inventory" (CI) program, whereby DIs would be allowed, under certain circumstances, to hold currency in their own vaults but accounted for on the Fed's books. This program would compensate DIs for the higher opportunity costs they will incur when they hold currency and recirculate it among their customers. DIs may qualify to participate in the CI program when they recirculate 200,000 or more notes (200 bundles) of $5s, $10s, and $20s per week.

Second, the policy would charge DIs a fee for using Federal Reserve currency services if they could have recirculated the currency among their customers. This fee would replace the current denial-of-service penalty for cross-shipping contained in the Federal Reserve Banks' Cash Services Operating Circular No. 2. The fee would be assessed on all deposits of *fit* notes in the $5 to $20 denominations that are followed or preceded by an order of the same denomination within the same calendar week. The fee would range from $5 to $6 per 1,000 notes, based on the Federal Reserve's long-run incremental cost of receiving, processing, storing, and paying out this currency. Charging a fee to recover Reserve Banks' costs, as opposed to denying service, encourages DIs to choose the least-cost alternative when determining how to supply currency to their customers.

Please note that the fee will not be assessed on deposits of fit notes in the $5 to $20 denominations if they are not followed or preceded by an order of the same denomination within the same calendar week. In addition, deposits of unfit notes will not be subject to the fee.

The Board must receive comments regarding the proposed policy changes by January 15, 2004. Please address comments to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. However, because paper mail in the Washington area and at the Board is subject to delay, please consider submitting your comments by e-mail to **regs.comments@federalreserve.gov**. All comments should refer to Docket No. OP-1164.

ATTACHMENT

A copy of the Board's notice as it appears on page 59176–82, Vol. 68, No. 198 of the *Federal Register* dated October 14, 2003, is attached.

MORE INFORMATION

For additional information, please contact one of the following at the Board: Eugenie E. Foster, Project Leader, Cash Section, Division of Reserve Bank Operations and Payment Systems at 202-736-5603, or Michael Lambert, Manager, Cash Section, Division of Reserve Bank Operations and Payment Systems at 202-452-3376.

You may also contact Rick Mase at the Dallas Office, 214-922-6531; Jane Pyke at the El Paso Office, 915-521-8265; C.O. Holt at the Houston Office, 713-652-1530; or Mario Garcia at the San Antonio Office, 210-978-1300.

Detailed information about the Custodial Inventory program will be available on the Federal Reserve System financial services web site at **www.frbservices.org/Cash/index.cfm** beginning January 29, 2004.

Paper copies of this notice or previous Federal Reserve Bank notices can be printed from our web site at **www.dallasfed.org/banking/notices/index.html**.

Sincerely,

Helen E. Holcomb

FEDERAL RESERVE SYSTEM

[Docket No. OP–1164]

Federal Reserve Bank Currency Recirculation Policy

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comment; notice.

SUMMARY: The Board is requesting comment on proposed changes to its cash services policy to reduce depository institutions' overuse of Federal Reserve Bank cash processing services, which will affect approximately 100 institutions with large cash businesses. The Board proposes revising its policy by adding two elements: (1) A custodial inventory program that provides an incentive to depository institutions to hold currency in their vaults to meet customers' demand, and (2) a fee to depository institutions that deposit currency to and order currency from Reserve Banks within the same week instead of recirculating currency deposited with them among their customers. The Board has authorized Reserve Banks to conduct a proof-of-concept program during 2004 to provide information about the proposed custodial inventory program.

EFFECTIVE DATE: Comments must be received by January 15, 2004.

ADDRESSES: Comments should refer to Docket No. OP–1164 and may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. However, because paper mail in the Washington area and at the Board of Governors is subject to delay, please consider submitting your comments by e-mail to *regs.comments@federalreserve.gov*, or faxing them to the Office of the Secretary at 202/452–3819 or 202/452–3102. Members of the public may inspect comments in Room MP–500 of the Martin Building between 9 a.m. and 5 p.m. on weekdays pursuant to § 261.12, except as provided in § 261.14, of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

Comments on the collections of information under the Paperwork Reduction Act should be sent to the Secretary, with copies of such comments sent to the Office of Management and Budget, Paperwork Reduction Project (7100—to be obtained), Washington, DC, 20503.

FOR FURTHER INFORMATION CONTACT: Eugenie E. Foster, Project Leader (202/736–5603), or Michael Lambert, Manager (202/452–3376), Cash Section, Division of Reserve Bank Operations and Payment Systems; for the hearing impaired only: Telecommunications Device for the Deaf, Dorothea Thompson (202/452–3544).

SUPPLEMENTARY INFORMATION:

1. Background

The Federal Reserve Banks (Reserve Banks) supply genuine (new and fit) currency and coin to depository institutions throughout the nation to meet the public's cash demand. Historically, Reserve Banks have removed unfit notes from circulation and served as intermediaries among depository institutions, accepting deposits from those with a surplus of fit notes and providing currency to those with a shortfall.[1] Depository institutions, in turn, have acted as intermediaries among their customers, recirculating currency from merchant customers, for example, to meet the cash demands of households and other customers.

These traditional patterns have been changing as depository institutions have used fewer fit notes deposited by customers to fill other customers' orders. Today, depository institutions often order currency directly from Reserve Banks to fill their customers' orders and deposit notes received from their customers directly with Reserve Banks. A number of depository institutions, for example, have reorganized their businesses to distribute currency to ATMs separately from currency distributed to large retail customers or to the institution's branches. Each of these depository institutions' business lines withdraws currency from Reserve Banks without first exhausting currency that its other business lines may accumulate from customer deposits within the same geographic area.

Further, actions taken by many depository institutions to reduce their required reserves may have permitted them to reduce their holdings of vault cash.[2] Depository institutions with vault cash in excess of that needed to satisfy reserve requirements have an incentive to economize on holdings of currency in their vaults, particularly by increasing the size and frequency of their deposits of currency to and orders of currency from Reserve Banks.[3]

Reserve Banks' order and deposit activity during 2002 indicates that deposits of nearly 6.7 billion $5 through $20 notes were followed or preceded by orders of the same denomination by the same institution in the same business week.[4] This pattern suggests that some depository institutions are relying on Reserve Banks to recirculate a substantial amount of currency within the depository institutions' own organizations and that this currency makes up a significant portion of their cash deposits to Reserve Banks. Further, this activity is primarily concentrated in 100 depository institutions with large cash businesses. Underpinning depository institutions' decisions to use—and overuse—Reserve Bank cash processing services is the fact that Reserve Banks offer basic currency processing services without charge.

2. Current Policy

Reserve Banks' Operating Circular 2, Cash Services, states:

> If you deposit fit currency with us, you may not order currency of the same denomination within five business days prior to or following the deposit of that denomination. This practice, known as "cross-shipping," is not permitted at the depositing office level. When practicable, cross-shipping should be minimized or eliminated at the depositing institution level.[5]

This policy has proven ineffective in reducing or preventing cross-shipping for several reasons. The direction to depository institutions to minimize cross-shipping at the institution level (instead of the branch or business-unit level) "when practicable" does not provide sufficient guidance to depository institutions or Reserve Banks with respect to the circumstances under which cross-shipping should not occur. More fundamentally, the only tool Reserve Banks currently have to enforce

[1] Fit notes are of acceptable quality for circulation, whereas unfit notes are unacceptable. For example, unfit notes are often soiled, torn, or defaced. New notes are previously uncirculated notes that Reserve Banks issue.

[2] Depository institutions can satisfy their reserve requirements with vault cash, or with reserve balances held at a Reserve Bank either directly or through a pass-through correspondent. Since the mid-1990s, however, many depository institutions have sharply reduced their reserve requirements by sweeping balances held by retail customers in deposit accounts that are reservable into deposit accounts that are not reservable. For some institutions, the reduction in required reserves left them with more vault cash than necessary to meet requirements.

[3] Vault cash holdings do not earn interest. If an institution deposits currency with a Reserve Bank, it receives credit to its account at the Federal Reserve. The depository institution can then earn a positive return on those funds by lending them to another institution, such as in the federal funds market.

[4] This amounts to 35 percent of notes deposited in these denominations, or 20 percent of total deposits in 2002.

[5] Federal Reserve Operating Circular 2, January 2, 1998, section 3.3. *http://www.frbservices.org/Cash/index.cfm.*

the policy is to deny currency services to depository institutions that do not comply with the operating circular requirement. Denial of service would be highly disruptive to the businesses of both the depository institutions and their customers. In addition, Reserve Banks have not had systematic tools for monitoring the quality of specific currency deposits, making the process of identifying cross-shipping cumbersome and costly.

3. Proposed Recirculation Policy

The Board believes that to minimize the societal cost of providing currency to the public, depository institutions should resume their traditional role of supplying fit currency from their customers' deposits to meet other customers' needs before turning to Reserve Banks to obtain currency. To provide incentives for depository institutions to adopt the least costly means of recirculating currency to their customers, the Board proposes to implement a policy that has two inter-related components: a custodial inventory program and a fee that would be assessed on deposits of cross-shipped currency.

Custodial Inventory Program

One reason that depository institutions engage in cross-shipping is to avoid incurring opportunity costs of holding currency, which earns no interest income. To mitigate these costs associated with holding currency long enough to facilitate its recirculation, the Board proposes to allow the depository institutions to transfer into custodial inventories $5, $10, and $20 notes that they might otherwise cross-ship. A custodial inventory is currency owned by a Reserve Bank but located within a depository institution's secured facility and segregated from the depository institution's currency. To be eligible to hold a custodial inventory under the proposed program, a depository institution must be capable of, and commit to, recirculating substantial amounts of currency in the $5 through $20 denominations in order to justify the administrative costs and the risks to Reserve Banks of allowing depository institutions to hold Reserve Bank currency in their vaults. Under the custodial inventory program, depository institutions could move to Reserve Banks' accounts currency that is temporarily surplus but that the institutions expect to pay to customers within the same business week. The Board understands that custodial inventories may facilitate smoother use of depository institutions' processing equipment by allowing them to store peak-day deposits of unprocessed currency for handling later in the week. Custodial inventories also may allow depository institutions to avoid the costs of preparing and transporting their temporarily surplus currency to and from Reserve Bank cash offices. For years, central banks in some other G–10 countries have used custodial inventory programs to increase recirculation by depository institutions.

While the Board intends for the custodial inventory program to provide an incentive to depository institutions to avoid cross-shipping, institutions should continue to maintain on their own books sufficient currency inventories to meet normal currency operations and contingency needs. Depository institutions could transfer to a custodial inventory no more than 25 percent of the value of their total holdings in the $5 through $20 denominations. In addition, any institution that uses a custodial inventory to circumvent the intent of the recirculation policy, for example, by alternating the weeks in which it orders and deposits currency to a Reserve Bank, would lose its eligibility to participate in the program.

Custodial Inventory Proof-of-Concept Program

Before undertaking a permanent custodial inventory program, the Board has authorized Reserve Banks to implement during 2004 a one-year proof-of-concept program. The purpose of the proof-of-concept program is to allow Reserve Banks to evaluate how custodial inventories influence depository institutions' patterns of depositing and withdrawing currency, while allowing depository institutions to assess the costs and benefits of participating in the program. Reserve Banks also need to evaluate more fully the costs as well as the operational risks and risk management procedures for the custodial inventory program before undertaking a permanent program. Reserve Banks would select approximately 15 proof-of-concept sites from depository institution applications. Throughout the proof-of-concept program, Reserve Banks would monitor the order and deposit activity of participating institutions to determine whether they have recirculated more currency within their organizations than they did before the establishment of the custodial inventory.

Reserve Banks will select proof-of-concept sites from a cross-section of depository institutions that are high volume users of Reserve Bank cash services. At a minimum, proof-of-concept program participants must demonstrate that they will recirculate at least 200 bundles of currency per week in a Reserve Bank zone or sub-zone.[6] An institution that currently cross-ships at least 200 bundles of currency per week in a zone or sub-zone would meet the recirculation threshold for a custodial inventory proof-of-concept. Alternatively, an institution could meet the threshold for a proof-of-concept site by providing deposit and payment records demonstrating that it recirculates at least 200 bundles of currency weekly among its customers. After reviewing the results of the proof-of-concept program, Reserve Banks will determine the minimum bundles of currency a depository institution must recirculate weekly to qualify for a custodial inventory. Thereafter, Reserve Banks would review annually the minimum bundles required to support a custodial inventory.

The Board will review and use the results of the proof-of concept program to develop an inventory cap formula for determining the amounts of currency that depository institutions may transfer to Reserve Bank books. Each proof-of-concept custodial inventory will be subject to an inventory cap of either (1) 25 percent of average closing balances of currency during the previous week at that location (including both depository institution and Reserve Bank balances) in the $5 through $20 denominations, or (2) 25 percent of average daily closing balances of currency for the four previous same days of the week in the $5 through $20 denominations at that location.[7] Reserve Banks will test both formulas to enable the Board to determine the inventory cap percentage that allows the proper balance between providing an incentive to depository institutions to recirculate and limiting the transfer of inventory to Reserve Bank accounts. The Reserve Banks will also evaluate whether one inventory cap better promotes efficiency and administrative convenience for the

[6] A bundle of currency is a standard package of 1,000 notes. A zone is the area to which a Reserve Bank office provides currency services. Under this proposed policy, Reserve Banks may establish sub-zones for large metropolitan areas at a significant distance from the nearest Reserve Bank office. Deposits and orders by institutions with branches and vaults in a sub-zone would be assessed cross-shipping fees separately from the institutions' activities in the rest of the zone.

[7] For example, under alternative 1, a depository institution that had daily balances averaging $100 million during the previous week would be subject to an inventory cap of $25 million. Under alternative 2, Monday's cap would be based on the average of the previous four Mondays, Tuesday's cap would be based on the average of the previous four Tuesdays, and so forth.

depository institutions and Reserve Banks.

Reserve Banks will select proof-of-concept program participants to include depository institutions that:

(1) Deposit more than they order, order more than they deposit, and deposit and order in roughly balanced amounts;

(2) Are located a range of distances from the nearest Reserve Bank office;

(3) Serve differently sized markets; and

(4) Use a range of currency processing equipment and engage in a variety of currency handling practices, including, for example, outsourced or consortium arrangements.

The Board will begin to evaluate the results of the proof-of-concept program after six months of operation and will measure the success of the program to the extent that:

(1) Proof-of-concept participants significantly reduce cross-shipping or recirculate significant amounts of currency within the Reserve Bank zone or sub-zone in which the proof-of-concept site is located; and

(2) Deposits received from proof-of-concept participants contain a higher proportion of unfit notes than the average for all deposits in the same denominations in the Reserve Bank zone or sub-zone in which the proof-of-concept site is located.

Based on the public comments and the results of the proof-of-concept program, the Board will determine whether to implement a permanent custodial inventory program. If a program is implemented, proof-of-concept participants will have the opportunity to continue operating custodial inventories consistent with the final requirements.

Proof-of concept applications and the custodial inventory contract will be accessible through the Federal Reserve System Financial Services Web site, *http://www.frbservices.org*, beginning on January 29, 2004. Reserve Banks expect to accept applications between January 29, 2004, and March 15, 2004, for proof-of-concept sites located in the areas currently served by the following Federal Reserve offices: Boston; Charlotte; Chicago; Cleveland; Denver; Detroit; East Rutherford; Houston; Kansas City; Los Angeles; Miami; Minneapolis; Nashville; Oklahoma City; Philadelphia; San Francisco; Seattle; and St. Louis.

Recirculation Fee

Because the Board expects that custodial inventories alone will not substantially reduce cross-shipping, it proposes to establish a recirculation fee to provide further incentive for depository institutions to recirculate currency. Based on current levels of Reserve Bank costs, the fee would be $5 to $6 per bundle of cross-shipped currency. Depository institutions would pay the fee when they deposit fit currency and order the same denomination within the same business week in a Reserve Bank zone or sub-zone. The fee would not be assessed on deposits of unfit or surplus fit currency, where surplus is defined as currency that is not needed by the depository institution within the business week of its deposit. The fee also would not be assessed on deposits of $50 and $100 notes because these notes are a relatively minor component of cross-shipped currency and, more importantly, because of the risk that depository institutions might recirculate high-denomination counterfeit notes. The Reserve Banks estimate that the recirculation fee would affect approximately 100 of the Reserve Banks' largest cash customers.

The Board proposes initially to exclude one-dollar notes from the recirculation policy. Because of the relatively low incidence of counterfeiting and the low value of one-dollar notes, depository institutions handle them differently from higher denominations in various ways that minimize costs. The incremental costs to depository institutions of sorting and recirculating fit one-dollar notes instead of ordering them from Reserve Banks would likely be greater than the costs for higher denomination notes. Reserve Banks are working with the banking industry with the goal of achieving net savings comparable to those that Reserve Banks could realize by including one-dollar notes in the recirculation policy. If this collaborative effort fails to yield comparable savings to those achieved by Reserve Banks through implementation of this policy within two years of the effective date of the permanent custodial inventory program, the Board proposes to apply the recirculation policy to one-dollar notes.

The Board proposes to set the recirculation fee to recover Reserve Banks' costs that vary with the quantity of currency that they process. The recirculation fee would not be subject to the pricing requirements of the Monetary Control Act (MCA). The MCA applies to currency and coin services such as transportation and coin wrapping, but not to services "of a governmental nature, such as the disbursement and receipt of new or fit coin and currency." [8] The Board determined, in the development of its pricing principles, that "currency and coin processing (paying, receiving, and verifying both coin and currency, and issuing, processing, canceling, and destroying currency) are governmental functions and would not be considered priced services subject to MCA." [9] The proposed recirculation fee is not for priced cash services subject to MCA; rather, it is a recovery of costs intended to encourage private-sector behavioral changes that would lower the overall societal costs of cash processing and distribution by curtailing overuse of a free governmental service.

De minimis Exemption

The Board proposes to exempt *de minimis* levels of cross-shipped currency from the recirculation fee. Depository institutions would not pay a recirculation fee for the first 1,000 bundles of currency cross-shipped in a zone or sub-zone each quarter for three reasons.[10] First, the exemption would compensate for minor differences between currency fitness determinations made by depository institutions and Reserve Banks in processing these notes.[11] Second, the exemption would limit the effect of the policy on institutions whose small scale of currency operations may not justify investments in sorting equipment. Third, the exemption would allow depository institutions experiencing unanticipated swings in customer demand to order or deposit currency without incurring a fee. The proposed exemption would not have a material effect on Reserve Bank processing volumes, but would reduce or eliminate the cost of the policy for a large number of depository institutions.

A Reserve Bank would apply the *de minimis* exemption to currency that a depository institution cross-ships in a zone or sub-zone during each quarter. Depository institutions could not transfer a *de minimis* exemption from one zone or sub-zone to another. All or part of an exemption that a depository institution did not use during a quarter would expire at the end of that quarter. Reserve Banks would apply the exemption against depository

[8] 126 Cong. Rec. S3168 (March 27, 1980) (statement of Senator Proxmire).

[9] 45 FR 56893, September 4, 1980.

[10] Reserve Banks will review the level of the *de minimis* exemption annually. The 1,000-bundle exemption excludes one-dollar notes.

[11] Because Reserve Banks would assess the recirculation fee for all fit notes deposited above the *de minimis* exemption, depository institutions would have an incentive to ensure that their fitness determinations are comparable to those of Reserve Banks.

institutions' total volumes of cross-shipped currency, not against each individual denomination.

Cost Analysis of the Recirculation Policy

During 2002, Reserve Banks processed 34.2 billion notes, with total costs of approximately $342 million. This number includes 19.4 billion $5 through $20 notes, 6.7 billion of which depository institutions cross-shipped. Curtailing current cross-shipping and its expected future growth would reduce Reserve Banks' expenses by enabling them to scale down currency processing operations and delay future capital investments in equipment and facilities. The Board estimates that by implementing the proposed recirculation policy, Reserve Banks could avoid currency processing costs of up to $35 million per year based on 2002 expense data.[12]

Custodial Inventory Program

Reserve Banks would incur approximately $400,000 per year in operating costs to administer the proposed custodial inventory program, including auditing the custodial inventories, managing the overall program, and amortizing an investment to develop software to monitor Reserve Bank currency in custodial inventories. The Reserve Banks estimate that during the first year of the program their costs would total approximately $600,000 because of one-time charges for training and site evaluations.

The Board believes that depository institutions also may incur some additional costs in operating a custodial inventory. For example, depository institutions may have to modify their facilities to segregate Reserve Bank currency or to enhance their physical security, perhaps by installing surveillance equipment. They may also have to enhance physical- and procedural-access controls and engage in additional sorting and other handling of the notes held in a custodial inventory.

Recirculation Fee

Most of the depository institutions with the largest cash operations have reported that, whether or not the Board adopts this recirculation policy, by 2006 they will use medium- or high-speed sorting equipment to process much of the currency deposited to Reserve Banks. Most of these depository institutions would need only inexpensive modifications to their processing equipment to recover fit currency for recirculation. The Board estimates that the total annual incremental expense would be approximately $2 million for all institutions using automated equipment to identify notes that are fit to recirculate.[13]

With the recirculation fee at $5 to $6 per bundle of cross-shipped currency, the Board projects that depository institutions would incur up to $18 million in fees annually where it is not economical for them to install currency fitness sorting equipment.[14] Instead of paying a recirculation fee to cross-ship this currency, however, the Board would expect depository institutions to explore lower-cost alternatives, such as having tellers manually sort currency at the point of receipt, paying currency to customers without fitness sorting when a range in the quality of notes is acceptable to customers, or obtaining currency processing services from other local institutions or armored carriers able to offer pricing that reflects economies of scale.[15] The Board would expect, therefore, that altogether depository institutions would incur total costs of approximately $20 million annually for recirculating most of the $5 through $20 denomination notes they currently cross-ship.

Conclusion

The Board projects that the societal benefits of implementing the recirculation fee would outweigh the societal costs by up to $15 million per year.[16] For the most part, the benefits would accrue from avoided operating expenses at Reserve Banks. Greater recirculation by depository institutions would reduce the growth of Reserve Bank currency receipts and processing, and delay expansion of publicly owned and operated currency-processing infrastructure. Depository institutions may incur increased costs if they elect to participate in the custodial inventory program, take actions to avoid paying fees, or choose to pay fees. Any costs incurred by depository institutions are estimated to be significantly smaller than the costs that Reserve Banks will avoid if the institutions reduce or cease cross-shipping currency.

Phased Implementation

The Board proposes to implement the recirculation policy in phases. If the Board approves implementation of the custodial inventory program following the proof-of-concept program, the first phase will expand the program to all eligible participants. In the second phase, which will begin approximately one year after the effective date of the permanent custodial inventory program, Reserve Banks will begin assessing the cross-shipping fee.[17] In the third phase, which will begin two years after the effective date of the permanent custodial inventory program, the Board would extend the recirculation policy to one-dollar notes if the Reserve Banks' net savings from collaborating with depository institutions is not comparable to those resulting from the implementation of this policy for $5 through $20 notes.

5. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (PRA)[18], the Board reviewed the proposed rule under the authority delegated to it by the Office of Management and Budget (OMB). The proposed rule contains requirements that are subject to the PRA and required to obtain a benefit. The respondents/recordkeepers are for-profit financial institutions. The Board may not conduct or sponsor, nor is an organization required to respond to, this information collection unless it displays a currently valid OMB control number. The Board will obtain an OMB control number.

In 2003, the Board authorized Reserve Banks to implement a one-year proof-of-concept program starting in 2004. The proof-of-concept program would allow Reserve Banks to evaluate how custodial inventories influence depository institutions' patterns of depositing and withdrawing currency, while allowing

[12] This estimate includes costs that vary with the volume of currency processed, including labor, materials, and equipment. The amount by which Reserve Banks are able to reduce costs would depend on the actual decline in volumes because of this proposed policy. This decline would depend on the extent to which: (1) Depository institutions elect to pay the fee instead of recirculating; (2) depository institutions take full advantage of the *de minimis* exemption; and (3) depository institutions alter their handling of denominations not covered by the proposed policy.

[13] The Board assumes that depository institutions that use or acquire medium- or high-speed sorting equipment would use it to process all but one-dollar notes for quality. This estimate also assumes that under the proposed policy those depository institutions would process most of the $5 through $20 notes that they deposited with Reserve Banks during 2002.

[14] This is the total estimated recirculation fee that depository institutions would incur if they cross-shipped 50 percent of $5 through $20 notes.

[15] Depository institutions indicate that their customers are willing to accept a wider range in the quality of $5 notes than for the higher denominations.

[16] The incremental costs to Reserve Banks to implement the recirculation fee will be minimal—primarily costs associated with amortizing a $600 thousand software development investment that will allow Reserve Banks to track cross-shipping systematically.

[17] If the Board decides not to implement the custodial inventory program, it will implement the recirculation fee one year after termination of the proof-of-concept program.

[18] 44 U.S.C. 3506; 5 CFR 1320 Appendix A.1.

depository institutions to assess the value of participating in the program. To initiate the proof-of-concept program, Reserve Banks would select 15 depository institution sites from applications submitted via the Internet. The Board estimates that it would take a depository institution, on average, 12 hours (ranging from 8 and 16 hours) to complete and submit an application. The application would request information such as: A description of the vault and vault security; contact person information; prior year's loss history for the proposed vault; volume, amount, and daily averages of vault holdings; personal computer availability and Internet access; and certification of insurance coverage. After being accepted into the proof-of-concept program, depository institutions would be required to use an Internet-based inventory tracking system that would take each institution approximately 15 minutes per day (excluding weekends and holidays) to track cash inventory.

The Board would begin to evaluate the results of the proof-of-concept program after six months of operation. Based on the public comments and the results of the proof-of-concept, the Board would determine whether to implement a permanent custodial inventory program.

If the Board implements a permanent program, the 15 proof-of-concept participants would have the opportunity to continue operating custodial inventories, and Reserve Banks would select up to 135 additional sites. These new participants would be required to submit an application and, if accepted into the program, use the Internet-based inventory system.

The Board will review and, if needed, revise the following burden estimates after the first six months of the proof-of-concept program:

(1) *Number of proof-of-concept program sites:* 15.

(2) *Number of custodial inventory sites:* 150.

(3) *Response time:* 12 hours per application submitted; 15 minutes per day for inventory tracking; estimated total annual burden: 11,175 hours.

The Board requests comment on how many depository institutions will complete and submit the application to partake in the proof-of-concept program or the custodial inventory program, including:

(1) Whether the proposed collection of information is necessary for the proper performance of the Board and Reserve Banks' functions; including whether the information has practical utility;

(2) The accuracy of the Board's estimate of the burden of the proposed information collection, including the cost of compliance;

(3) Ways to enhance the quality, utility, and clarity of the information to be collected; and

(4) Ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology.

6. Comments

The Board requests comments on all aspects of the proposed recirculation policy as described below, on the benefits and drawbacks of implementing it, and, in particular, on the following questions:

(1) How effective will the proposed custodial inventory program and the recirculation fee be in reducing or eliminating cross-shipping? What are the major benefits and drawbacks of custodial inventories and the recirculation fee?

(2) Are there effective alternate approaches that the Board should consider to increase depository institutions' recirculation of currency?

(3) Are there factors not described in this notice that would affect a depository institution's decision to pay a recirculation fee or undertake greater recirculation of currency within its organization? What are the benefits and drawbacks of allowing a *de minimis* exemption of 1,000 bundles of currency per depository institution per quarter for a zone or sub-zone? Is there an alternative approach to administering the *de minimis* exemption that would address identified drawbacks and still achieve the intended objectives of reducing the burden of complying on depository institutions with small currency operations while ensuring that most cross-shipping activity is governed by the policy?

(4) Under what circumstances would it be reasonable and practical for depository institutions to adopt lower-cost alternatives to the recirculation fee, such as having tellers manually sort currency at the point of receipt, paying currency to customers without fitness sorting when a range in the quality of notes is acceptable to customers, or obtaining currency processing services from other local institutions or armored carriers able to offer prices that reflect economies of scale?

(5) Are there alternative approaches that could be used to improve the efficiency of handling one-dollar notes other than applying the cross-shipping fee? What savings would an institution expect to realize from these alternative approaches?

(6) What costs would a depository institution anticipate incurring for operating a custodial inventory? How should Reserve Banks calculate the cap on the amount of currency that a depository institution may deposit in a custodial inventory? How many bundles of currency should Reserve Banks require a depository institution to recirculate per week to qualify for a custodial inventory?

(7) What would be the effects of the program, if any, on depository institutions' customers, on armored carriers, or on other parties?

7. Proposed Federal Reserve Cash Recirculation Policy

The Board proposes the following policy to promote depository institution recirculation of currency.

Policy

Reserve Banks' role in the distribution of currency is to make available to depository institutions a supply of genuine (new and fit) currency sufficient to meet the public's cash demand. Reserve Banks remove unfit notes from circulation and act as intermediaries between depository institutions, accepting notes from those that have a surplus and providing currency to those with a shortfall. Depository institutions act as intermediaries to recirculate fit currency among their customers. Cross-shipping occurs when an institution deposits fit currency and orders currency of the same denomination, above the *de minimis* exemption, within the same week, in a Reserve Bank zone or sub-zone.

Custodial Inventory Program

The Board proposes to establish a custodial inventory program to promote currency recirculation by reducing depository institutions' opportunity costs for holding currency. Participants in the custodial inventory program would hold, in their vaults, currency on the books of the Reserve Banks that they otherwise might have shipped to, and then ordered from, Reserve Banks during a business week. This program would include the following elements.

(1) Only depository institutions are eligible to participate in the custodial inventory program; however, depository institutions that outsource their currency vault(s) to a third party would also be eligible.

(2) A depository institution must be able to recirculate among its customers a substantial volume of eligible denominations of currency in the zone

or sub-zone of a proposed custodial inventory site. If the Board approves implementation of a permanent custodial inventory program, Reserve Banks will determine the minimum bundles of currency that depository institutions must be able to recirculate on a weekly basis to qualify for the custodial inventory program. Thereafter, Reserve Banks will review annually the minimum bundles required for depository institution participation in the custodial inventory program.

(3) Depository institutions may deposit into custodial inventories notes that they sort by denomination, count, and package in bundles. Depository institutions may deposit notes of any denomination that is subject to the recirculation fee.

(4) Depository institutions may deposit currency into or withdraw currency from custodial inventories at any time during the local Reserve Bank's business day.

(5) Depository institutions may maintain currency in custodial inventories on the Reserve Bank's books during fitness sorting or re-packaging.

(6) After reviewing the results of the proof-of-concept program, the Board will establish the inventory cap for currency that depository institutions may deposit into custodial inventories.

(7) Depository institutions that operate custodial inventories may continue to order currency from and deposit currency to Reserve Banks, which will monitor the activity for cross-shipping.

(8) Reserve Banks will require depository institutions to account for custodial inventory transactions via a Reserve Bank-provided, Internet-based accounting and inventory tracking system, to allow both Reserve Banks and the depository institutions to monitor the Reserve Bank-owned currency.

(9) Depository institutions that operate custodial inventories must agree to requirements that mitigate the risks that Reserve Banks incur by allowing the institutions to hold their currency. These measures include the following:

(a) A depository institution that operates a custodial inventory must indemnify the Reserve Bank against theft or loss of Reserve Bank currency. As provided in Reserve Banks' Operating Circular 1, *Account Relationships*, any such obligation is secured by all of the institution's assets in the possession of, or maintained with, any Reserve Bank, including its Federal Reserve account.

(b) Potential custodial inventory sites must comply with Reserve Bank physical security guidelines for vaults, access control, and camera coverage.

(c) Depository institutions proposing potential custodial inventory sites must agree to operate their facilities in accordance with Reserve Bank guidelines for access and control.

(d) Depository institutions that operate custodial inventories must segregate Reserve Bank currency from other currency.

(e) Depository institutions that operate custodial inventories must allow full access to Reserve Banks, the Board, the General Accounting Office, and their agents for unannounced audits of Reserve Bank currency.

(f) To qualify for a custodial inventory, a depository institution must be financially sound, as determined by its administrative Reserve Bank.

(10) Any depository institution that uses a custodial inventory to circumvent the intent of the recirculation policy will lose its eligibility to participate in the program.

Recirculation Fee

(1) *Fee.* Reserve Banks will charge depository institutions a recirculation fee to recover currency processing costs for every 1,000 fit notes that a depository institution cross-ships, above a *de minimis* exemption. A Reserve Bank will assess a recirculation fee if a depository institution deposits fit currency and orders the same denomination within the same business week, within a Reserve Bank zone or sub-zone. This policy does not apply to $50 and $100 notes.[19] Based on current costs, Reserve Banks project that the recirculation fee will be in the $5 to $6 range for every 1,000 notes of currency that a depository institution cross-ships. Reserve Banks will announce the amount in the quarter before implementing the fee.

(2) *Recirculation fee components.* The recirculation fee will be based on those Reserve Bank costs that vary with the quantity of currency processed. Such costs include personnel, materials, and equipment. The fee will not include overhead costs such as facilities, legal, business development, audit, and protection services that Reserve Banks incur to meet their central bank cash services responsibilities.

(3) *Recirculation fee de minimis exemption.* Reserve Banks will allocate recirculation *de minimis* exemptions to depository institutions for each zone or sub-zone where they do business. Reserve Banks will apply the exemptions to depository institutions' total cross-shipped volume; exemptions will not be denomination specific. *De minimis* exemptions may not be transferred from one zone or sub-zone to another. Unused *de minimis* exemptions will expire at the end of each quarter. Initially, the *de minimis* exemption would be 1,000 bundles per quarter. Reserve Banks will review the level of the *de minimis* exemption annually.

(4) *One-dollar notes.* Initially, Reserve Banks will not assess a recirculation fee for one-dollar notes. Reserve Banks will work with the banking industry to achieve, within two years of the effective date of the permanent custodial inventory program, Reserve Bank net savings comparable to those that could be realized by including one-dollar notes in the policy. Reserve Banks will review one-dollar recirculation annually for the duration of the collaborative program. If this collaborative effort fails to yield savings comparable to those achieved by Reserve Banks through implementing this policy to the $5 through $20 denominations, the Board will include one-dollar notes under the recirculation policy.

(5) *Reserve Bank zones and monitoring.* Reserve Banks will monitor currency orders and deposits for all endpoints of depository institutions in each Reserve Bank office service area (''zone'') for recirculation. Reserve Bank zones with large metropolitan areas located at a significant distance from a Reserve Bank office may be divided into smaller service areas (''sub-zones''). Reserve Banks will monitor together endpoints located in and near a sub-zone under the recirculation policy. Reserve Banks will monitor endpoints in other parts of a zone as a group separate from the endpoints in the sub-zone. Customers may choose the zone or sub-zone in which to include border endpoints. The criteria for establishing sub-zones balance the size of a metropolitan area against its distance from the Reserve Bank office. The table below outlines proposed sub-zone criteria, as well as the cities that would currently qualify. Reserve Banks will review sub-zone criteria annually.

[19] Initially, Reserve Banks will also not assess a recirculation fee for one-dollar notes.

TABLE 1.—RESERVE BANK SUB-ZONES

	Distance from reserve bank office	Metropolitan statistical area (MSA)	Population [20]
MSAs > 1000 miles from RB with population > 250,000.	2,387	Honolulu, HI	876,156
	1,448	Anchorage, AK	260,283
MSAs > 250 miles & with population > 500,000	275	Las Vegas, NV	1,563,282
	270	Albuquerque, NM	712,738
	270	Sarasota—Bradenton, Orlando, Tampa, FL	4,630,517
	278	McAllen—Edinburg—Mission, TX	569,463
	260	Charleston, SC	549,033
MSAs > 125 miles & with population > 1,000,000	125	San Diego, CA	2,813,833
	168	Raleigh—Durham—Chapel Hill, NC	1,187,941
	156	Grand Rapids, MI	1,088,514
MSAs > 100 miles & with population >1,500,000	114	Indianapolis, IN	1,607,486
	111	Columbus, OH	1,540,157

[20] Census Bureau Ranking Tables for Metropolitan Areas: Population in 2000, and Population Change from 1990 to 2000, number PHC–T–3.*http://www.census.gov/population/www/cen2000/tablist.html*.

(6) *Weekly monitoring*. Reserve Banks will monitor depository institutions' order and deposit activity weekly for cross-shipping (Monday through Friday). If a depository institution circumvents the recirculation policy, for example, by alternating the weeks in which it orders and deposits currency, Reserve Banks will apply the recirculation fee to fit notes in such deposits.

(7) *Monthly reports*. Beginning February 2004, each Reserve Bank will make available to any depository institution, upon request, a monthly report showing that institution's order and deposit activity, and an estimate of recirculation fees in each Reserve Bank zone and sub-zone where it does business in that district.

(8) *Zone quarterly average fitness rate*. To calculate an institution's recirculation fee for a zone or sub-zone, Reserve Banks will determine the number of fit notes deposited as a percentage of total notes deposited during each quarter. Reserve Banks will then apply this quarterly average fitness rate by zone or sub-zone to an institution's deposits during the following quarter to determine how much currency it cross-shipped.[21]

(9) *Fitness criteria.* By December 31, 2003, Reserve Banks will provide fitness sorting guidelines and equipment calibration standards.

[21] For example, if an institution's deposits in a zone or sub-zone included 80 percent fit currency during the period January through March, the Reserve Bank would apply an 80 percent zone or sub-zone quarterly average fitness rate to deposits from that depository institution during the April through June period. The Reserve Bank would apply the depository institution's zone or sub-zone quarterly average fitness rate for second-quarter deposits of each denomination in determining the recirculation fee for its third-quarter deposits, and so forth.

By order of the Board of Governors of the Federal Reserve System, October 7, 2003.

Robert deV. Frierson,

Deputy Secretary of the Board.

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