

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

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.frbsservices.org/Cash/index.cfm>.

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