

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.