

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."<sup>8</sup> 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."<sup>9</sup> 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.<sup>10</sup> First, the exemption would compensate for minor differences between currency fitness determinations made by depository institutions and Reserve Banks in processing these notes.<sup>11</sup> 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

<sup>8</sup> 126 Cong. Rec. S3168 (March 27, 1980) (statement of Senator Proxmire).

<sup>9</sup> 45 FR 56893, September 4, 1980.

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

<sup>11</sup> 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.