

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.