BANKERS' BANK
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January 16, 2004

Jennifer J. Johnson, Secretary
Federal Reserve Board
20th and C Street, N.W.
Washington, DC 20551

RE: Comment Regarding Docket No. OP-1164

Dear Ms. Johnson:

Thank you for providing the Bankers' Bank Northeast the opportunity to respond to the proposed recirculation policy changes. We are pleased to see that the Federal Reserve is in the process of addressing the currency and coin issue we have discussed at great length here at the Bankers' Bank Northeast and with the Federal Reserve Bank of Boston.

Background:
Bankers' Bank Northeast is one of 20 bankers' banks located in the United States. Our bank serves community banks in New England and New York State. Collectively, bankers' banks service over 5,200 community banks. We are owned by community banks and by charter are restricted to providing service only to other banks. Therefore, we concentrate our efforts on community banks' needs; including basic banking functions such as currency and coin. The Bankers' Bank Northeast is a unique business partner for community banks – we are not a competitor and our only business is correspondent banking.

Bankers' Bank Northeast has been providing currency and coin services to community banks in Connecticut and Massachusetts since 1996. We have worked closely with the Federal Reserve Bank of Boston and a large private sector bank (Mellon Trust of New England N. A.) to provide this service to over 675 endpoints of community banks and credit unions. Over the course of time, our staff has developed significant knowledge regarding currency and coin service and our current market share is approximately 25% of the financial institutions in Massachusetts and Connecticut. As a result of our involvement the Federal Reserve does not have to expend resources to service these 675 endpoints on a direct basis. The servicing of these locations has successfully been "privatized".

The Bankers' Bank Northeast's currency and coin program has been successful because we maintain inventories close to our delivery endpoints. Our program was created to provide community banks the ability to order today for delivery tomorrow. By structuring our service in this fashion we have been able to create economies of scale in the form of cash ordering/delivery methods. Key benefits of our program include the ability for our community banks to receive the currency and coin on an "as needed" basis and the ability to reduce excess branch cash held (a non-earning asset that has become extremely expensive in light of the reserve reduction programs many banks have now employed). In addition, armored transportation costs have been reduced by utilizing shared [by our client banks] armored transportation routes and by locating cash inventories at multiple locations.

We have limited the growth of our program due to the fact we can no longer find alternative sources of excess reserves. Our partner, Mellon Trust of New England N. A., has implemented a reserve program and has limited reserves allocated for the cash vault operation. We have, accordingly, expressed our desire to have the Federal Reserve Bank of San Francisco allow "SIL's" be operated by private sector banks (see attached letter to John F. Moore dated March 8, 2002). Such action would enable us to expand our program. Expansion of the program would be beneficial to the Federal Reserve's intention of increasing the recirculation activities of the community banking industry.

As discussed in our letter to John, we continue to be concerned about the growing cost to community banks of handling cash. We concur with the Federal Reserve's desire to reduce the societal cost of this antiquated payment medium. We reiterate the fact that banks (both private and public sector); unlike other financial intermediaries such as brokerage and insurance companies bear the total cost of handling cash. Like the Federal Reserve we also are typically not paid for the service by assessing a fee to retail and merchant customers. We, therefore, need to address the cost issue in order to remain competitive with competing financial institutions that do not handle cash.

General Comments:

1) **The proposed changes to the Central Bank's cash processes should address the needs of thousands of <u>community</u> banks that complete the fabric of the U.S. banking industry.**

The request for comment letter recognizes the large bank issues and the possible resultant impact of the changes on merchants and consumers. It does not seem to recognize the potential impact on community bank cost structures. We suggest that any action taken that raises the cost to large banks would have a negative impact on community banks since many of them use large correspondents.

The proposed recirculation policy changes address the impact and/or benefit to large financial institutions. The fees imposed to the 100 institutions with large cash business also represents a number of community banks that "buy" cash services from these financial institutions. These financial institutions may pass additional cross-shipping costs down to the community banks or find that the costs to run a currency and coin program are too great and ultimately abandon the bank-to-bank business sector. Either way the community bank will pay more out-of-pocket expenses to provide a very basic service to the community.

2) Proof-of-concept participants should include entities such as bankers' banks that specialize in creating economies of scale for community banks.

We request the opportunity to participate given our function to community banks. We are confident that by working with an armored courier, we can grow our existing program to reduce further the cost to the Federal Reserve. To date we have been limited to working through another financial institution because we, as a bankers' bank, have had no reserve requirement and, therefore, no "excess" reserves that we could use for required inventory. The Federal Reserve's proposal to place a portion of its cash, remote from the central vault, would enable us to manage an inventory for the benefit of community banks without having to carry the heavy burden of a non-earning asset.

The fact that we have not historically worked directly with the Federal Reserve's cash services should not preclude us from participating in the proof-of-concept operation.

Since we by charter are restricted from offering services to the general public our involvement would be directed solely for the benefit of community banks. We would effectively insure that additional cost burdens placed on large banks that currently cross-ship would not be unfairly off-loaded to other banks that they may service.

3) The current low rate environment is likely to persist well into the proof-of-concept program's calendar. The rate of interest is the primary measure of the cost of holding non-earning assets.

The above is simply an observation for which I cannot think of a solution. One would hope that banks would at least apply a long-term rate when evaluating the proposed opportunity, however, private sector banks must operate with the reality that their incremental cost of funds is the next dollar of "freed-up" non-earning assets that currently is close to 1%. Suffice it to say, if there is interest today in utilizing locally available Federal Reserve owned cash the interest will grow exponentially when rates rise to more historic levels.

Summary:
We applaud the proposed action by the Federal Reserve to decentralize the maintenance of the Nation's cash inventories. Bankers' Bank Northeast is ready and willing to put our resources to work to help to reduce the cost of handling cash.

Sincerely,

Peter J. Sposito
President & CEO

Enclosure (1)
C: Paul M. Connolly, First Vice President & COO
Marla Borowski, Vice President

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March 8, 2002

John F. Moore, First Vice President and COO
Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, CA 94105

Dear John:

I read with interest the article regarding Cash Services in the February 22nd edition of the American Banker. The article addresses several issues that we have considered at length here at the Bankers' Bank Northeast.

I am CEO of one of 19 bankers' banks located throughout the Nation. My bank serves banks in New England and New York State. As a group, we service over 5,200 banks. We are owned by community banks and by charter are restricted to providing service to only other banks. We accordingly concentrate our efforts solely on the needs of community banks.

We have worked closely with the Federal Reserve Bank of Boston and a large private sector bank to provide "Currency and Coin" service to over 600 branches of community banks and credit unions. We estimate that we service about 25% of all community based branch offices within Massachusetts and Connecticut. We have developed a significant knowledge base regarding the business.

Our success in building the large volume base in less than 5 years is due primarily to our concentrated efforts to maintain inventories close to the delivery endpoints. Our proximity allows banks to order today for tomorrow delivery. The system was designed to enable banks to reduce their branch held vault cash; a non-earning asset that has become increasingly expensive in light of the reserve reduction procedures now ubiquitously employed by banks.

Our own program is under increasing pressure in that we can no longer find new sources of "excess reserves," i.e., our current program operates with an inventory supplied by a large bank that has significant transaction accounts and no branches of its own. Our partner has indicated that it can no longer provide additional resources because it too has instituted a reserve reduction program. Bankers' Bank Northeast has been seeking additional sources of cash including private sector sources such as a local casino.

However, no source is as attractive as the Central Bank for a variety of security and efficiency concerns.

We suggest that the Federal Reserve consider allowing banks to maintain inventories “off balance sheet”, that is, enable banks to keep Federal Reserve owned cash at locations close to the user branches. We have proven that such stores of cash are economical by using large trucks to transport large “wholesale” orders and by recycling as much as possible locally. We are able to justify the transportation, security, order preparation, deposit verification and insurance costs while removing multiple branch level handling volume from the cost center of the local Federal Reserve. (I would add that we were also able to assist in the Y2K issues at the close of the century).

It is interesting to note that our experience indicates that our bank's cash handling system substantially exceeds the industry statistics in terms of recycled currency. We recycle more than 80% outside of Central Bank intervention, since we are able to balance net “buyer” banks with net “seller” banks within our own vaults. Included in the 20% “returns” are unfit and mutilated currency.

“Off site” solutions are not without precedent. For example: 1) Federal Reserve owned Coin is currently held at decentralized locations in Connecticut and Massachusetts. 2) “SILS” were set up to address the Y2K issue. 3) A system of central bank cash held at private sector locations operates in Great Britain. Bankers’ Banks and large correspondents are capable of assisting efficiency improvements for the banking public. They can do so by participating in a program that would keep cash closer to the user without placing the cost exclusively on the banks and credit unions. I believe that bankers’ banks throughout the Country would be willing to help solve the problem. I intend to pose the issue at our next Bankers’ Bank Council Meeting knowing that other bankers’ banks are also committed to assisting their client banks to maintain competitive payment system involvement. I would expect that large correspondents could also be recruited to address the market need.

I am increasingly concerned about the erosion of payment system activity relative to the banking industry. We see non-depository institutions increasingly embrace the least expensive payment systems such as the brokerage offered IMMA’s and the various Internet based programs, while none, other than the largely unregulated check cashing operations, will handle coin and currency. That leaves community banks as the primary source of cash for the retail and commercial clients. Banks along with the Federal Reserve are frustrated with the cost of handling this inefficient payment mechanism. However, we feel that our charters require us to bear the burden. It is a cost that banks, like the Federal Reserve are not compensated for, in the sense that we typically do not charge for the service. Banks pay for all aspects of the process: transportation, security, insurance, tellers, supervisory as well as significant overhead in the form of bricks and mortar locations which is unmatched by our non-bank competitors. We feel strongly that cash has become the payment mechanism of necessity for those bank customers least able to pay for other forms of payments such as credit cards, debit cards and Internet alternatives. This segment of our markets should be remembered when we discuss various ideas to improve the process.

Marla Borowski's presentation last November at ICCOS included striking statistics. The amount of currency in circulation ($615,000,000,000 or 97% of the amount during the Y2K peak) and the growth of activity as measured by the volume of notes handled by the Federal Reserve alone are up (70% since 1991)! Her call to action is warranted. Our bank stands ready to respond to her challenge to find market solutions and partnerships.

As mentioned above, a specific idea that merits immediate attention would involve the establishment of large wholesale "SILS" near our clients to supplement the 37 Central Vault locations. The local inventories would enable us to service our clients with less frequent costly round trip transportation. We would: 1) manage the inventory activity; 2) pay transportation to and from the Central Vaults and 3) pay the cost of insurance coverage of the "SILS" based inventories. The Federal Reserve would retain ownership of the cash and be responsible for periodic audits. Costs would be controlled by marketplace competition since private sector participants would be responsible for transportation and insurance. That is to say inventories would be kept at minimum levels to keep insurance premiums low and trips to and from the Federal Reserve central vaults would be minimized to keep transportation costs low.

The scenario works because it would deconstruct the current requirement that cash be maintained at large central locations. The concept is not unlike the reasoning for grocery distributors that maintain warehouses close to retailer locations. Establishment of "SILS" for currency would also debunk the criticism of the current system that: "it is beneficial *only* to banks located close to the Central Vault". We would be pleased to participate in a beta test here in New England where it appears that the population density and commercial practices create an atmosphere that would rapidly attract the participation of our clients. We need no monetary incentive to participate since the business case is already in place in terms of the economic viability of the proposed program. Proximity of cash inventories, I believe, would have also appeal to the largest banks. They currently expense significant amounts to carry cash back and forth to the Central Vaults in order to service their own branches.

Decentralizing inventories would also help to ensure availability of cash to the public. Our proximity to the events of 9/11 caused us to pay particular attention to the needs of our client banks during the crisis. We immediately set up communications with our clients watching for any sign of public panic and its potential negative impact on bank cash stability. We quickly responded to two branches within our 600-location program that felt the need for additional cash. We kept the Federal Reserve and the State Banking authorities apprised of our findings. Nothing extraordinary occurred. However, *we* would have felt much more secure if we had access to a closer Federal Reserve controlled inventory. Although we are only 100 miles from the Central Vault, the logistics are difficult at best in a crisis situation because of the demographics and urban traffic patterns of the Northeast. (One has to wonder if the general public feels a similar need [to have cash nearby] as evidenced by their propensity to hold more cash since 9/11).

The private sector strategies referred to in Marla's presentation are, in our opinion, right on target. Consolidations, sweeping of retail accounts and reducing of non-earning assets are all in play and for good reason. Banks compete with non-banks. Non-banks do not have to maintain reserves against their funding sources. These competitive forces require banks to consolidate and to find ways to reduce non-earning assets in order to survive the onslaught of the non-banks. Legislation, which would allow payment of interest on reserves [reserves held at the Federal Reserve – not in cash vaults], will further elevate the need to reduce non-earning assets. The heat will clearly be felt once rates rise. These issues are new. Previous discussions of the use of "SILS" occurred prior to the recognition of the impact on bank earnings of "excess vault cash". We believe that the new environment requires serious consideration of new approaches.

Marla's research also found that few "cash champions" are found within the banking industry. We concur. We have difficulty getting banks to recognize some of the finer points of cash services and the significant impact cash handling can have on the efficiency of their banks.

I did not intend this to become a monograph. It is said too often, "If I had more time I would have written a shorter letter". I apologize for the length of my correspondence with you.

Please contact me with your thoughts. I will continue to maintain a dialogue with our First District Federal Reserve officers. I also offer my participation in the Customer Advisory Council initiative that you are forming. I believe that we can help to quickly implement a Central Bank/private sector solution that would address the $200,000,000 cost estimate mentioned in the American Banker article.

Thank you for your interest. I look forward to hearing from you.

Sincerely,

Peter J. Sposito
President & CEO

Cc Paul M. Connolly, First Vice President and COO
Marla Borowski, Vice President