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WACHOVIA

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DELIVERED BY ELECTRONIC AND REGULAR MAIL

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Docket No. OP-1164
Electronic Address: regs.comments@federalreserve.gov

Re: Proposed Federal Reserve Bank Currency Recirculation Policy

Dear Ms. Johnson:

This letter is submitted on behalf of Wachovia Corporation and its subsidiary companies, including Wachovia Bank, National Association (collectively referred to as "Wachovia").

Wachovia believes that the proposed Federal Reserve Bank Currency Recirculation Policy ("Proposal") would adversely affect depository institutions, commercial entities and consumers. Several financial institutions have commented on the estimated financial impact to their respective organizations, and have noted the substantial burden this Proposal would present. We believe that a Board policy to increase recirculation practices system-wide and influence commercial behavior should and must address overall product direction, economic and operational goals, technology, risk, demographic evolvement, and private sector needs. We do not believe that the measures set forth in the Proposal would achieve the objectives of reducing use of governmental services and lowering costs to commercial entities and consumers. Should depository institutions be required to pay the proposed fee, the Policy's objectives are not achieved, use of governmental services are not reduced, and costs to commercial entities and consumers are not lowered.

We do not expect the Proposal to have a positive effect on overall fitness, accuracy, or counterfeit detection. We have an additional concern that the proposed Proposal will lead to unanticipated changes in the flow of currency that could either limit the Proposal's effectiveness in achieving its objectives, or that might render the Proposal ineffective to curtail deposit volumes. The Proposal attempts to address an increase in deposit volumes by focusing on a by-product of deposits instead of addressing the root cause of increasing deposit volumes, namely the opportunity costs of holding excess currency.

Reserve Banks have indicated that their deposit volumes have been growing at seven percent annually since 1996 versus an average of three percent in domestic circulation growth. They later indicated that year-to-date volume growth for 2002 had decreased to one percent. Under this actual growth rate, expected future growth in Reserve Bank volume is questionable, as are future capital investments in equipment and facilities. The potential for Reserve Bank contraction and its effect on currency flow in the system is unknown. The private sector's ability to address changes in the flow of currency is limited by the Custodial Inventory ("CI") as proposed. It is our belief, however, that an effective CI program is the critical factor to improve recirculation. Increasing volumes of repatriated currency inflate zone and sub-zone deposit volumes, with no special accommodation in the Proposal.

The de minimis exemption recommendation clearly punishes larger depository institutions for having a presence, particularly a dispersed presence, within zones or sub-zones. The enactment of this Proposal serves to undermine a segment of the depository institutions customer base, i.e., other smaller financial institutions, both domestic and international. The Proposal has no accommodation for these relationships, but instead risks the migration of many of these relationships to the Reserve Banks. The proposed exemption creates competitive inequities based on overall scale, as well as relative operational concentration. Lastly, while the Proposal applies to all depository institutions, the de minimis exemption directs the effects of the Proposal to 100 of approximately 8,000 depository institutions, thereby limiting the public comment on the Proposal.

Counterfeit rates continue to show alarming growth rates. In the banking sector, and in select markets, we have seen a rapid rise in the volume of counterfeit $20 notes, with most originating from overseas, and indications are that this trend will continue.

Finally, there is the matter of seigniorage risk associated with the Proposal. The long-term implications of the Proposal could have an impact on the Treasury's seigniorage income. It is logical to consider and recognize that increased and undetected counterfeiting could diminish public confidence and ultimately soften the demand for U.S. currency, in particular international demand. The relative impact on U.S. currency circulation volumes may be reflected in the offsetting increases with other hard currencies. It is also plausible to imagine that the cost burden of this program would likely be shared with corporate and commercial entities, and ultimately, consumers. The further migration from cash as a trade option could be accelerated, thereby, affecting overall demand and circulation volumes.

To further assist the Board's consideration of the Proposal, the following are our responses to questions raised in the request for comment.

> Question 1: How effective will the proposed custodial inventory program and the recirculation fee be in reducing or eliminating cross-shipping? What are the major benefits and drawbacks of custodial inventories and the recirculation fee?

We expect that depository institutions will continue improving efficiency and responding to customers' needs. Depository institutions will continue to ship excess cash in order to avoid opportunity costs, and will continue to seek the lowest cost solutions. The Proposal is likely to cause secondary markets to take advantage of the new cost structure. On the surface, this appears to achieve the goals of the Proposal to an extent, but as depository institutions continue to move toward the lowest-cost solutions, deposits will gravitate toward the Reserve Banks, and orders will move in the direction of secondary providers.

Secondary providers will need to supplement fit currency inventories through Reserve Bank orders. The flow of currency within this network cannot be predicted, however, it is not difficult to identify potential flows that do not meet the goals of the Proposal. It is probable that incremental orders from the Reserve Banks to secondary providers will not incur cross-shipping fees to the extent that the secondary providers either do not make fit deposits and therefore do not cross-ship, or whose orders exceed fit deposits and thereby exceed the penalty prescribed by the proposal (i.e., orders in excess of fit deposits are free of charge under the Proposal). It is probable that higher volumes of deposits and orders will be processed by the Reserve Banks than would otherwise be expected under an effective policy. Societal cost savings will be minimized through secondary providers that marginally under-price the static Reserve Bank fee.

Major benefits of custodial inventories are the reduction of opportunity costs for holding excess currency to the extent that the cap allows, a potential reduction in transportation costs, and the elimination of an archaic approach to the physical flow of currency through the system as a requisite for the accounting system. The major drawbacks of custodial inventories include the physical space requirements, the cap limitation, the denomination restrictions, the limited number, and the unknown aspects of the CI awarding process.

The Proposal introduces competitive advantages to those depository institutions either not affected by the Proposal, or that with minimal expense, can recirculate currency without paying the Reserve Bank fee. There are no benefits to the depository institutions that pay the recirculation fee, which according to the Proposal, represents a few of the largest 100 users. The fee relieves Reserve Banks of a portion of their expenses, but fails to achieve the main purposes of the Proposal of reducing the usage of governmental services while lowering societal costs for those depository institutions that must pay the fee.

The fee's major drawbacks include its application to a limited number of users (i.e., to the 100 largest users) without regard to each depository institutions relative use or overuse, or to the societal cost impact. The proposed recirculation fee is intended to move most of the largest users who are equipped with sorters, toward their own lower cost solution, while it penalizes the remaining depository institutions in the top 100 who are not sorter equipped and do not have a lower cost solution. Depository institutions that chose to pay the fee are, therefore, not overusing the governmental service, as Reserve Bank processing is the most efficient solution. Fees that are paid by depository institutions do not lower societal costs. The few depository institutions within the targeted group of the 100 largest users that must pay the fee are placed at a competitive disadvantage.

The imposition of fees on a zone or sub-zone basis favors larger centralized operations of the scale that can support sorter technology. Depository institutions with distributed processing sites within a zone or sub-zone, none of which may be able to support sorting equipment, are collectively punished by the Proposal.

The proposal acknowledges that traditional patterns of currency movement have changed and that businesses have reorganized into separate currency distribution channels. The motivations are driven by traditional business goals of lower costs, increased accuracy, higher fitness, and counterfeit-free currency. Depository institutions within the targeted group will be negatively affected by the Proposal in all four areas. A reduction in societal costs cannot be determined with any level of confidence or certainty. What is clear is that, in addition to the negative consequences cited in this letter, the Proposal would affect some of the top 100 depository institutions more than others.

One can infer from the Proposal that roughly half of the cross-shipped volume (i.e., 10% of the Reserve Banks' volume) will be recirculated and the other half is expected to incur the fee. The cost to "most of the depository institutions" namely, those equipped with sorters, to recirculate the expected cross-shipped volume is estimated by the Board to be $2 million. This suggests that a penalty of roughly $0.60 per bundle would change the economics of recirculating currency for the entire cross-shipped volume that will be eliminated by the Proposal.

The Proposal points to sorter-equipped depository institutions as those responsible for overusing a free governmental service valued at $5 to $6 per bundle in order to forego an incremental $0.60 per bundle internal cost. The remainder of the top 100 depository institutions that are not sorter-equipped or able to recirculate currency at a lower cost will be penalized with a $5 to $6 fee per bundle. It is clear that the depository institutions that pay the fee are not overusing governmental services – they do not have a less expensive alternative. It is also clear that depository institutions that pay the fee do not have the means to lower societal costs. The Proposal's presumed intent, to encourage private-sector behavioral changes that would lower the overall societal costs for cash processing and distribution by curtailing overuse of a free governmental service, is not achieved for these depository institutions.

According to the Proposal, "most of the largest depository institutions" will expend $2 million in aggregate to enable recirculation, and the few remaining targeted depository institutions will pay an aggregate fee of $18 million, with all other depository institutions exempt from the Proposal's affects regardless of overuse, or societal cost, based on their relative size alone. The Proposal creates a competitive disadvantage for some larger depository institutions.

Our additional concerns include the following: (i) the validity and communication of CI proof-of-concept results given the wide-range of circumstances and potential differences in participant strategies and effectiveness; (ii) the effect of potential vendor site CI's on the total number of CI's available to depository institutions; and (iii) future changes to Reserve Bank costs and the impact on fees.

> Question 2: Are there effective alternate approaches that the Board should consider to increase depository institutions' recirculation of currency?

Depository institutions are under pressure to reduce cash balances to avoid opportunity costs that are higher than the proposed fee and associated transportation costs for half of the current cross-shipped volume. Given the Board's desire to replace a portion of Reserve Bank processing with depository institution processing, the Proposal must provide a means for depository institutions to hold excess currency at no penalty, allowing depository institutions to determine the most efficient method of processing. In this environment, one can be sure that societal costs will be reduced.

An effective CI program could provide an incentive to depository institutions to introduce capital, offset by reductions in opportunity costs and transportation. The Proposal prescribes CI's for larger, qualified, sorter-equipped operations. A CI program in qualified smaller operations, or operations without sorters, can also be effective. Smaller inventories could be tapped for processing by larger sorter equipped operations and secondary providers as opposed to traveling to Reserve Banks, or could be consolidated into less frequent and larger shipments to Reserve Banks improving efficiency and reducing societal costs. Penalties could be a last resort option to charge for true overuse, instead of arbitrarily assessing the top 100 users in an inequitable fashion. The de minimis exemption, cross-shipping reporting, and billing software development could be eliminated.

Reserve Banks, traditionally, have had no need for systematic tools to monitor the quality of specific currency deposits. If a Proposal can be constructed to reduce deposits, and increase recirculation as a matter of necessity, then an investment in monitoring specific deposit quality becomes unnecessary. As an alternative, administrative costs for the CI program should be born directly by participants. The 150 CI limit could be replaced with some number to be determined by the market. Depository institutions should be able to decide in each case whether the costs of meeting Reserve Bank standards and paying administrative costs makes managing a CI worthwhile in terms of cost savings and increased ability to recirculate currency.

A related issue with the Proposal is the timing of implementation. CI's will be in place for one year after which fees begin. The increases in Reserve Bank volumes occurred over a number of years through incremental changes. Depository institutions will be given no more than one year from CI implementation to resolve all cross-shipping to the de minimis level. This abrupt approach to implementing a costly policy will no doubt cause disruption. A more manageable approach would be to phase in the volume targeted, or phase in the penalty, or both, allowing depository institutions to implement incremental change to their operations.

The Proposal shortens the cross-shipping time frame from 10 business days to five days within one business week; however, the demands of the current market make a shorter time frame more appropriate. Under current market conditions, the definition of cross-shipped should be counted on a one day prior and after basis. All other ordering activity should be considered necessary and not subject to a fee.

The Board projects societal benefits of $15 million, which is wholly derived from sorter, equipped depository institutions that overuse Reserve Bank services. Again, based on the fact that approximately half of the cross-shipped volume would be removed from Reserve Bank processing and the estimated cost to depository institutions of $2 million, the decision point to recirculate works out to approximately $0.60 per bundle or one-tenth the proposed fee. If fees are to be incorporated as a last resort measure in the Proposal, the fee should not exceed the minimum rate at which behavioral change occurs.

An alternative to the proposed penalty is to charge a nominal fee to all depository institutions for all ordered bundles, not just cross-shipped, which will encourage recirculation at all depository institutions. The system-wide aggregated revenues with this approach could serve the purpose of recovering the Reserve Banks' incremental impact costs. This approach, albeit punitive to all, would have a more modest financial impact on individual institutions; would be easily administered; and would be deemed as equitable treatment without an unfair focus on large financial institutions. A similar charge for deposits is not recommended, as it would serve to further erode the overall quality of notes in circulation.

Given that the Proposal focuses on cross-shipped versus deposit activity, and cross-shipped activity at 100 of 8,000 depository institutions, and cross-shipped activity for three of six denominations, there are concerns regarding effectiveness, equity, and unforeseen consequences. The competitive landscape is dramatically tilted toward smaller depository institutions and to depository institutions that are sorter equipped and/or that are more concentrated operationally. Proposal should be directed toward all participants.

> Question 3: Are there factors not described in this notice that would affect a depository institution's decision to pay a recirculation fee or undertake greater recirculation of currency within its organization? What are the benefits and drawbacks of allowing a de minimis exemption of 1,000 bundles of currency per depository institution per quarter for a zone or sub-zone? Is there an alternative approach to administering the de minimis exemption that would address identified drawbacks and still achieve the intended objectives of reducing the burden of complying on depository institutions with small currency operations while ensuring that most cross-shipping activity is governed by the policy?

The proposed de minimis exemption to be set at 1,000 bundles per quarter was established for what the Proposal states as three reasons. The second reason given, that smaller scale operations may not justify investments in sorting equipment, raises the following concerns. First, some large depository institutions are composed of smaller-scale operations, yet those operations combined with others in a zone or sub-zone are subject to the penalties of the Proposal, while smaller depository institutions in the same zone with similar operations will not be penalized. Second, the Proposal correctly implies that sorting equipment is a requirement for effective recirculation. Third, the Proposal implies that sorter-equipped operations that cross-ship overuse governmental resources and increase societal costs, yet all 100 larger depository institution users are included without regard to their sorter capabilities.

The de minimis level could foster secondary markets for fit and unfit currency, secondary providers that specialize in particular denominations, and exchanges of currency to help depository institutions find lower cost alternatives or to generate revenue to offset regionalized sorter equipped operations costs. The de minimis level may result in smaller depository institutions exploiting excess de minimis exemptions through correspondent relationships. Reserve Banks may not see the reduction they expect in volumes, and cross-shipping fees may be reduced. Smaller depository institutions may also exploit the de minimis by ordering more cross-shipped currency up to the de minimis and sell excess fit currency to other depository institutions. As secondary markets develop, depository institutions may order currency in excess of their retail commercial customer demands to fulfill correspondent depository institution customer demands at no additional cost to the ordering DI. The effects of these secondary markets on depository institution recirculation and Reserve Bank processing volumes are unknown.

An alternative approach is to set the de minimis level at a percentage of each depository institutions fit deposits. This gives Reserve Banks the ability to phase in the implementation across all depository institutions through annual reductions to the point where the desired outcome is achieved. A phased implementation provides depository institutions with a better opportunity to manage the change that the Proposal creates.

The risks associated with changes in customer behavior as a result of the Proposal's implementation, particularly around pricing, accuracy, fitness level, and counterfeits, are unknown. Potential risks associated with changes to the armored transportation network are unknown.

> Question 4: Under what circumstances would it be reasonable and practical for depository institutions to adopt lower-cost alternatives to the recirculation fee, 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 process that reflect economies of scale?

The Proposal suggests that those depository institutions that pay the fee will explore manual methods of recirculation to avoid paying the fee. It is clear that manual methods are more expensive and do not lower societal costs. To offset higher manual processing costs, depository institutions and their customers must be willing to accept lower quality notes, a lower degree of accuracy, and with an increased risk of recirculated counterfeits. Based on these three outcomes, manual methods are highly unlikely to succeed in approaching the Proposal's goals.

> Question 5: Are there alternative approaches that could be used to improve the efficiency of handling one-dollar notes other than applying the cross-shipping fee? What savings would an institution expect to realize from these alternative approaches?

Depository institutions and the Reserve Banks are investigating alternative approaches. In addition to these alternative approaches, lessons learned by the Reserve Banks in processing dollar coins could be applied to dollar notes.

The reasons for not running $1 notes on sorting equipment include the lower value proposition of running low value notes on limited high dollar sorting equipment, which is generally reserved for higher denominations due to tight processing windows, as well as the general condition of $1 notes. Expanding processing windows through an effective CI program could improve a depository institutions ability to process some percentage of $1 notes to improve recirculation. The volume of $1 notes could create physical limitations within depository institutions. Depository institution processing windows for $1 notes cannot begin to approach the Reserve Bank processing windows.

> Question 6: What costs would a depository institution anticipate incurring for operating a custodial inventory? How should Reserve Banks calculate the cap on the amount of currency that a depository institution may deposit in a custodial inventory? How many bundles of currency should Reserve Banks require a depository institution to recirculate per week to qualify for a custodial inventory?

The proposal limits the number of CI's to 150; based on a desire to keep administrative costs at some prescribed level. 150 CI's for the 100 affected depository institutions means that either a large number of depository institution operations will not be granted CI's, or that a large number of depository institution operations do not meet the proposed threshold for qualification. In the first case, the Reserve Banks will be perceived as awarding franchises creating potential advantages for depository institutions that are awarded CI's. Depository institutions that are not awarded CI's are forced to incur opportunity costs, transportation costs, or cross-shipping fees. Where cross-shipping fees are mitigated by a currency exchange between depository institutions, the limited number of CI's will limit competition for this service. Efficiency and pricing will not be enhanced and societal costs will not be minimized. If a depository institution operation is not awarded a CI and is sorter equipped, it will be prohibited from taking full advantage of its recirculation capability.

In the latter case of depository institution operations not meeting CI thresholds, the Proposal dictates the scale of operation to be used in depository institution currency processing. The large number of depository institution operations that would not be awarded a CI also indicates that their individual scale may not be large enough to support sorter solutions, however, due to their membership in the targeted 100 users group they are forced to incur opportunity costs, transportation costs, or cross-shipping fees. Recirculation is not maximized and societal costs are not minimized.

If the CI cap is monitored by dollar value as opposed to denomination, it will be used to satisfy lower denominations first to decrease the number of bundles ordered from the Fed, which may be a source of manipulation. The problems associated with the proposed cap methods using either lagging indicators or averages are well known and will lead to shortages in the CI requiring cross-shipped ordering. CI caps should accommodate peak order and processing volumes. Efficient recirculation may require longer processing windows in which to fitness sort deposited volumes. This aspect is not adequately accounted for in the Proposal. As depository institutions insure the Reserve Banks for the CI's, the cap should be that amount that avoids the opportunity cost of holding excess currency.

There is a concern that the Proposal will not provide the means with which to distinguish ordering and depositing activity that constitutes intentional policy circumvention from normal operational fluctuations.

> Question 7: What would be the effects of the program, if any, on depository institutions' customers, on armored carriers, or on other parties?

The traditional roles that the Fed would like to return to and that are mentioned in the Proposal include supplying genuine (new and fit) currency and coin, removing unfit notes from circulation, accepting surplus fit notes and providing currency to those with a shortfall. A fourth traditional role not specifically mentioned in the Proposal is the removal of counterfeit notes from circulation. It is this role that has lead to the exclusion of $50 and $100 notes from the Proposal. Depository institutions are, however, unlikely to incur the transportation and operational costs of separating and shipping $50 and $100 notes to the Fed. Once recirculation approaches have been established all notes are likely to be recirculated. It stands to reason that the number of $50 and $100 counterfeit notes will increase. It also stands to reason that with less scrutiny being applied to $20 notes, there will also be an increase in $20 counterfeit notes in circulation. The ability to identify the source of counterfeit notes will be severely compromised. Customers who detect counterfeit notes will seek relief from the depository institutions increasing their costs, costs that have not been included in the analysis.

Depository institutions will find ways to minimize expenses and once these methods are employed the means with which the Reserve Banks monitor depository institution activity will be lost and consequently the ability to take action will also be lost. The market could migrate to a select number of depository institutions that become currency providers in lieu of the Reserve Banks, while the number of depositors to the Reserve

Banks remains the same. The deposit and order volumes at the Reserve Banks could change very little, theoretically, from current levels, and cross-shipping fees could be significantly less than projected as orders could far exceed fit deposits from the select number of currency providers. Secondary providers could "specialize" in a single denomination with the same effect – no less volume going through the Reserve Banks and significantly less in the way of cross-shipping fees. Several strategies could develop with the main goal being cost reduction or avoidance, where the end result is less than the Proposal is intending and where the Reserve Banks would have little means at their disposal to influence. In addition to the Proposal failing to achieve its stated objectives, the credibility, accuracy and fitness quality of currency under these circumstances could be called into question. Depository institution depositing behavior can be influenced in the desired direction by removing its major driver - the opportunity cost penalties of holding excess currency - through an effective CI program.

Recirculation will lead to a lowering of overall fitness quality. These notes will eventually make their way to the Reserve Banks. The higher percentage of unfit recirculated notes coming in to depository institutions and passed to the Reserve Banks will serve to lower the fitness levels by DI, and consequently lower the volume of bundles defined as cross-shipped. Reserve Banks will see a reduction in their cross-shipped bundles and charges even though deposit and order activity remains the same.

While the Proposal does not include $50 and $100 notes as a means to encourage depository institutions to deposit them to Reserve Banks, it is likely that they will follow the recirculation flow of the other denominations. Depository institutions will not incur transportation costs to cross ship $50's and $100 if a recirculation alternative is available at lesser cost. The Proposal will serve to encourage the recirculation of counterfeit bills of all denominations. There is a concern for the growing number of counterfeit $20's and the likelihood that their number will increase further as a result of this Proposal. An alternative that would encourage the shipment of higher denominations more susceptible to counterfeiting and at the same time making transportation costs more tenable to the depository institutions is to focus the Proposal on $1, $5 and $10 notes and exclude $20, $50 and $100 notes. Or with the enhanced counterfeiting detection available to depository institutions, open the CI's to all denominations and trust that counterfeiting will be detected.

The societal costs do not account for the increased risks that will be incurred by depository institutions, or the risks commercial customers could face as they take actions to reduce increased fees. The impact of reduced note quality and increased circulation of counterfeit notes are also not accounted for in the societal savings. Losses will increase, as well as the risk of personal injury, as commercial customers chose to avoid increased fees through their own increased recirculation, which implies higher inventories in less secure facilities.

Wachovia appreciates this opportunity to comment on the Proposal and we look forward to the opportunity to continue working with the Board on these issues. Should you have any questions, please call Michael Scarlett, Senior Vice President, Currency Operating Services at (954) 545-4350, or Michael Garwood, Vice President, Currency Operating Services at (704) 427-9524, at your convenience.

Very truly yours,

Michael A. Watkins

cc: via electronic mail
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