# Wells Fargo & Company

Formal Response

FEDERAL RESERVE SYSTEM

[DOCKET No. OP-1164]

Federal Reserve Bank Currency Recirculation Policy

January 15, 2004

Wells Fargo appreciates the opportunity to participate in the public comment process regarding proposed changes to the Federal Reserve System cash services policy. Existing guidelines have created inefficient practices for depository institutions and Reserve Banks alike; it is our hope that this collective effort will result in marked improvements that benefit all associated partners.

As one of the nation's largest financial institutions, Wells Fargo will be greatly affected by the proposed policy changes. We understand the issues that have created the need to reassess procedural interaction between depository institutions and Federal Reserve Banks. Our goal is to identify the most efficient and cost-effective methods to evolve this system in order to:

(1) Maintain the integrity of core Federal Reserve functions and services
(2) Reduce Federal Bank currency processing expense
(3) Reduce redundant operational functions
(4) Provide real incentives to depository institutions to streamline operations without incurring additional expense

**POLICY COMMENTS**

**Cross-Shipping Overview**
Cross-shipping practices exist today since transportation costs to/from Reserve Banks are often lower than the cost of funds expense of vault cash balances. Efforts to manage funds expense in this manner result in unnecessary cash handling including the institution's prepatory counting and sorting of cash – a process repeated by Federal Banks upon receipt of funds shipment. In addition to the added expense of transporting cross-shipped funds, carriers incur unnecessary risk by moving large amounts of cash from one storage facility to another. The fundamental value proposition of this policy reevaluation and process reengineering is found in a solution that eliminates redundant procedures and reduces unneeded cash movement.

**Custodial Inventory**
Implementation of a depository institution custodial inventory is clearly the best solution to address the overuse of Federal Bank resources. If properly executed, this approach effectively eliminates deposit institutions' incentive to cross-ship and provides the requested relief to Federal Banks.

The custodial inventory program proposed in the Federal Reserve Bank Recirculation Policy does not afford depository institutions the benefits of this concept and therefore severely limits its usefulness in the following ways:

(1) Selective Denominations – since only those denominations subject to cross-shipping charges are eligible for the custodial inventory, there is an incentive to continue cross-shipping practices for all remaining denominations. Since the fixed element of cash preparation and transportation remain in this fragmented approach, the overall benefit of this otherwise promising strategy is only marginal.

(2) Limited Custodial Inventory Holding Percentage – There is significant financial exposure to depository institutions by warehousing 75% of nonperforming cash assets. With the objective of reducing the movement of cash, it follows that larger cash balances will be retained within depository institutions by delaying the shipment of surplus cash in order to fulfill future cash orders. Since cash demands by customers ebb and flow throughout the month, there can be long time periods where substantial cash balances merely sit without being used.

**Cross-Shipping Fees**

As noted by the Federal Reserve, a custodial inventory program cannot completely encourage the elimination of cross shipping; therefore, a complementary method of discouraging cross-shipping is a reasonable approach. The fees associated with cross-shipping should correlate with the Federal Reserve Bank's internal cost to process the incremental cross-shipped cash bundles. This cost recovery approach therefore serves the purpose of discouraging depository institutions from cross-shipping and transfers a true service cost where cross-shipping may be unavoidable or the least costly of several expensive options.

The concept of a de minimis exemption is applicable given the nature of the cash demand fluctuations described above. A fixed bundle exemption provides relief for small institutions where volumes are low enough to avoid the burden of cross-shipping fees. For large institutions, the fixed exemption amount may only provide marginal relief and falls short of accounting for the high volumes of these operations.

## RECOMMENDATIONS

As noted throughout the comments section, the fundamental framework of the proposed Recirculation Policy is sound and provides opportunity to reduce or eliminate inefficient and redundant practices. To achieve the Federal Reserve's primary objectives of reducing cross-shipping and increasing cash recirculation, Wells Fargo recommends modifications to the Custodial Inventory program as a first initiative. Subject to the limits of these modifications, additional changes are suggested to the cross-shipping fee structure.

**Custodial Inventory**

Since depository institution cash vaults are constantly receiving and sending cash through its operations, a custodial inventory of 100% of its holdings would be unreasonable and unnecessary. The optimal percentage will most likely vary across vaults and institutions but it is in the interest of both the Federal Reserve and depository institutions to determine a simple, consistent formula that directly corresponds to custodial inventory challenges and provides enough incentive to encourage participation. Since the proposed cap of 25% of holdings will always leave 75% of an institution's cash vault holdings subject to funds expense, there is too much cost exposure – particularly considering the longer cycle time resulting from the reduction or elimination of shipping schedules with the Federal Reserve.

If the custodial inventory percentage was raised to 75% – 80%, depository institutions could effectively maintain balances throughout the month and extend the period of cross-shipment monitoring with the Federal Reserve from a weekly to a monthly basis. This proposed change encourages depository institutions to recycle cash throughout the month to minimize the overall interaction with Reserve Banks and still discourages depository institutions from maintaining unnecessary balances.

In order to reduce transportation inefficiencies, which represents a significant expense opportunity for depository institutions, all denominations and mutilated cash should be eligible to be held in custodial inventory. Large denomination verification and mutilated cash exchange can be scheduled in a manner mutually beneficial to both Reserve Banks and depository institutions. Including $1's denominations in custodial inventory with the incentive for depository institutions to recirculate also addresses the concern of future practices with this denomination.

There must be some minimum requirements for a vault to quality to hold custodial inventory as detailed in the Federal Reserve proposal. The primary qualifications are the depository institutions' acceptance of full liability for Federal Reserve funds and minimum facility security standards. Minimum shipping/receiving volumes may be applicable depending upon the Federal Reserve's desired controls in this category. Wells Fargo also proposes an exemption of cross-shipping fees in cases where natural disasters (e.g., earthquakes, floods, hurricanes) cause a significant, unanticipated demand for cash in adversely affected areas, due to the disruption or breakdown of other payments systems (e.g., credit and debit cards and automated teller machines). In the event of such a natural disaster, depository institutions may be subject to substantial demands for currency from their customers, causing them to turn to the Reserve Bank to meet these demands. When the Reserve Bank provides this currency, the depository institutors may become subject inadvertently to cross-shipping fees during the course of the applicable month. Depository institutions should be afforded safe harbors for these unforeseen requests without penalty or fee.

**Cash Clearing House**

Wells Fargo has researched the concept of using a clearing house to manage the movement of cash among depository institutions as a vehicle to recirculate cash and reduce shipments to and from Reserve Banks. Based on the initial findings, we intend to proceed with the creation of a non-profit organization in conjunction with other financial institutions.

**Cross-Shipping Fees**

The implementation of an effective custodial inventory program would minimize the impact of cross-shipping fees and achieve the desired result set forth by the Federal Reserve. Since not all depository institutions will qualify or cannot otherwise implement a custodial inventory practice, the cross-shipping fee amount should be priced in the context of a service fee using a cost recovery methodology. The de minimis exemption should also be adjusted to include a variable amount in addition to the fixed base of 1,000 bundles per quarter to account for variations in institution scope of operations. The variable increase over and above the base exemption may be unnecessary if custodial inventory can be designed to effectively change the practices of depository institutions.

**Conclusion**

The opportunity exists to redefine how depository institutions interface with Reserve Banks in a process that encourages efficiency and provides expense relief for both parties. Understanding prior conditions that have resulted in today's operating challenges is key to redesigning the new process. In addition, identifying creative alternatives that leverage broad-scale opportunities and maintaining the integrity of the Federal Reserve is even more beneficial for both the public and private sectors. It is our wish that we have been helpful in this review process and that we may continue to provide assistance in the development of this policy. For example, Wells Fargo is well positioned geographically to contribute to the Cash Clearing house pilot testing in 2004; we are eager to participate and confident that testing results will help identify additional areas of opportunity.