TEN

FEDERAL RESERVE BANK OF KANSAS CITY

Winter 2007

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E-Banking

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Changing Nature of Banking

PERSONAL SAVING

Rates are low, but might not be as dire as predicted

PHOTO BY JOSHUA LAWTON

TEN

WINTER 2007

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This Time It's Different (Or Is It?)

Those of you with several years of business experience in this part of the country may recognize that many of the things we are hearing today about the economy have counterparts in the past: Asset values are appreciating, farmland values are strong and we are all well-aware of what has occurred this year with the energy markets. In short, for many in this area of the country, times are good.

At the start of the 1980s, we were told that oil prices could only go higher, farmland was a solid investment because "they aren't making any more of it," and housing and stock markets would continue to climb.

Of course, if you were involved in business or banking 20 years ago, you will recall that several of the financial decisions made on those speculative forecasts created their own sets of problems, some reaching far beyond local banks.

Today, I am told that while there may be some similarities with current banking conditions and those of a quarter century ago, things are different this time. You may be hearing the same thing from investors and bankers, and, in fact, you may be saying to yourself: "This time, it's different."

Or is it?

Through the late '70s and '80s I had the opportunity of being an officer in banking supervision at the Federal Reserve Bank of Kansas City. I spent those years heavily involved in the banking crisis that enveloped the Tenth Federal Reserve District, a region that includes the central United States: Nebraska, Kansas, Oklahoma, Wyoming, Colorado, northern New Mexico and western Missouri.

Confidence abounded among borrowers, bankers and even supervisors during the early 1980s. And, as with any euphoric environment, potential pitfalls abound.

I realize this is not new information to many of you—maybe to none of you. But I believe that this is a particularly apt time to take a retrospective look at banking and finance.

We now have a new generation of bankers who haven't experienced much in the way of a substantial banking downturn. Furthermore, many who can recall the 1980s will soon be leaving the business, and we need to gain from their knowledge and experience before they leave. Lastly, it never hurts to be reminded of important lessons.

Let me share with you some statements that we actually heard from bankers and bank directors during the '80s:

- "I am the CEO of this bank, and we're doing it my way."
- "Yes, we loaned a hundred percent on this project, but everyone knows that the collateral value can only go up during construction."
- "If you understood this better, you wouldn't have a problem with it."
- "Although this is unconventional, our accountant says it is perfectly legal."
- "The corporate plane will save money for the bank in the long run."
- "We have put our problems behind us—our bank rating will be much improved at our next exam."
- "If it weren't for the examiners, this bank wouldn't have failed."

Lessons from the 1980s

Before I go further, let me provide a brief background on the 1980s to remind us of the context of these stories—all of which happened in our Federal Reserve District. In the 1980s, community banks made up much of the District banking population, with a number of regional organizations filling out the total—a trend that continues today with additional entry by a number of large interstate organizations.

District banks played various roles in speculative booms in agriculture, energy and commercial real estate—all of which were significant for the District economy—and which all came to a precipitous end. The price of crude oil, for example, rose from $2.75 a barrel in 1973 to a peak of nearly $37 in 1981 before dropping to $10 in 1986. Similarly, farmland values in Nebraska rose by more than fourfold in the 10-year period before 1982, but then dropped by 45 percent during the next five years. Inflation was around 13 percent at the beginning of the 1980s, and the prime rate reached 20.5 percent in 1981.

The sharp economic fluctuations had a severe impact on District banks. During the 1980s, 309 banks failed in District states, which was 11 percent of the 1980 District banking population. Now, let me recognize one very important point before I go on. Most banks in the 1980s, like banks today, were well-run, prudent and successful. But some managers couldn't resist the possibility of greater profit. These examples are designed to steer you away from similar mistakes.

For each of the statements I shared previously, there is a story around the events that eventually unfolded. I have three more statements for which I want to provide the story of the consequences. I hope these will serve as examples of what you, as directors, need to be alert to when exercising oversight at your banks. Age-old behaviors, such as greed, shortsightedness, and arrogance, are at the center of these problems, and, I would caution, they are with us today just as they were in the 1980s.

The first comment stems from one of the most prominent examples of the '80s banking crisis:

"The examiners are dead wrong, they don't understand what we're doing–they don't have a clue about our business."

At the height of the agricultural, energy and commercial real estate booms of the late 1970s and early 1980s, competition among lenders was intense. When our examiners would ask about a loan with questionable characteristics during this period, they too often heard bankers say, "If I don't make the loan, the banker down the street will." In many cases, unfortunately, this turned out to be a race to the bottom.

Nowhere was this more evident than in the area of energy lending. Good loan underwriting standards were often swept away under an aura of optimism and the belief that oil prices could only go up. In this environment, repayment ability was not a concern, especially because rising oil prices would bail out any lender, and good loan documentation was something to be done later, provided the lending business slowed down at some point.

One notable or, in this case, notorious District energy lender was Penn Square Bank of Oklahoma City. If you've read books like "Funny Money" or "Belly Up," you know a lot of major banks courted Penn Square and competed with one another to participate in the bank's seemingly lucrative energy lending business. Energy lending was the hottest ticket in banking then, and in the race to stake out a

position, none of these major banks paid any real attention to Penn Square's loan underwriting and administration, or did much in the way of their own due diligence. In many cases, the loan participations were bought on blind faith and unlimited optimism.

For Penn Square, this provided an incentive to make loans to anyone who walked in the door, and Penn Square sold more than $2.1 billion in loan participations to 88 banks, including eight of the top 50 banks in the country. Greed, thus, overwhelmed reason for all who were involved. This, in some ways, strikes me as similar to some "hedge funds" excesses of the recent past.

The outcome of these practices back then was the failure of Penn Square Bank during the Fourth of July weekend in 1982. At the Federal Reserve, we were faced with a decision on whether to continue lending to Penn Square through the Discount Window or to stop and let it fail that weekend.

With all the questionable energy loans on Penn Square's books, there was little to be salvaged, and a few colleagues and I found ourselves spending the holiday weekend working on what to do about it. After Penn Square's failure, FDIC Chairman William Isaac made clear where the blame lay when he stated, "The Penn Square debacle was caused by a gross dereliction of duty on the part of the bank's board of directors and management."

Penn Square's failure also led to a ripple effect within the banking industry. A staggering total of more than $1.1 billion in Penn Square loans had been sold to the supposedly more sophisticated Continental Illinois National Bank. These loans received little, if any, review by Continental Illinois' management and served as the initial impetus toward that bank's eventual failure in 1984. Seattle First National Bank was also a heavy buyer of Penn Square loans.

After Penn Square's failure, Sea-First quickly slipped from being a darling of stock market analysts to a bank shut out of funding markets and pushed to the brink of failure. The only thing that prevented it from becoming the largest U.S. bank failure at that time was its hurried acquisition by Bank of America under a special Washington state failing-bank law. Several other major banks also took significant losses on Penn Square loans and fell into a weakened condition.

The simple fact is there are times when it is wise not to jump on the bandwagon. In some instances, it is better to let the parade pass you by. As directors, you should be extremely cautious if your management can't fully and clearly explain the business lines they are about to enter or if there is too much of a rush to jump in.

"If you understood this better, you wouldn't have a problem with it."

There are a host of stories from the 1980s and early 1990s of individuals thinking they had a sure thing—something that would produce spectacular returns with little or no risk.

Unfortunately, bank directors have sometimes been caught up in this enthusiasm as well. One banker, for instance, became a loan originator, relying entirely on another organization to be the secondary market conduit.

It seemed like a foolproof strategy with far better returns than the bank's ag lending business in the 1980s—simply find willing loan customers funneled through from distant sources, make sure the loan paperwork is filled out properly, and then watch the conduit purchase the loans and place them in the secondary market.

For several years, this strategy

worked—great origination and servicing fees, virtually no credit risk with the quick sale of loans, and a big boost to local employment. Eventually, however, the market conduit canceled its contract with the bank, thus leaving the bank itself to fund and hold all the loans it was making. The bank's balance sheet ballooned with the influx of loans, and the bank soon found that many of these loans were of questionable quality—a fact that eventually led to the bank's failure.

Another bank from this period had a history of struggling along and was glad to finally pick up some new ownership, especially because this change brought in two fast-track partners from a securities firm. Soon the bank's investment portfolio was earning returns well above market rates—an outcome that pleased the directors and led to management bonuses.

No one seemed prepared to question how the bank could continue to earn above-market returns on U.S. government securities. The answer came out later. One of the partners in the securities firm was charged with fraud, through a Ponzi scheme, and with money laundering, and the bank became a defendant in a securities lawsuit. After losing the lawsuit, the bank was insolvent.

Similar stories can be found in other banks. A particularly common story concerns structured notes. How many banks bought such notes through bond salesmen with the idea that they carried high returns but were safe because they were backed by the Federal Home Loan Bank System and the federal government? One banker even told us he didn't have to worry about his securities because his broker "controlled" the risk for him. In many cases, bankers never gave a second thought to the significant risks structured notes presented to their banks.

"Didn't you learn from corporate finance that leverage can be powerful?"

Franklin Savings was a Kansas thrift institution that made a name for itself through its complex arbitrage operations, expert staff and ability to "outsmart" major securities firms on trades. Franklin Savings started out as a small traditional thrift institution in a small Kansas town.

Like many thrifts in the early 1980s, Franklin Savings faced substantial losses from interest rate mismatches in its mortgage portfolio. In response, Franklin changed its business model to an arbitrage and hedging strategy, using brokered deposits to fund its positions in mortgage-backed securities, junk bonds and the futures market.

The thrift brought in an impressive staff of Wall Street and capital markets hotshots to carry out its strategies, and in just a few years, Franklin grew from virtually nothing to one of the largest and most profitable thrifts in the country with more than $11 billion in assets.

While Franklin Savings had impressive returns for a number of years, its rapid growth —along with tighter thrift capital standards under FIRREA (Financial Institutions Reform, Recovery and Enforcement Act of 1989)—turned its leverage into a regulatory issue. Also, unexpected movements in interest rates led to sizable losses at Franklin in 1989, and to further declines in its capital ratio and net interest margins.

In a dispute over accounting practices, the Office of Thrift Supervision seized Franklin in 1990. What followed was a series of articles and court cases in which a number of well-known arbitrage experts took turns defending and criticizing Franklin's reporting of hedging gains and losses and the length of time it could take in recognizing some notable losses. There

was no consensus on whether Franklin was a viable institution or was truly insolvent. In the end, the courts largely deferred to the OTS.

Among the lessons we can learn from Franklin Savings is that an institution's management should be able to explain fully its strategy and risk exposure to directors, current and prospective investors, and bank supervisors. Franklin also could be regarded as forerunner to today's hedge funds, except that it was relying on insured depositors and its thrift charter for funding advantages and didn't have large, sophisticated investors as its target clientele. As a result, it had a great responsibility to be transparent in its strategies and to maintain its capital at prudent levels and in compliance with minimum supervisory standards.

Some might quibble about whether the thrift examiners were knowledgeable enough to judge Franklin's activities. But they had enough experience by then to be skeptical when managers at problem institutions would tell them: "We're too sophisticated to get into trouble," "You don't understand, we know what we are doing," and "We have a tax—or an accounting—angle that will make this pay off."

Conclusion

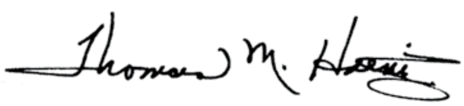
My purpose in reviewing these stories with you today is not that I think a return to a 1980s-style crisis is imminent. Certainly, banking conditions today are good: strong earnings, good asset quality, no bank failures in more than two years. However, those who, in the early 1980s, predicted an endless rise in energy markets and real estate values were as confident in their outlook as we are today. And, certainly, the same rules and lessons continue to apply in banking and finance.

Although the world has changed during the last quarter of a century, at least one thing has not: human nature. As I mentioned earlier, greed, pride, arrogance and other human frailties are often at the root of bad banking decisions, and those qualities remain with us today. They still motivate behavior as they have in the past, and, in many cases, these frailties keep us from acting on the lessons we should have learned from previous generations.

In addition, no matter how sophisticated we think current analytical tools, management information systems and financial instruments are, the most critical element in banking is still individual experience and judgment. In the end, bank employees, and, I would stress to this audience, bank directors, are still making the important decisions. The quality of those decisions will always depend on human characteristics and our ability to learn from the past.

One banking scholar said, "There is really nothing new in banking and finance, each generation just thinks there is."

So, are we in a different situation than 20 years ago? I would suggest that one way we can ensure a different outcome is if you, in your oversight capacity as bank directors, are willing to be skeptical, willing to ask the difficult questions and unwilling to accept the answer "This time, it's different."



THOMAS M. HOENIG, PRESIDENT
FEDERAL RESERVE BANK OF KANSAS CITY

TOM HOENIG delivered this speech Oct. 29 at the Western States Bank Directors Education Foundation's annual symposium. To learn more about bank director training programs from the Federal Reserve Bank of Kansas City, turn to Page 30.

PHOTOS BY GARY BARBER

Still earning interest

Despite online technologies, customers value bank location

Even though Stephanie Laws is responsible for the family banking, she refuses to balance the checkbook, rush to the bank before closing time or stand in long teller lines.

For the past five years, Laws hasn't had to.

"I love online banking," she says.

Laws, of Kansas City, Mo., does the majority of her banking from her home computer, logging on for just a few minutes three to five times a week to check account balances, pay bills and monitor direct deposits.

It's easy, convenient and, most important for the new mother and young professional, banking online saves time, she says.

Laws estimates she visits her bank only once or twice a month, but she still ranks location as one of the most crucial features a bank can offer its customers.

Laws is not alone. Despite increasing use of electronic banking, the majority of U.S. households still consider bank location the most important factor in choosing their primary financial institutions, says Eric Robbins, a policy economist at the Federal Reserve Bank of Kansas City.

"Widespread use of online banking technologies doesn't mean the importance customers place on bank location has declined," Robbins says.

Robbins recently researched the effect electronic banking has on the importance of bank location to consumers. His research is based on interviews with banks from around the Tenth District, which includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern

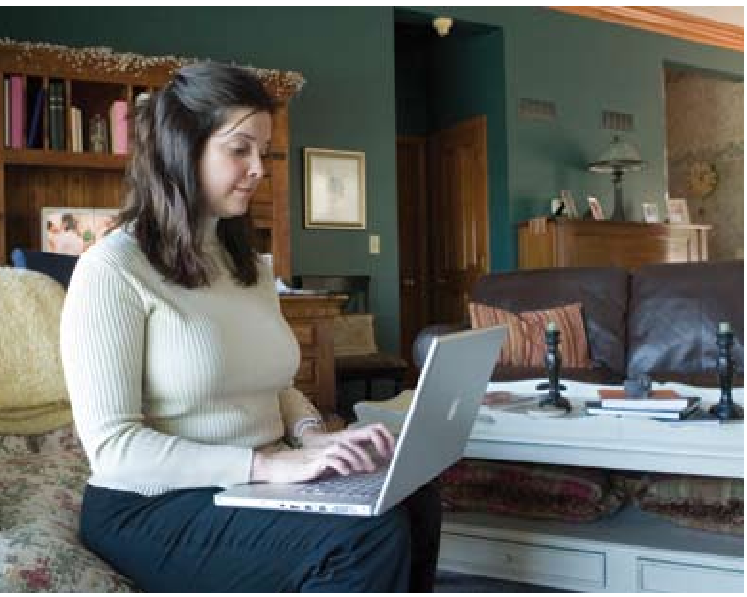
New Mexico, as well as the Federal Reserve Survey of Consumer Finances, which is a triennial interview that includes financial services information from more than 4,000 U.S. families.

Robbins concludes that although the popularity of e-banking has grown in the past 10 years, a large percentage of customers still don't use these online technologies. And those who do, continue to value their bank's location.

"E-banking is not a perfect substitute for a physical presence in the marketplace," Robbins says. "Bank location is relevant to consumers for the same reason electronic banking is relevant—bank customers value convenience."

E-beginnings

More than a decade ago, the banking industry underwent considerable change. As banks were consolidating, e-banking was emerging. In 1995, Wells Fargo Bank was the first to offer online account statements and Security First Network Bank became the first online-only bank, although it has since discontinued Internet operations.



STEPHANIE LAWS likes banking online for its convenience. Although the popularity of e-banking has increased, a large percentage of customers, like Laws, still opt to visit their bank and value its location.

At that time, 35 percent of households with bank accounts had an ATM card, 20 percent used a debit card and a mere 4 percent used some type of online banking service, according to data from the Survey of Consumer Finances. However, more than 50 percent of U.S. households used direct deposit.

"Widespread use of online banking technologies doesn't mean the importance customers place on bank location has declined."

During the early years of e-banking, bank location was still a key factor in choosing a bank for most households. Among 31 possible factors, nearly half of those surveyed said locality was most important. With the exception of the number of services offered and low fees, other factors were almost insignificant.

"The importance of bank location is not surprising given the options available to consumers at that time," Robbins says. "Most households didn't have ATM cards and were not using debit cards."

Since 1995, computer banking use has increased by more than 800 percent and debit card use has increased by more than 200 percent. Use of automatic payments, ATM cards and direct deposit services also has increased significantly.

In many cases, consumer adoption of some e-banking products appears to be reaching maturity. For some products, the growth in adoption peaked between 1995 and 1998, Robbins says.

However, research shows 30 percent of banks still don't offer online banking. And many that do, like Peoples Bank in Lawrence, Kan., view it as another feature—not the banking wave of the future.

Face time

The smell of fresh baked cookies fills the air, inviting guests to the comfy living room to watch TV or read, in addition to doing their banking. The cozy setup is actually the lobby of Peoples Bank, where the motto is "banking unusual." That means "people over technology," says Wint Winter, president and CEO.

"We absolutely value the face-to-face over online contact," Winter says. "In our case, it (e-banking) will never substitute or act as a proxy for face-to-face consultative service."

Peoples Bank customer and local attorney Steven Massoni does a large portion of his business and personal banking online, but says there are some things, like making deposits, that he'll always go into his bank to do.

E-banking technologies may not be a perfect substitute for personal interaction.

"Rather than acting as a substitute for services offered by bank branches, e-banking products are likely viewed by consumers as complementary to bank locations," Robbins says.

Roughly 44 percent of customers visit their bank at least once a month, according to Robbins' research, and they still want face-to-face service, even if they do the majority of their banking online.

Data from the Federal Reserve show most customers who use online banking services do so to monitor their accounts and only about half of them pay bills online. Those most likely to e-bank are younger, more educated, higher-income households.

For Peoples Bank, which has 14 locations, online banking is viewed as an extension of service, like ATM or phone banking, Winter says. Instead the bank focuses on customer interaction, offering personal attention and small perks, such as gourmet coffee, with each visit.

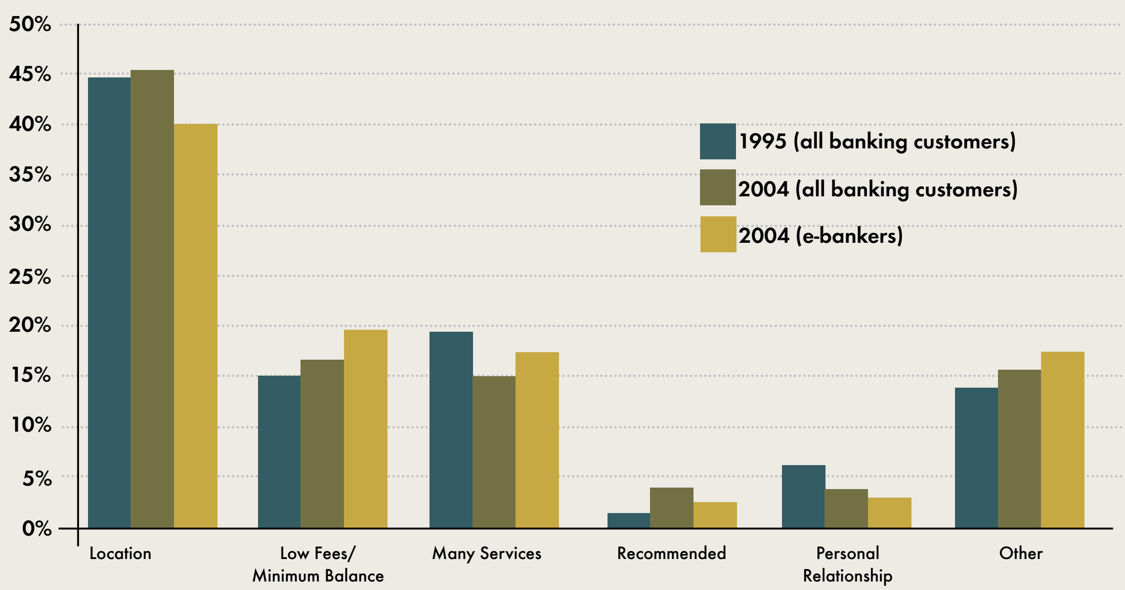
Still, Peoples' customers are banking online. In the last 14 months, the number of online users has nearly doubled, as have users of online bill pay. But, this doesn't mean Peoples will shift its efforts electronically, although it already has upgraded its website and will continue to do so in the future.

"The bottom line is: Focus on service but don't ignore e-banking," Winter says. "We'll always choose that strategy."

Location, location, location

Robbins says the importance of bank location may vary depending on a number of factors, such as a consumer's distance from a bank. Data show the majority of U.S. households are less than five miles from their bank.

Customers' Most Important Reason for Choosing a Bank



Source: Federal Reserve Survey of Consumer Finances

ALTHOUGH HE PREFERS TO BANK ONLINE, Steven Massoni still visits Peoples Bank regularly. He chose Peoples because of its proximity to his office.

Those who live a greater distance from their bank may place less emphasis on its location because they don't have options like those who live near multiple banks.

Even though they may be miles away, Bank of Commerce customers in rural Rawlins, Wyo., and the sparsely populated surrounding area also prefer to visit their bank rather than log onto the bank's website, says Sherrod France, president.

Bank of Commerce was the first in the county to offer online banking about five years ago, but today only about 15 percent of customers use the service.

As a result, the bank's strategy is to grow physically rather than electronically, with additional branches and ATMs within the 100 square miles of the county.

This seems to be the trend nationwide. Despite the increased adoption of e-banking and overall consolidation among banks, the number of bank branches and ATMs has steadily grown, Robbins says. Since the early '90s, the number of new branches has increased by 2 percent on average, increasing to about 3 percent by 2005. ATMs have boomed since the early '90s, from less than 30,000 to nearly 400,000 by 2005.

Additionally, growth in retail branches, such as grocery stores, is outpacing stand-alone bank branches, which increased by 12 percent in 2005.

"As a result, even bank customers who do not adopt sophisticated e-banking products, like online banking, can benefit from more convenient locations," Robbins says.

E-banking on the future

Although he founded Bank of Blue Valley and serves as president of its five locations in eastern Kansas, Bob Regnier has gleaned some insight, not just from industry experience, but also from one of the bank's customers in particular: his 25-year-old son, who lives in California but banks with Blue Valley via the Internet.

"Younger bank customers have a different approach," Regnier says. "(Online banking) isn't an additional selling point. This is a necessity."

While Regnier acknowledges bank location is most important now, he predicts a large shift toward e-banking as younger demographics, like his son's, characterize the majority of banking customers. But in the meantime, Bank of Blue Valley likely will build branches every few years, Regnier says, noting online banking will never completely replace location banking.

Robbins says survey data may not reflect a shift in importance of bank location to e-banking; it may be too early to see the impact. As younger customers continue to adopt e-banking, the impact will become more prevalent.

"Ten years from now, five years from now," Regnier says, "if you don't have an online product, you're not going to be competitive."

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

LOCATION, LOCATION, LOCATION: HAS ELECTRONIC BANKING AFFECTED THE IMPORTANCE OF BANK LOCATION? By Eric Robbins
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

PHOTO BY KEITH BALL

Taken to Lunch

After grabbing lunch at a fast-food restaurant one afternoon, Jason Snyder ended up with a tab totaling more than $10,000—and a lot of frustration.

As Jason Snyder unsuspectingly filled out a check to pay for his meal, he chatted with the cashier, who asked if Snyder worked in that area of Oklahoma City, or attended the university nearby.

"I just thought he was being friendly," Snyder recalled. "I didn't think anything of it."

It wasn't until more than a year later when Snyder was rejected for a car loan that he realized the cashier used not only personal information printed on the check, but also details from that casual conversation to get a student loan at a local college.

The then-20-year-old had a harsh realization: "I had uncollected debt and bad credit."

Snyder, who rarely wrote checks and does so even less frequently now, still may have been victimized even if he had opted for a different payment method.

"With any form of payment there is a risk," says Terri Bradford, Payments System Research Specialist with the Federal Reserve Bank of Kansas City.

Bradford and Bruce Cundiff, an analyst for Javelin Strategy & Research, recently collaborated on a summary of the firm's study on how payments fraud—the use of a payment mechanism by someone other than the authorized user—is becoming more common. The study's findings indicate fraud is most often conducted in low-tech ways, compared to more sophisticated scams that may rely on technology.

While risk exists, Bradford and Cundiff say there are equally easy ways for consumers to prevent or reduce payments fraud, taking into consideration both the sources of fraud and the ease of resolution based on the payment type.

Significant impact

Snyder is just one of the millions of fraud victims. More than 9.3 million Americans were victimized during a one-year period, according to a 2005 study sponsored by Visa USA, Wells Fargo Bank and CheckFree Services Corp.

Snyder's brief encounter with the fast-food cashier was enough for the fraudster to assume Snyder's identity on a loan application. The culprit spelled Snyder's name incorrectly, but knew enough details, such as Snyder's place of employment and financial institution, to obtain a loan.

Later, authorities told Snyder the cashier used this same strategy to take out almost $200,000 in loans at the same school using the identity of more than 20 others.

If fraud occurs, the minimum impact will be the unplanned loss of funds, which could ultimately result in legitimate payments being returned due to insufficient funds in the account. Furthermore, the account holder may experience corresponding insufficient funds fees. Or, the impact may be more severe, as in Snyder's case, resulting in marred credit and trouble getting loans and credit cards.

Whether victimized by an online scam or having your wallet stolen, the financial and emotional effects are usually significant, says Jay Foley, co-founder of the Identity Theft Resource Center, a national nonprofit organization that serves as a resource for fraud victims. Foley started the agency in 1999 with his wife, Linda, who was a victim of identity theft a few years earlier.

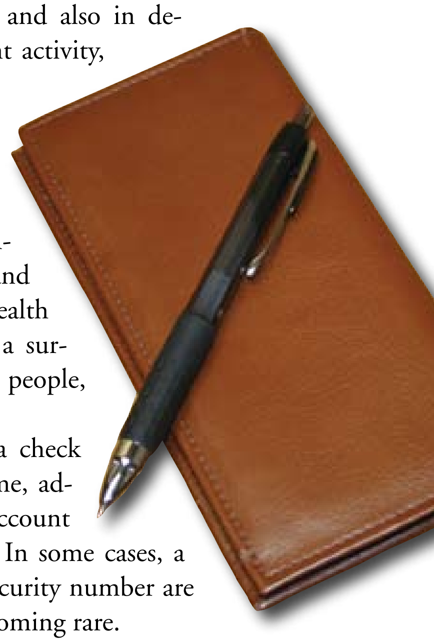
Although fraud victims can receive assistance from these types of agencies, along with law enforcement, credit bureaus, and their own finacial institutions or card networks, Foley says personal and professional exprience has taught him the best way to combat fraud is prevention.

"People just don't know how," he says.

Detecting fraud

Fraud is usually discovered in two ways. According to Javelin research, the consumer in most instances (53 percent of the time) is notified by another party such as a bank or credit card provider. Otherwise, it is discovered by the consumer (47 percent of the time) when monitoring accounts or credit reports, for example.

Consumers have a clear role to play in protecting themselves from fraud when using different payment methods and also in detecting potentially fraudulent activity, Bradford and Cundiff say.



Checks:

Although it is a declining payment choice, many consumers are still reaching for their checkbooks, and in turn, handing over a wealth of personal information to a surprisingly large number of people, Bradford says.

Typically included on a check are the account holder's name, address, phone number, account number and bank location. In some cases, a driver's license and Social Security number are also included, but this is becoming rare.

After a check is written, these details are then passed to everyone involved in the check clearing process: store employees, transportation staff and bank personnel. There are numerous opportunities to commit fraud by either opening a new account or tapping into the existing account. Roughly 15 percent of identity fraud, equating to $8.5 billion, is the result of information taken by a corrupt employee, according to Javelin research.

There are several consumer safeguards, including keeping unused checks locked up at home, mailing checks from a locked mailbox or from the post office, allowing merchants to convert checks to electronic transactions, paying bills online, patronizing trusted merchants or recipients, monitoring account activity, and reviewing cleared checks to ensure they have not been altered.

ACH transactions:

Automated clearinghouse (ACH) transactions, such as payroll direct deposit or direct payment of bills such as mortgages or loans, are a safer payment method than writing checks because both the amount of information available and the physical handling of that information is reduced. However, there is still risk because consumers must provide third parties with account numbers.

Methods of fraud protection include monitoring account activity, securing documents, and providing account information to trusted entities or individuals.

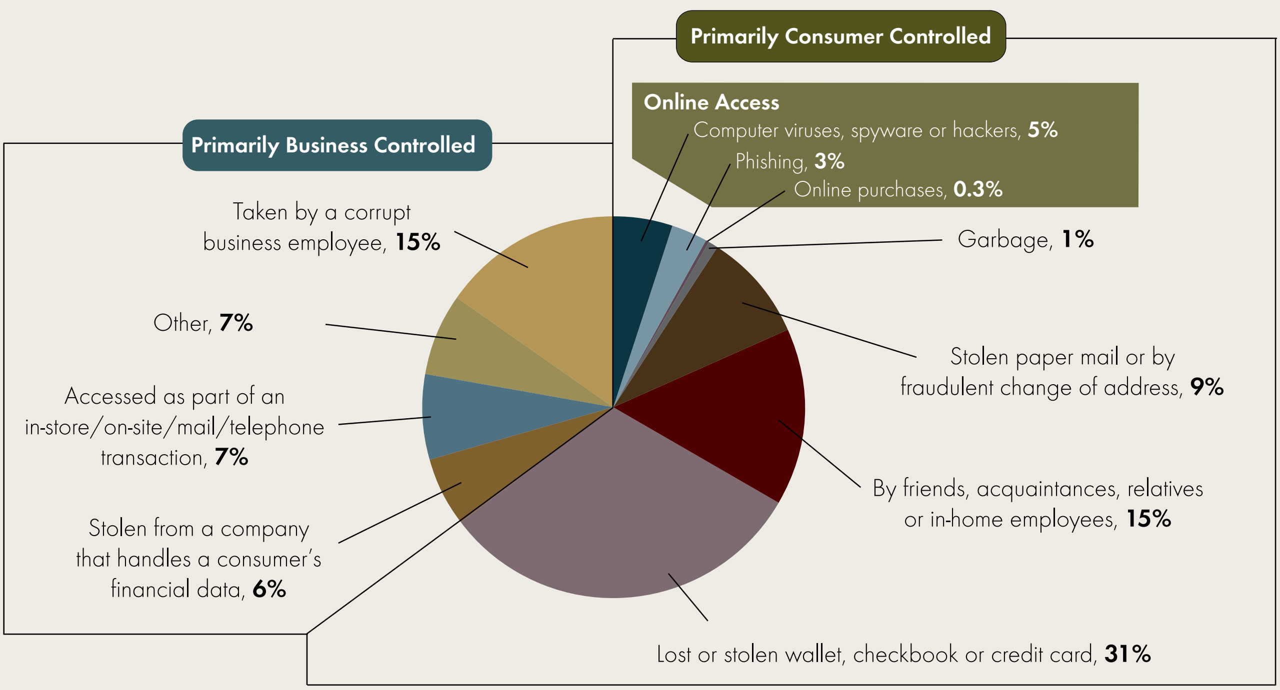
Debit and credit cards:

Like checks and ACH transactions, debit card payments also may provide unwanted access to consumers' checking accounts. The fraud implications (direct loss of funds and immediate impact) are similar as well, but many debit card issuers apply the same "zero liability" protection that credit card networks offer.

Both PIN and signature authorization for debit card use should be protected to avoid fraud. PIN users should guard themselves so others can't see the numbers entered. The PIN itself should never be written on the card or left unsecured. Securing debit cards is similar to credit card precautions.

"Credit card payment may well be one of the safest options when it comes to fraud concerns," Bradford says.

How Fraudulently Used Consumer Information Is Obtained



Note: This sample size was 206 respondents. The base was those who knew how their information was obtained. © 2006 Javelin Strategy & Research

Because credit cards physically don't list personal information other than the cardholder's name, they are an unlikely source of new account fraud. Additionally, the consumer generally maintains control of the card, as opposed to checks, which pass through many hands. If a fraudulent purchase does occur, the consumer is protected by zero-liability policies, making fraud recovery less burdensome.

"Nonetheless, credit card fraud is a significant issue and, at the very least, a hassle for consumers," Bradford says, adding there are several ways cardholders can be victimized—with more methods emerging continually.

"Skimming," for example, occurs when a card is swiped and information is gathered from its magnetic stripe, allowing replication and fraudulent charges to be made. Online credit card usage is also a threat. Although stolen card information is infrequent, fraudsters via social engineering can deceive the consumer into divulging other personal information, such as a Social Security number. However, overall theft of the actual card is the primary source of fraud.

Consumer protection includes maintaining control of the card as much as possible, eliminating paper statements to avoid mail theft, constantly monitoring accounts, having phone numbers handy to immediately report incidents and having a level of trust with online merchants.

Beware

In addition to existing account fraud, with the right information, fraudsters can open new credit accounts in consumers' names.

"New account fraud is much more difficult to detect, and often results in much larger fraud amounts and is more burdensome to resolve," Bradford says. "Consumers can guard against new account fraud by regularly monitoring their credit reports for unrecognizable activity."

Now, several years later, Jason Snyder checks his credit report every six months or so. Thankfully, there have been no other theft incidents. This steady monitoring likely would catch another I.D. thief, which is how Snyder discovered the crime. After obtaining the loans in his victims' names, the

"Consumers must understand that their own education and interaction with their financial institutions contribute greatly to the mitigation of fraud."

fraudster made the first few payments to buy himself more time. It wasn't until a confused Snyder analyzed again and again his tainted credit report that he realized just what had happened.

"Consumers must understand that their own education and interaction with their financial institutions contribute greatly to the mitigation of fraud," Bradford says. "While detection methods vary among payment types, frequent and meticulous monitoring of accounts, and even credit reports, has been found to be a primary way for consumers to detect and abate fraud."

Snyder agrees.

"It took five, six years to get this all taken care of," he says.

The hours spent dealing with credit bureaus, financial institutions, authorities and the loan grantors added up quickly.

"I think at this point it's fully resolved," Snyder says. "Finally."

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BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

PAYMENTS FRAUD: CONSUMER CONSIDERATIONS
By Terri Bradford and Bruce Cundiff
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.


PHOTO BY SCOTT INDERMAUR

The Health of Personal Saving

Rates are low, but might not be as dire as predicted

After Janel Ward starts collecting her salary as a doctor, she'll still drive her '98 Buick with its cracked windshield. Her family will still live in their modest townhouse in Denver. And for years to come, those big paychecks won't go toward vacations or nights out, but paying bills—still.

When Ward graduates from the University of Colorado's School of Medicine this year, she will have accumulated more than $200,000 in student loans.

"It's pretty scary," she says. "But, if I want this career, I have to have this debt."

For Ward, and many of her fellow med students, this means costs have to be cut. Life's luxuries are out of reach. Building a nest egg must wait.

But they hope not for long.

Their anticipated annual salary, usually in the hundreds of thousands, makes the debt incurred early in life an easier pill to swallow, they say.

It's this behavior—when households rationally plan spending based on expected income and assets—that illustrates why the decline in the country's personal saving rate may not be as alarming as is often portrayed, says Alan Garner, an assistant vice president and economist at the Federal Reserve Bank of Kansas City.

Data show for the last two decades, Americans' personal saving has been steadily dwindling and has dropped to a negative rate. While Garner acknowledges many Americans aren't saving adequately for long-term needs, he says this current-spending-based-on-future-income theory suggests the low saving rate may not be as dire as initially stated.

Additionally, there may have been various measurement problems with the most recent saving rate calculations. Recognizing these factors can reduce concern about Americans' well-being and the nation's economy.

"The low personal saving rate may not foreshadow wrenching future adjustments in consumer spending," Garner says.

A penny saved

The most commonly cited measure of personal saving is calculated from the national income and product accounts, or NIPA, from the U.S. Department of Commerce. It measures the funds taken out of current household income (after taxes) and saved, not including capital gains or losses on existing assets.

Personal saving has plummeted from about 10 percent of disposable income in the 1980s to 2 percent in 2004. But by 2005, the saving rate turned negative for the first time since the Great Depression, falling to -0.4 percent.

"The downward trend in the personal saving rate has prompted expressions of concern by economists and other observers," Garner says. "Underlying these and virtually every other discussion of saving trends is one point of agreement: Saving for the future is important."

Much of the concern about the low saving rate stems from the aging population's burden on health care and retirement systems. Projected population aging during the next 25 years creates unfunded Social Security and Medicare liabilities. Adding to the health care burden, medical costs are climbing faster than inflation.

Additionally, the decline in saving eventually might prompt a sudden increase in saving, effectively reducing growth of consumer spending, and in turn, real output and employment.

The purpose of saving is to increase resources for future use, Garner says, whether it's for vacations, retirement or unexpected loss, such as an illness or job layoff. Typically, savings are invested in financial assets—bank accounts, mutual funds or real estate.

"Today's saving influences future consumption because investments in financial assets are channeled into productive investments in factories, industrial

Personal Saving as Percent of Disposable Personal Income

machinery, computers and other kinds of capital," Garner says.

Increased saving could help reduce these burdens by raising the domestic capital stock and increasing workers' output. This would lead to higher earnings and make it easier to pay higher social insurance taxes if needed in the future to support Social Security and Medicare, he says.

Explaining the drop

Many explanations for the saving decline have been suggested, such as overspending and increased access to credit. However, Garner says much of the debate considers wealth effects on spending.

"Modern economic thought suggests saving and consumption depend on expectations about the future—expected future income or expected returns on stocks, bonds and other investments," Garner says. "Thus, economists assume current consumption and saving depend on expected future resources as well as current resources."

Right or wrong, this is the way Americans live, agrees Eric Seff, of Seff Investments Inc. in Albuquerque, N.M.

Seff is a long-time financial planner, specializing in spending- and investment-program development for his clients, who most often come to him for help tackling their debt, whether it's from student loans or spending beyond their means.

This concept of spending now because you will earn later has at least one major risk: "Emergencies do come up," Seff says, "whether it's a broken furnace or something medical. There's no cushion. There's nothing there at all."

However, economists traditionally have believed permanent-income and life-cycle views of consumption imply a dependable relationship between wealth and consumption for the economy as a whole.

Estimated life-cycle consumption implies a $1 increase in household net worth raises consumption by about 3 cents. Recent increases in

PHOTO BY JOSHUA LAWTON

JANEL WARD says rather than focusing on the debt she's accumlated from student loans, she thinks about her future career. "This is what I want to do in my heart," she says.

the stock market and home equity may have raised consumption relative to current disposable income and lowered the measured saving rate. Some argue that the overall decline in the personal saving rate since the mid-1980s is the result of capital gains on corporate stocks.

Estimates of the wealth effect on consumption are difficult to pin down empirically, Garner says.

Should we worry?

Although the personal saving rate may be revised upward in the coming years as data are further analyzed, the revisions would have to be exceptionally large to eliminate this downward trend, Garner says.

One factor in assessing the severity of the situation is the rising net worth of U.S. households, which is a sharp contrast to declining saving. Recent data estimate assets of households

Crunching the numbers

There are several issues in measuring the rate of Americans' personal saving that may alter its current–and negative–estimate, says Alan Garner, assistant vice president and economist at the Federal Reserve Bank of Kansas City. Coupled with rising net worth and expected income, revised calculations might mean the rate isn't as alarming as initially thought.

However, alternative measures of the national income and product accounts, or NIPA, saving rate generally do not eliminate the downward trend, Garner cautions.

For example, counting purchases of consumer durables as a form of saving raises the personal saving rate but it doesn't eliminate the downward trend. Neither does adding federal taxes on capital gains back into disposable income.

But possible future revisions, even if they are small, may gradually raise the saving rate. This has happened in the past, often decades later, and the revision can be substantial.

Published estimates from 1965 to 1999 were revised upward by about 2.8 percent. For the fourth quarter of 1981, the upward revision was 7.3 percent; the average revision for 1980-84 was 5.1 percent.

Garner says there is some evidence the NIPA revision may raise the personal saving rate. It is possible personal consumption expenditures may have been overstated, or income understated, which could return the personal saving rate to a positive–but still low–value.

and nonprofit organizations totaled about $64 trillion in 2005. Liabilities, which were mostly home mortgages and consumer credit, were about $12.2 trillion.

The growth of household wealth relative to income has been quite high. From 1980 to 2004, the average household net worth rose by about 34 percent of disposable income annually. Growth was volatile from year to year, ranging from almost a 72 percent gain in 1999 to a 22 percent decline in 2002.

"Weighing the long-run concerns may be more difficult than assessing the short-term risks to economic performance," Garner says.

Projected aging during the next several decades is unprecedented in our nation's history and may pose unexpected challenges. The best way to meet these challenges: more personal saving, say most economists and policymakers.

If you are in debt, Seff says, "The best strategy is to try to avoid more debt." He adds that developing good saving habits means first developing good spending habits. It's this simple approach that can raise the country's saving rate one person at a time.

Seff's advice: "Pay yourself first." Factors specific to the individual, such as age, income, debt and expenses, including children and their education, determine how much should be saved, he says.

Not so bleak

Sam Ceridon has lived a financially disciplined life, always budgeting and religiously saving for his golden years. Until now.

In fact, he's spent all the money—plus some—that he'd put away during his three most-frugal years working as an engineer, and has even cashed in his retirement fund.

As in Janel Ward's case, it's all gone toward tuition, but it's barely made a dent. Ceridon, only halfway through medical school at the University of Colorado, estimates his debt at $180,000. For someone who never carries a credit card balance, it's "terrifying," he says.

Rather than think of his debt as a

PHOTO BY JOSHUA LAWTON

MED STUDENT SAM CERIDON is willing to go into debt now and assumes his future salary as a physician will pay it off quickly.

liability, Ceridon considers it an investment in his future. He predicts his salary as an orthopedic surgeon will have him not only living debt free again in about 15 to 30 years, but also saving again.

Although they are incurring large debts, Ward and Ceridon also are building specialized knowledge that raises their future earning power. If such growth of the knowledge economy was fully incorporated in saving measures, the personal saving rate would likely rise and current high asset values would appear more sustainable. These assets could provide financial resources to meet future needs, and associated growth in productivity of firms and workers would create more output.

Meanwhile, short-term concerns are focusing on the possible decline in consumer spending, reducing demand and economic growth.

The personal saving rate could adjust upward gradually if consumption grows at a longer-term average rate while the growth rate of disposable income increases. This is consistent with a permanent-income or life-cycle theory of consumer behavior.

"If new information were to become available that disposable income is likely to increase faster in the future, households might immediately boost their estimates of permanent income, and would increase consumption accordingly," Garner says. "But if the income increases materialize as expected, consumption need not be adjusted further, and more rapid gains in disposable income would raise the measured saving rate."

Med students Janel Ward and Sam Ceridon know this to be true.

"A low personal saving rate," Garner says, "does not necessarily imply painful economic adjustments in the future."

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BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

SHOULD THE DECLINE IN THE PERSONAL SAVING RATE BE A CAUSE FOR CONCERN?
By C. Alan Garner
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Manufacturing a Survey

The Federal Reserve Bank *of* Kansas City goes to the source for data on the District

The best way to gauge manufacturers' recent changes in production, orders and inventories around the Tenth District is simple: just ask them.

Since 1994, the Federal Reserve Bank of Kansas City has surveyed manufacturers in the District, which is western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

Before the survey was conducted, little timely information had been available on regional manufacturing performance even though it is a major force in the District economy—accounting for 11 percent of output and 9 percent of employment.

The results are a valuable source of information not only about the District's manufacturing sector, but also for specific variables such as prices and capital spending, for which no independent data regionally exist.

Along with other regional surveys, the District's results also can play a key role in assessing the state of the national manufacturing sector.

Staff from the Oklahoma City Branch of the Federal Reserve Bank oversees the process, which is outlined here.

Did you know?

- The manufacturing survey is the Bank's primary source of timely regional information on several economic indicators, such as prices, production and capital spending.
- The Kansas City Bank is one of just five Federal Reserve Banks (Philadelphia, New York, Richmond and Dallas) that conducts manufacturing surveys.
- The first manufacturing survey conducted entirely online was in July 2001. During the years prior, surveys were conducted by mail.

TEXT BY BRYE STEEVES, SENIOR WRITER
ILLUSTRATIONS BY CASEY MCKINLEY, SENIOR GRAPHIC DESIGNER

1

Every other year, the Bank purchases a list of all manufacturers in the Tenth District. Based on size, industry and location, a sample of participants is then selected for a database of manufacturers to be surveyed.

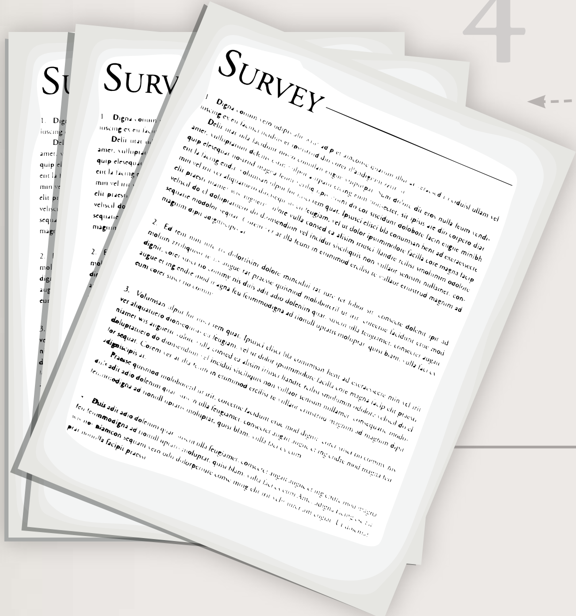
Manufacturing industries in the database are diverse, including food, machinery and computer producers. They range in size, from less than one hundred employees to more than 1,500, with annual sales less than $10 million to more than $500 million. There is geographic representation of all seven states in the District.

2

3

Links to a secure online survey are e-mailed to the manufacturers toward the end of each month. The survey includes 13 standard questions, as well as special questions relevant to current regional or national economic trends.

4



The Bank generally receives upward of 130 responses each month. Survey replies, which must be submitted online within four business days, are tallied by a website application developed by the Bank's Research Automation Department.

5

Bank staff then creates a report, which summarizes the findings for each major question. Changes in indicators, such as production, shipments, and prices of raw materials and finished products, are recorded.

6

On the last Thursday of the month, the report is distributed.

It's released to the media. Results are published and analyzed by regional and national media outlets, as well as various economic websites.

It's used in preparation for pre-Federal Open Market Committee meetings.

It's used by economists for research. Accumulated results also help identify the effectiveness of the survey.

PHOTO BY GETTY IMAGES

The changing nature of banking

As trusted financial intermediaries, banks have long served a unique role in the U.S. financial system.

"During the past 25 years, however, deregulation and technological innovation have dramatically changed the banking industry," says Esther George, senior vice president of the Supervision and Risk Management Division at the Federal Reserve Bank of Kansas City. "Competition is intense, resulting in evolving operations and expanded services and products."

George recently examined these changes and their effects on banks' current and future role. She presented her findings to the Federal Reserve Bank of Kansas City's board and the Bank's Denver, Omaha and Oklahoma City Branch boards of directors.

Historically, state regulations limited banks' ability to establish branches, and, in turn, limited customers geographically—they banked locally or within their state. Other regulations limited the services banks could offer.

As laws changed to accommodate more growth opportunities, the industry experienced heightened acquisition activity as banks merged and consolidated. Banks expanded their geographic footprint by buying other banks or opening new branch offices, and by using technology to reach more customers. As a result of these regulatory changes and technological innovations, banks have merged, consolidated and branched, offering one-stop shopping and an array of customer services.

"I think the big thing is the constancy of change, (and) the magnitude of change," says Bruce K. Alexander, president and CEO of Vectra Bank, a $2.4 billion bank in Denver.

Despite significant changes, many in the industry say there is at least one constant:

"Banks remain vital to both the economy and financial intermediation," George says. "And they will continue to be vital in the future."

An evolving nature

Size: Mergers and branches

The movement to statewide branching in the mid-1980s caused the number of banks to decline drastically as banks merged and consolidated.

"Although the number of banks in the Tenth District declined by roughly 50 percent in the past 25 years, the loss of a bank doesn't necessarily mean an area is no longer served by a banking office," George says. "Often, main offices of banks became branch offices of other banks."

The decline in the number of banks was offset by an increase in the number of bank branches, which more than doubled between 1980 and 2005.

Nationwide, mergers led to a decline in the total number of banks—from 14,414 in 1985 to 7,457 in 2005. The total number of bank offices, which includes both bank branches and head offices, increased by 60 percent to 78,505.

As new bank offices have flourished in the District, ownership of banking offices also shifted to out-of-state banking organizations. As late as 1990, most bank offices were owned by in-state banking organizations. However, by 2005, out-of-state banking organizations owned one-third of the banking offices in the District, putting District banks face-to-face with national competitors.

These mergers also resulted in substantially increased asset sizes for banks. By 2005, the average asset size of all U.S. banks was $1.2 billion, compared to $191 million in 1985, before branching laws were relaxed.

Industry assets are becoming more concentrated among a small number of large banks. In 2005, roughly 80 percent of the industry's assets were concentrated in just 53 of the largest banks with assets greater than $20 billion. These banks held $6.3 trillion of the industry's $7.9 trillion in combined industry assets.

Technology

Technological innovations are also changing the nature of banking and how banks serve customers. Similar to the growing number of bank branches, ATM deployment has grown rapidly through the years with nearly 400,000 machines in use in 2005. ATMs, bank branches and online banking not only increased the ways banks could reach customers, but also aided in attracting customers.

"It's these technological innovations in service delivery that have not only changed banking," George says, "but also largely shaped it."

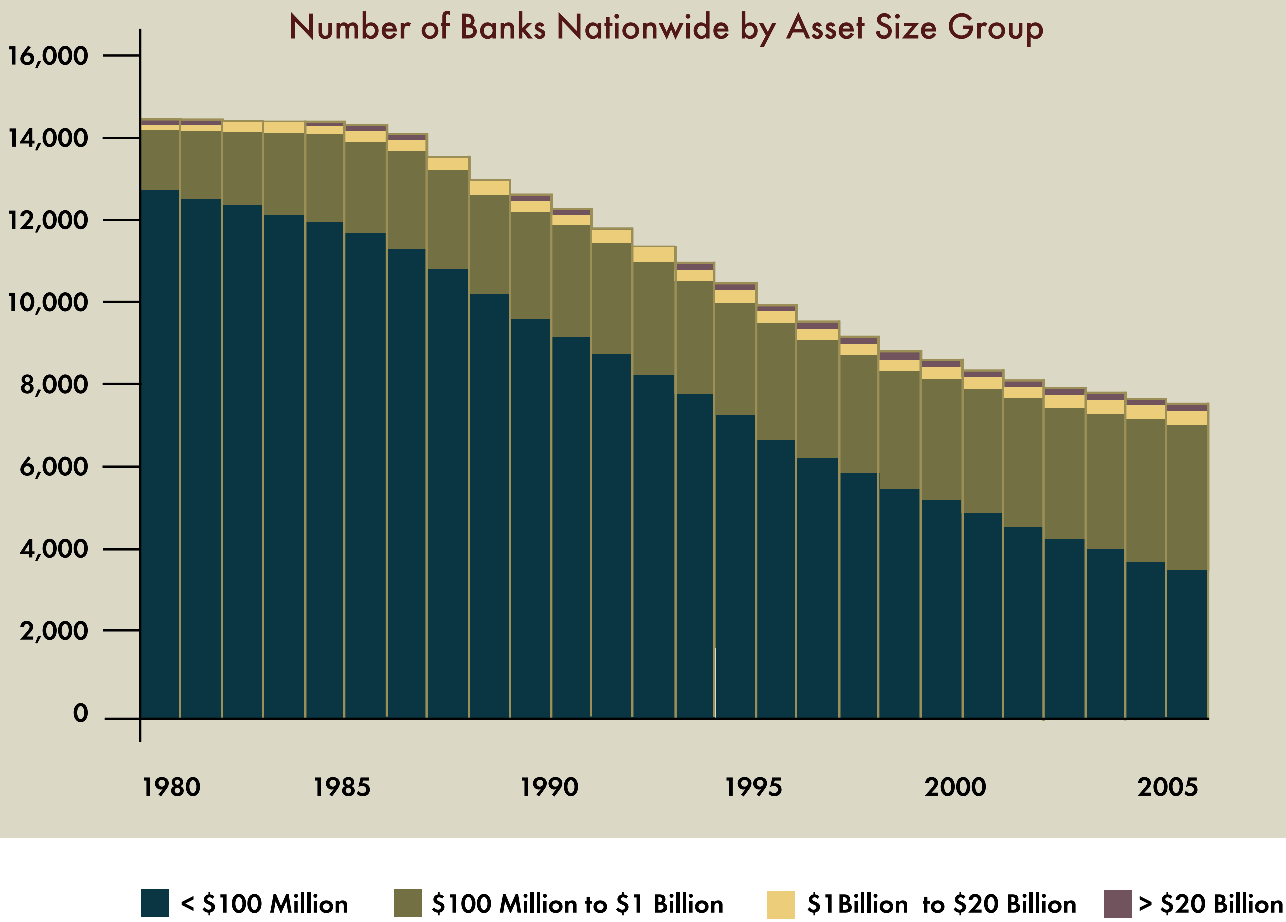
Although relationship banking may still be a part of today's business model, electronic banking technologies are reducing consumers' dependence on personal interaction. Today, customers can obtain many services without entering a bank—a growing percentage of households are using electronic banking while banking in person is leveling off.

"This is leading to increasing competition among banks, as both large national and community banks (those with less than $1 billion in assets) use technology to vie for loan and deposit customers," George says. "For consumers, this means more loan options and more investment opportunities."

Presidents of banks of varying sizes throughout the District agree technology has significantly impacted, as well as advanced,

"In the face of growing competitive pressures, banks still have a special role to play in the financial services industry."

Consolidation is Reducing the Number of Banks



Source: Reports of Condition and Income

customers' banking experience.

Dave Brownback, president and CEO of Citizens State Bank & Trust Co., a $60 million bank in Ellsworth, Kan., has seen the effects of technology, whether it be increased ATM deployment or more online usage.

"People can bank 24/7—that's the biggest change," Brownback says. "We're no longer a 9 (a.m.) to 3 (p.m.) organization. ... Technology has made our world smaller."

Mark A. Sutko, president and CEO of Platte Valley State Bank & Trust Co., a $390 million bank in Kearney, Neb., agrees technology is certainly advancing the banking industry, but says at the same time it is also raising costs in product expenses and data protection.

Competition

As financial service providers cross geographic and product boundaries, the competitive environment of banks is changing. Deregulation and technological innovation have allowed customers access to credit from many sources—not just banks—and more competitive rates for their savings.

Prior to these changes, most community banks viewed their strongest competitors as other community banks. This may no longer be the case as banks feel pressure from other competitors, George says.

Community banks face increasing competition from out-of-market financial service providers. Banks also face increasing competition for consumers' deposits and lending needs from nonbanks. These include brokerage and securities firms, farm credit lenders, and captive finance companies that are owned by automobile manufacturers, such as GMAC, and farm machinery producers, such as John Deere. As a result, consumers and businesses have greater access to new sources of credit and investment options.

Increased technology heightens competition as banks are challenged to attract new customers, Brownback says.

"You don't have to bank with the bank down the street," he says.

Sutko agrees, adding that competition means banks must place a greater emphasis on customer relations.

"There are more players to slice up the pie," says Sutko, who is also a director of the Omaha Branch of the Federal Reserve Bank of Kansas City. "To keep a competitive edge, you're constantly monitoring and updating."

Technological innovations are also affecting competition for loan customers. As banking industry assets have become concentrated in larger banks, these banks have gained an increased share of all consumer loans, while community and midsize banks have seen a decline.

In the past, community banks played a significant part in meeting consumer and home mortgage lending needs. However, technological advances have led to commoditization of consumer credit and provided large banks the ability to become the dominant providers. Large banks utilize more sophisticated modeling techniques to better analyze the risks associated with this type of lending.

Commoditization of consumer and home mortgage lending is changing the dynamics of customer and bank relationships.

Despite increasing competition, recent bank performance is sound.

"If you look at the last couple (of) years, banks have done well," says Vectra Bank's Alexander, who serves as a director of the Denver Branch of the Federal Reserve Bank of Kansas City. He attributes this to several factors, including a strong economy, managing costs and risks, strong loan growth, and low interest rates.

Constant amid change

"In the face of growing competitive pressures, banks still have a special role to play in the financial services industry," George says, "both as the intermediary to consumers and businesses, and in the regional and national economies."

Banks will continue to face stiff competition, market concentration and technological transformation. And, the regulatory environment will remain challenging.

A greater emphasis on regulations—and the new regulations themselves—requires increased manpower as well as expenses to comply, Sutko says.

As the nature of banking continues to transform, challenges will continue to arise. To meet these challenges, banks will need to be innovative, stay true to their niche and focus on improvements, Alexander says. Many agree banking will always be about developing relationships with customers, and offering good services and fair prices.

"Some things change," Sutko says, "and some don't."

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BY ERIC ROBBINS, POLICY ECONOMIST
& BRYE STEEVES, SENIOR WRITER

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Notes

Bank dedicates cornerstone

PHOTOS BY SCOTT INDERMAUR

FROM LEFT, Board Chairman Robert Funk, Bank President Tom Hoenig, Deputy Chairman Lu Cordova and First Vice President Rich Rasdall place the time capsule in the cornerstone after the dedication ceremonies in November.

FEDERAL RESERVE BANK OF KANSAS CITY officers and directors flank a graphic depiction of the new building's cornerstone.

The Federal Reserve Bank of Kansas City took the next step toward the completion of its new headquarters with November ceremonies dedicating the building's cornerstone and placing its time capsule.

Bank officers and directors took part in the brief ceremony held at the northeast corner of the new headquarters building, featuring comments from Robert Funk, chairman of the Bank's Board of Directors, and Dan Dillingham, director and chairman of the Bank's building committee.

In remarks to dedicate the cornerstone, Bank President Tom Hoenig recalled the words used by the Bank's first president, JoZach Miller, Jr., at a similar ceremony held in 1921 for the Bank's current headquarters at 925 Grand Blvd.

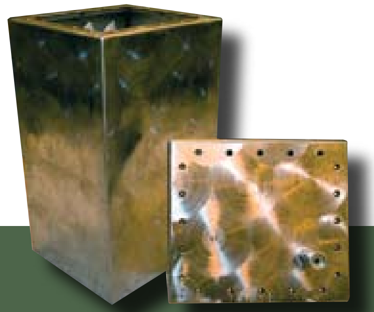
"We dedicate this cornerstone 'in the spirit of service and progress, and with a vision only to the welfare and progress of those who follow us,'" Hoenig said.

The midday ceremony followed a morning event where Bank officials filled a time capsule with items representative of the Bank's operations and work environment, ranging from a listing of all state member banks to a BlackBerry. Other items placed in the time capsule were representative of the Tenth Federal Reserve District, including a leaf from a Colorado aspen tree and a coin commemorating Oklahoma's centennial. The ceremony, held in the current Bank's lobby, was attended by employees and special guest, Jim Miller, whose grandfather was the Bank's first president.

For the Bank, the Nov. 16 ceremonies also marked two important anniversaries in its history: the 92nd anniversary of the Bank's opening and the 85th anniversary of the Bank's move into its current headquarters.

Construction continues on the 600,000-square-foot building at One Memorial Drive, with move-in scheduled for spring 2008.

IN ATTENDANCE at the time capsule ceremony was special guest Jim Miller, grandson of the Bank's first president, JoZach Miller, Jr., commemorated in this painting.



The Time Capsule

Speeches, events, programs

"Twelve Banks: The Strength of the Federal Reserve" speech Bank President Tom Hoenig delivered on Sept. 15, 2006

Annual report issue of *TEN* magazine

30th anniversary Economic Symposium program from 2006

April 2004 Issue of Omaha Views and News, featuring the story "Check Services: The End of an Era"

Aug. 2, 2005, special edition of Branching Out commemorating Oklahoma City Branch's 85th anniversary

90th anniversary booklet from Kansas City office's 2004 celebration

Nov. 16 time capsule and cornerstone event remarks and programs

Scroll containing signatures of employees who attended the 2006 time capsule ceremony

Photographs

St. Mary's Hospital in Missouri

The 925 Grand Blvd. building and Branch offices

The Kansas City skyline from Liberty Memorial

Management Committee

Chairman Ben Bernanke at the construction site of new headquarters in 2006

Items representing the Tenth District

Agricultural and mineral specimens

Commemorative state quarters from Tenth District states

List of state member banks as of Nov. 16, 2006

Nov. 16, 2006, issue of *Kansas City Star* newspaper

Oct. 10, 2003, *Kansas City Star* article about the new headquarters building

Items representing the Bank's current work environment, suggested by employees

2007 High Priority Objectives

Telephone directory of Supervision and Risk Management employees

Listing of current cafeteria prices

Cell phone

BlackBerry

NRAS computer token

Bank garage parking stickers

Keepsake bag of shredded currency given on Bank tours

Susan B. Anthony dollar

Sacagawea dollar

Single $1 and $100 notes

A substitute check

Timeline of Information Technology network history (1918-1980)

Bank President Tom Hoenig's employee badge

Items contributed by Bank Directors

Colorado aspen tree leaf

Giving Tree volunteer operation marketing piece

Oklahoma state legislative lapel pin

Soduko puzzle

Dillingham Insurance lapel pin

Wyoming cowboy lapel pin

Sheep ranching industry lapel pin

Grand National Quail Club lapel pin

Starbucks coffee cup sleeve

Nebraska state quarters

"Omaha In the Making of Nebraska Labor History" booklet

Photographs of the monument titled "Labor," a dedication to those who built the city of Omaha

Omaha Federation of Labor lapel pin

Armed Forces Bank commemorative coin

Uptown Partnership 2006 calendar of events

Oklahoma centennial coin

Susan B. Anthony dollar

A penny

Express Personnel commemorative coin and stuffed Angus cow

Items from Bank clubs

List of all District employees as of Nov. 16, 2006

25 Year Club lapel pin

25 Year Club member directory as of Nov. 16, 2006

Community Affairs focuses on asset building

As part of a conference on asset building—and a larger commitment to its study and development—the Federal Reserve Bank of Kansas City co-hosted a session on Native American asset building last fall in Arizona.

Staff from the Bank's Community Affairs Department partnered with First Nations Development Institute and First Nations Oweesta Corporation to host "Perspectives on Successful Native Asset Building."

The panel of speakers included: Michael E. Roberts, president of First Nations Development Institute; Tanya Fiddler, executive director of the Four Bands Community Fund; and Manley A. Begay, Jr., director of Native Nations Institute at the Udall Center for Studies in Public Policy at the University of Arizona and co-director of the Harvard University Project on American Indian Economic Development. They focused on governance and the effective delivery of programs.

"The asset-building field covers the core focus areas of the Community Affairs Department: financial education, affordable housing, entrepreneurship and small business development," says Paul Coquillette, Community Affairs officer and assistant vice president. "Why does the Federal Reserve System care about these things? Because asset building by individuals and families contributes to economic development, and programs that encourage financial literacy have the potential to improve the effectiveness of financial markets."

TRUDIE HALL of the Bank's Public Affairs Department was among the presenters during the 20/20 Leadership Program the Bank recently hosted for area high school students.

20/20 Leadership Program puts the Fed in focus for youth

For the first time, staff from the Federal Reserve Bank of Kansas City recently hosted workshops for more than 100 high school students as a part of the 20/20 Leadership Program that targets area juniors and seniors.

Bank staff spoke about leadership, careers, and the importance of education or training in relation to income, budgeting, decision-making, savings and credit. The students also learned of Bank-sponsored competitions available to them throughout the year. The Bank's commitment to economic and financial education will continue through the facilitation of additional workshops for area students in the future.

The 20/20 Leadership Program provides experiential education for juniors and seniors from 24 schools in Kansas and Missouri. The goal is to increase student awareness about real-life issues while improving aptitude and achievement levels. The program, which began in 1993, exposes students to government, economics, health, entrepreneurship, social services, media and more.

For more information about the Bank's involvement in economic education, go to www.FederalReserveEducation.org.

Registration for Fed Challenge now underway

Teams of high school students from around the Tenth Federal Reserve District can register for the 2007 Fed Challenge until Feb. 23.

The academic competition provides an insider's view of the Federal Open Market Committee (FOMC) decision-making process and promotes a better understanding of economics. Scholarships, grants, awards and the chance to compete nationally in Washington, D.C., are at stake.

"Fed Challenge stirs an interest in economics, business and finance that goes beyond high school years," says Gigi Wolf, economic education specialist at the Federal Reserve Bank of Kansas City.

Competitions will be held locally at students' nearest Federal Reserve Bank Branch office on March 28 or 29, regionally at the Kansas City office on April 17, and nationally May 19-21.

STUDENTS FROM EISENHOWER HIGH SCHOOL, Lawton, Okla., were among the participants in the 2006 Regional Fed Challenge hosted by the Federal Reserve Bank of Kansas City. The team won the local competition hosted by the Bank's Oklahoma City Branch to be one of four schools competing in the regional contest.

For more information and to register online, go to www.KansasCityFed.org/FedChallenge/challengemain.htm.

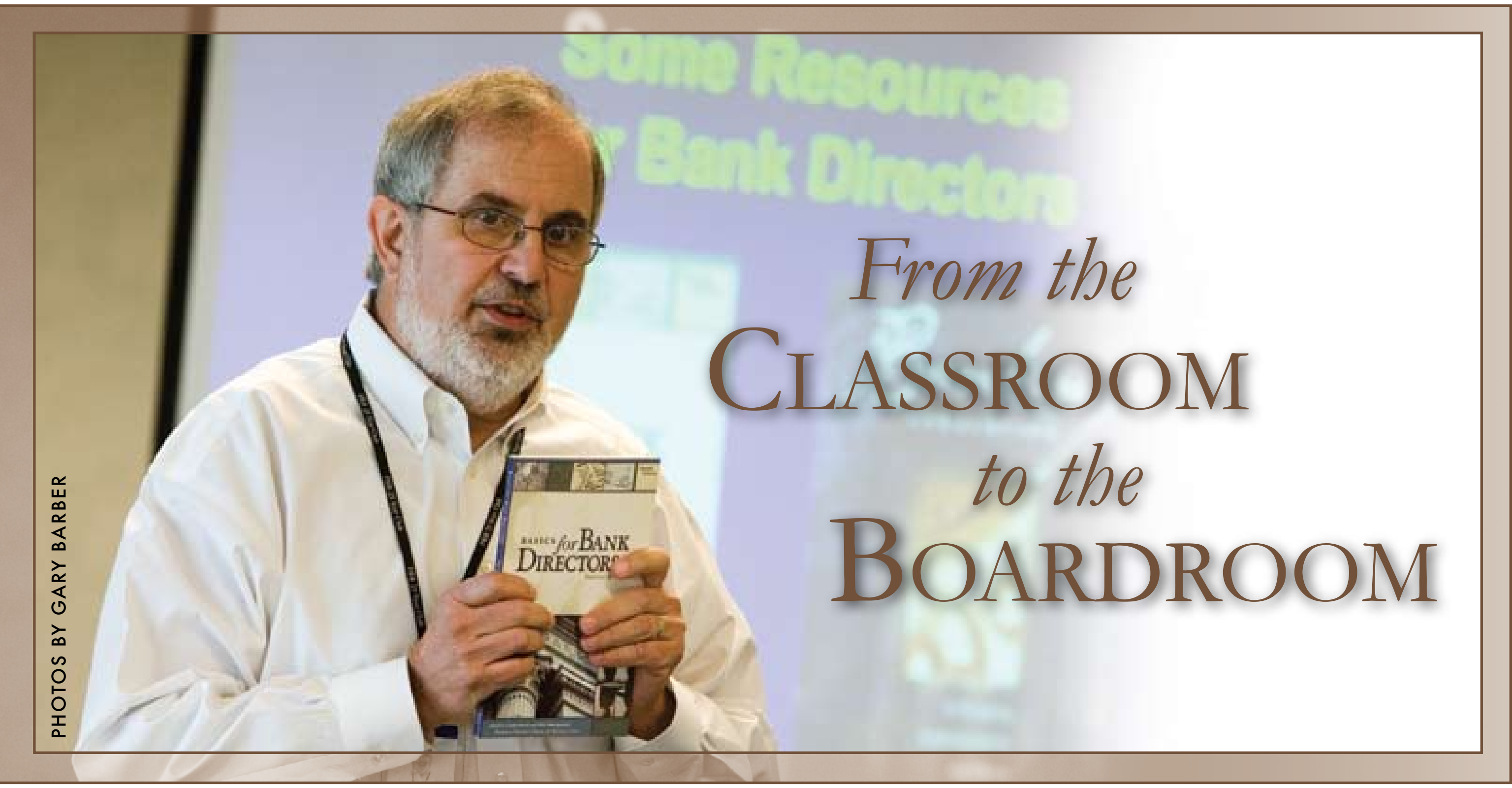
The following banks in the Tenth District are celebrating one, five, 10, or 20 or more years as Federal Reserve members during the first quarter.

Colorado B&TC of La Junta	La Junta	Colo.	83
Lusk State Bank	Lusk	Wyo.	73
St. Marys State Bank	St. Marys	Kan.	71
First Community Bank	Taos	N.M.	69
Community B&TC	Neosho	Mo.	65
Bank of Holden	Holden	Mo.	62
Colorado Mountain Bank	Westcliffe	Colo.	28
Bank At Broadmoor	Colorado Springs	Colo.	27
First State Bank	Wheatland	Wyo.	26
Freedom Bank of Oklahoma	Tulsa	Okla.	15
Solutions Bank	Overland Park	Kan.	5
Butte State Bank	Butte	Neb.	5
Bank 2	Oklahoma City	Okla.	5

Compiled By TEN Staff

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org

About...



PHOTOS BY GARY BARBER

From the Classroom to the Boardroom

The seasoned directors of the Community Bank of Raymore, Mo., and the new directors from the nearby just-opened Community Bank of Pleasant Hill recently found themselves together in the classroom.

The boards, whose banks have some common ownership, both needed training, whether a refresher course or an overview of the basics, says Jack D. Hopkins, president of the $101 million Raymore bank.

"We were looking for a common basis of knowledge," Hopkins says.

A one-day training session met this goal, he says. As part of its proactive approach to supervision, staff from the Federal Reserve Bank of Kansas City presented its on-site course designed to meet bank directors' supervisory needs.

Attendees left the session with a common understanding of their duties, further knowledge of the banking industry and a heightened comfort level with their roles, Hopkins says.

This, in turn, helps individual banks as well as the industry as a whole, says Forest Myers, a policy economist in the Supervision and Risk Management Division of the Federal Reserve Bank of Kansas City.

"When directors are active and effective in their oversight role," Myers says, "banking problems are often avoided or spotted early—when they are easier to resolve."

Lesson plans

Myers writes materials and leads the development of online and on-site courses for directors to help them better understand banking and identify problems at their institutions.

The courses replicate a bank board meeting. The goal is to prepare directors for discussion, prompt them to ask questions as well as walk them through fundamentals that nonbankers may not know.

- "Insights for Bank Directors" is an online course primarily for new directors. It offers tools and reference materials for improved management oversight, and includes information about basic financial analysis as well as the control and monitoring of credit, liquidity and market risks. Exercises and quizzes reinforce these points. Myers recently led an update of the course to emphasize the roles and responsibilities of directors.

- "Basic Training for Bank Directors" is a six-hour, on-site version of the "Insights for Bank Directors" online course. It provides bank directors with basic tools to better identify problems and ask questions about the management of their bank. This is the course the Raymore and Pleasant Hill boards attended.

- The "Basics for Bank Directors" book acquaints directors with banks and their supervision. It details the purpose of regulation while highlighting compliance pitfalls. It discusses and shows red flags in bank capital, asset quality, management, earnings, liquidity and sensitivity to market risk. The book is the basis for the online and on-site courses.

Because information is changing and evolving, Myers periodically updates these materials to include changes in regulations and supervisory policy, for example. Additionally, a website portal will be launched in the spring that will serve as a doorway to information useful for management oversight. It includes descriptions of available information. This type of assistance makes the portal somewhat unique.

"The portal is engaging and not intimidating," Myers says. "It's a way to help directors be better at their job."

Meeting banks' needs

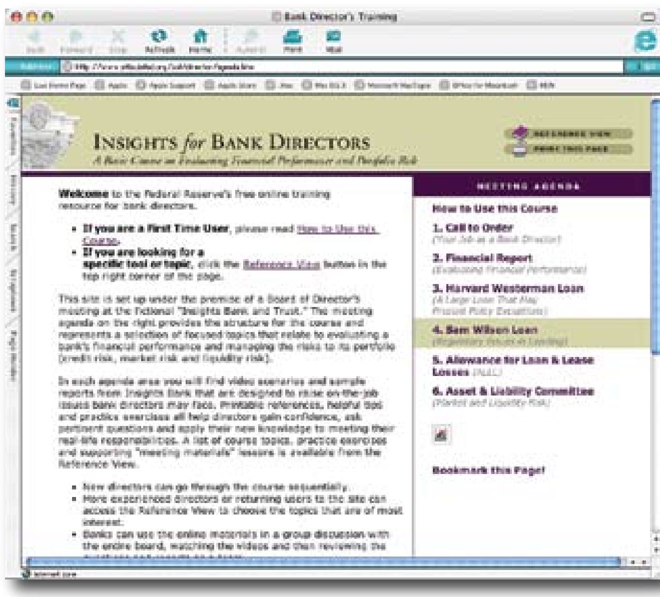
The information is free, and Myers and his colleagues facilitate on-site education throughout the Tenth Federal Reserve District, which includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

Several directors and staff members at Main Bank, a $40 million bank in Albuquerque, N.M., recently invited Myers to present materials during a one-day seminar.

Bob Croft, Main Bank senior vice president and chief credit officer, thought it would be valuable to board members, many of whom are area business leaders but new to the banking industry. Others had no prior bank board service experience.

"We were quite pleased with the presentation," Croft says.

Most beneficial, he says, was the reinforcement of the need for directors to ask questions and be more involved.



THE RECENTLY UPDATED ONLINE COURSE includes basic information, plus exercises and quizzes to reinforce these points.

DIRECTORS FROM TWO BANKS in western Missouri attended a one-day course, developed and administered by the Federal Reserve Bank of Kansas City as a proactive approach to bank supervision.

"It already has affected the bank," Croft says. "We would anticipate further training opportunities, and look forward to them."

Recently, Myers and his colleagues also presented a one-day seminar at Community Bank, a $160 million bank in Santa Fe, N.M.

Board members attended a refresher course with a focus on judging risk and assessing the effectiveness of risk management. Directors were able to relate the information to their bank, and more specifically to the banking needs in a tourism area, says Sharon James, senior vice president of operations and human resources director.

"That's what we were trying to accomplish," James says. "It was extremely informative."

Award-winning work

Myers' development of director training materials earned him national recognition in the fall when he received the William Taylor Award for Excellence in Bank Supervision.

Myers was one of four Federal Reserve employees recognized at a ceremony in Boston, where he was presented the award. He was honored again shortly thereafter among his colleagues at a reception in Kansas City.

During the latter, Bank President Tom Hoenig congratulated Myers on what he called an "extraordinary accomplishment."

The William Taylor Award is given annually to only a few of the nominees who work in the bank supervision and regulation area of the Federal Reserve.

It is the System's highest and most prestigious honor in bank supervision, in memory of a man who dedicated his life's work to financial regulation, first as an examiner at the Federal Reserve Bank of Chicago and ultimately as the chairman of the FDIC.

"Forest Myers' work not only exemplifies the precedent Taylor's past efforts have established," Hoenig says, "but also meets the needs of community bankers today."

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

"INSIGHTS FOR BANK DIRECTORS"
"BASIC TRAINING FOR BANK DIRECTORS"
"BASICS FOR BANK DIRECTORS"
By Forest E. Myers
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

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The Federal Reserve System

Congress created the Federal Reserve in 1913 to bring financial stability after a number of banking panics. It is the nation's third central bank. The first, established in 1791, and the second, created in 1816, were each operational for 20 years. In both cases, its charter failed to be renewed and the banks closed.

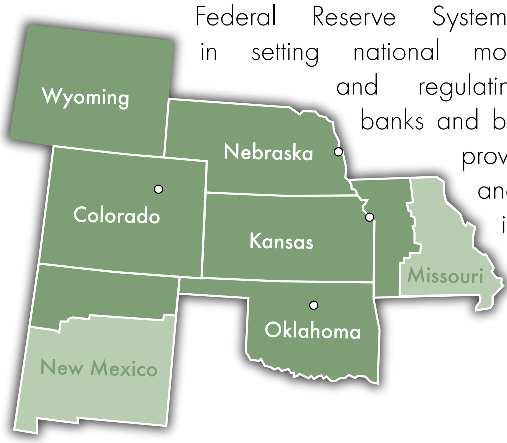
With the Federal Reserve Act, Congress sought to create a central bank the public would be more likely to support by making it "decentralized" with more local control. This new structure was designed to overcome one of the primary weaknesses of the previous central banks: public distrust of an institution that many felt could potentially be under the control of either government or special interests. The new central bank is a network of 12 regional Federal Reserve Banks, located throughout the country and under the leadership of local boards of directors, with oversight from the Board of Governors in Washington, D.C., a government agency.

The Federal Reserve is considered to be independent within government and broadly insulated from political pressures. While members of the Board of Governors are nominated by the president of the United States and confirmed by the Senate, the Federal Reserve's regional structure, including local boards of directors and advisory councils, ensures that views from a broad spectrum of the public nationwide contribute to the central bank's deliberations.

President Woodrow Wilson signed the Federal Reserve Act on Dec. 23, 1913, and the 12 regional Federal Reserve Banks opened on Nov. 16, 1914.

The Federal Reserve Bank of Kansas City

The Federal Reserve Bank of Kansas City and its Branches in Denver, Oklahoma City and Omaha serve the Tenth Federal Reserve District, which encompasses western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico. As a part of the Federal Reserve System, the Bank participates in setting national monetary policy, supervising and regulating numerous commercial banks and bank holding companies, and providing check processing and other services to depository institutions.



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The views and opinions expressed in **TEN** are not necessarily those of the Federal Reserve Bank of Kansas City, the Federal Reserve System, its governors, officers or representatives.

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