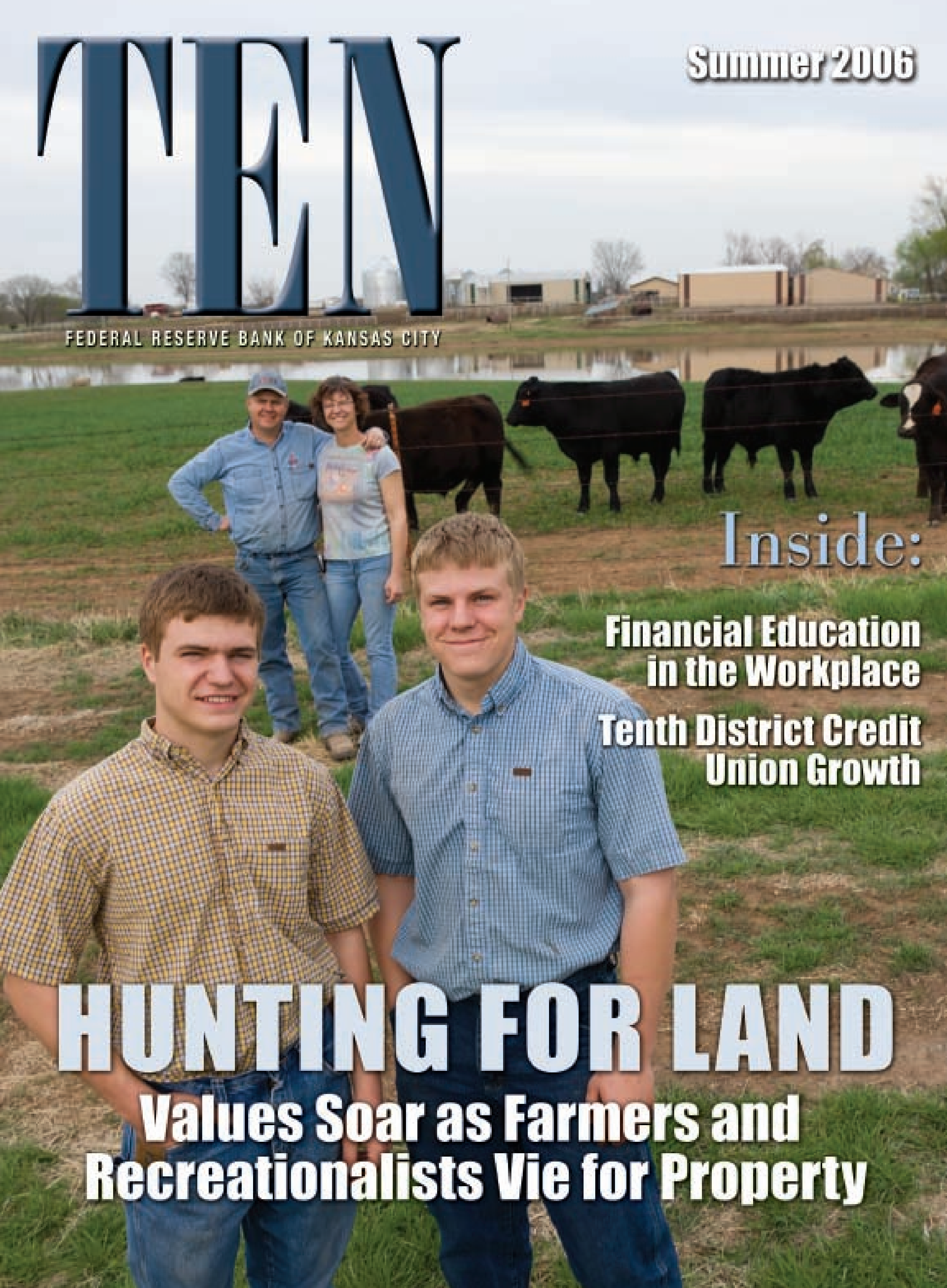

TEN
Summer 2006
FEDERAL RESERVE BANK OF KANSAS CITY
Inside:
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Tenth District Credit Union Growth
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Financial Education

Factors such as productivity gains or changes in raw materials costs are often mentioned in discussions about the national economy. The United States has a very diverse economy, and these items, along with innumerable others, are often cited to help paint a picture of our nation's financial condition or offer some suggestion of what the future may hold.

It is important to remember, however, that the factors influencing our national economy extend beyond what is captured in business and industry data. Similarly, maintaining a strong economy also involves more than simply maintaining a favorable business environment. Much of any economy's strength rests on one of its most basic components: financial decisions made by consumers.

Consumers are now faced with an increasingly complex set of choices in financial products that was perhaps unimaginable only a few years ago. Meanwhile, credit card debt has more than doubled over the past decade, and while consumers may be seeing their incomes rise, many are choosing to spend, rather than save, their increased earnings.

The importance of financial education is clearly rising. Research within our own Bank has suggested financial education might be able to change some of the recent trends. The study found that individuals with greater financial knowledge tended to have lower credit card balances relative to their credit limits and more adequate emergency funds.

There are also indications that providing financial education to employees can help businesses improve the productivity of their workers. Simply put, the stress caused by financial concerns at home can hamper performance in the workplace. Increasing numbers of businesses are recognizing the benefits of offering employees financial education programs and are seeing results. You can learn more by turning to Page 12.

In connection with our Bank's commitment to economic education, I am pleased to tell you that once again the Bank hosted its annual Fed Challenge competition. In these contests, teams of high school students facing a panel of judges act as the Federal Open Market Committee, analyzing the economy and determining the stance of monetary policy. A photo of our District's winning team from Boulder, Colo., appears on Page 22.

Meanwhile, our Bank recently sponsored the first of what we expect will become an annual student essay contest focused on economics. You can learn more about the contest, and this year's winner, Kimberly Logue of El Dorado High School in El Dorado, Kan., on Page 23.

Finally, I am pleased to say that several of our employees visited local classrooms this past spring to help students in the first through third grades learn the value of money management as part of Teach Children to Save Day. It was inspiring to see how inquisitive the children are about money and saving. The types of questions they asked make it clear that it is never too early to begin learning about how to make sound financial decisions.

To see more of the Federal Reserve's commitment to financial education, visit www.FederalReserveEducation.org. There you will find a number of tools suitable for any age group. Numerous links on the website offer an opportunity to learn more about personal financial education, economics and the Federal Reserve.

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

PHOTOS BY JASON DAILEY

INCREASED COMPETITION:

CREDIT UNION GROWTH CONCERNS BANKS — MORE EXPANSION IS LIKELY

When Kip Unruh decided to refinance one of his small businesses, Star Storage Inc. in Grandview, Mo., the first thing he did was shop for lenders.

"It was a million-dollar loan," Unruh says. "So I did my homework."

He began his search the way any small business owner would, by visiting a handful of area banks and comparing their rates and terms. In the end, though, his most attractive offer wasn't from a bank but a local credit union—a business-lending option Unruh didn't even realize he had until reading an article in a trade publication.

During the past few years, the once-inconspicuous credit unions have been expanding lending services and attracting small business owners like Unruh.

Recently liberalized membership requirements and expanding lending services are spurring credit union growth—and increasing competition with banks, says Eric Robbins, a policy economist at the Federal Reserve Bank of Kansas City, who researched how regulatory changes have affected credit union growth in the Tenth Federal Reserve District.

"As credit unions have expanded their customer base, they also have been able to grow their deposits and assets more rapidly than banks," Robbins says.

Credit unions say this expansion doesn't infringe upon banks' business, but increases competition. Banks argue that this is an encroachment aided by unequal regulatory treatment. Both entities agree, however, that credit union membership will increase as a result.

"Although most credit unions are small, they still may provide significant competitive pressure for Tenth District banks, which also tend to be small," Robbins says.

Turning up the competition

In addition to home and auto loans, many Tenth District credit unions, such as Mazuma Credit Union in Kansas City, Mo., now are offering small business loans.

Although it's "a shift in the way we do business," it's what many of their 51,000 members—and countless potential members—want, says Russ Dalke, Mazuma Credit Union vice president of finance.

"We've been hearing that for a few years," Dalke says. "We thought, 'Hey, we need to get on this.'"

As credit unions begin to compete with banks in small business lending, research shows banks are increasingly concerned about credit union growth. Almost half of the community banks in the Tenth District surveyed by the Federal Reserve Bank of Kansas City in 2004 said they expect "very intense" or "intense" loan competition from credit unions during the next five years.

"Banks may be concerned because credit unions are entering a segment of the lending market in which they were not previously involved," Robbins says. "In addition, business lending by credit unions is increasing, and the small business loans provided by credit unions likely would have been obtained from a bank in the absence of credit union competition."

While the percentage of business loans from credit unions tripled during the last four years, roughly 81 percent of federal- and state-chartered credit unions reported no business lending at the end of 2004, according to Robbins' research.

For most community banks, business loans are an important part of their lending portfolios. Community banks (those with assets less than $1 billion) account for about 37 percent of all small business lending. And these loans are about 19 percent of community banks' assets.

Although an increasing number of credit unions are pursuing business lending as a new source of income, the total lending by credit unions is still small compared to banks.

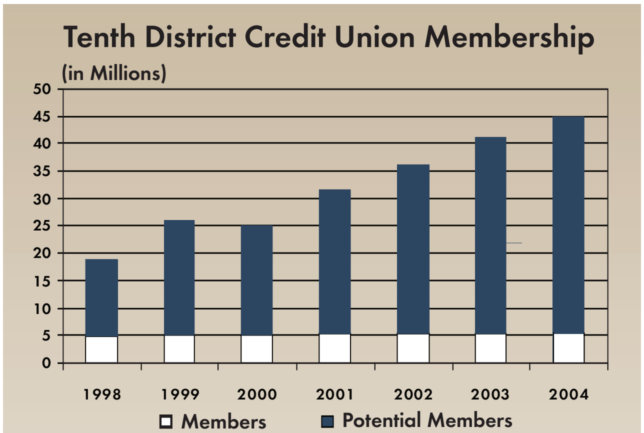
Still, Dalke acknowledges banks may feel threatened by credit unions' expansion into small business lending, but thinks it's unnecessary because credit unions are generally much smaller than banks. This is not a matter of one entity beating out another, but offering the customer more choices, he says.

EARLIER THIS YEAR, Kip Unruh (pictured left) obtained a loan for his storage facility from a credit union in Missouri. Many credit unions nationwide are expanding services and offering small business loans.

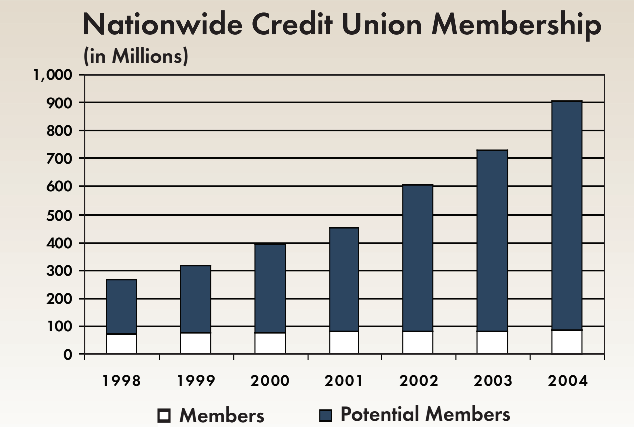
"You would hope they (banks) would look at this as competition—that's what capitalism is," Dalke says. "I want them to view it as a challenge."

Rob Gilbert, president of the Tulsa-based F&M Bank, says banks are certainly challenged by credit unions' growth. It's not just the expansion into small business lending, but the "uneven playing field" from which credit unions and banks compete for customers, he says.

"I truly believe we should all be on the same page," says Gilbert, who is also a member of the Board of Directors of the Federal Reserve Bank of Kansas City's Oklahoma City Branch.



The Tenth District includes: western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico



SOURCE: NCUA 5300 Call Report Data

The differences

When credit unions first migrated from Europe to the United States in the early 1900s, they were cooperatives that provided loans by pooling members' resources. The goal was to give credit to individuals who couldn't obtain financing through mainstream institutions.

Because they originated as nonprofits to serve those with modest means, credit unions have enjoyed exemption from most of the state and federal taxes that banks must pay. This means credit unions often are able to offer customers better deals than banks, such as fewer fees for services like ATM use and checking accounts.

Banks argue credit unions have deviated from their original mission but still reap the benefits enacted to support that mission.

"This notion of providing credit to those of small means as the primary purpose of credit unions has been a lightning rod to banks as credit unions expand lending and deposit services to a wider audience," Robbins says.

Unlike banks, there are no laws that require credit unions to prove whom they serve or in what capacity their members may be served. Credit unions aren't affected by the Community Reinvestment Act, which requires banking and thrift institutions to help meet the credit needs of their communities.

Furthermore, recently liberalized membership requirements have allowed credit unions to expand their membership. Banks charge that these regulatory differences further assist credit union growth as well as mission deviation.

In their early years, credit unions had a customer base more narrowly defined by membership. For example, federal credit unions were required to choose from three types of membership fields based on a common bond of association (such as fraternal or religious groups), occupation or community. These limitations were thought to be the best way to encourage borrowers to repay debts because of the common bond with other credit union members.

During the early 1980s, an increasing number of credit unions ran into financial difficulty, and in response, the government relaxed membership restrictions to help credit unions remain viable. The National Credit Union Administration, which regulates federal credit unions, altered the interpretation of common bond requirements to allow occupational and associational groups

Credit Union Member Business Loans (in millions)

	Total Loans and Leases	Agricultural Loans	Total Business Loans	Business Loans as a Percent of Total Loans	Increase in Business Loans 2000-2005
CREDIT UNIONS IN TENTH DISTRICT STATES					
2000	19,384	47	130	0.7%	529%
2005	26,902	79	818	3.0%	
ALL CREDIT UNIONS					
2000	305,261	599	4,817	1.6%	299%
2005	467,608	999	19,215	4.1%	

SOURCE: NCUA 5300 Call Report Data

to combine under one federal credit union charter, known as a multiple common bond charter. As a result, credit unions could increase the number of potential members within their fields.

"While this expansion of membership fields may have resulted in the improved financial condition of credit unions," Robbins says, "it also may have caused increased competition between banks and credit unions."

Gilbert of F&M Bank says, "It's just not right," adding that credit union growth is assisted by these advantages, leaving banks to "just compete with them as best they can."

Overall, credit unions' earnings lag behind those of banks, despite these advantages, according to Robbins' research. Also, credit unions do face restrictions that banks don't.

Although membership definitions have broadened, they still are restrictive. Membership fields have been redefined, but federally chartered credit unions must still choose from among three types: single common bond (such as occupational), multiple common bond or community charter.

In addition, credit unions cannot issue stock to increase capital. Capital growth is achieved through retaining earnings from year to year. Also, credit unions' total business lending portfolios cannot exceed 12.25 percent of their total assets.

Expanding into the future

Increased business lending and membership growth may lead to continued expansion of the credit union industry. While credit unions have consolidated during the last several years, as have banks, credit union membership has increased overall.

Credit unions in the Tenth District reported 4.9 million members in 1998—the year membership restrictions were expanded to allow multiple common bond credit unions. By 2005, membership increased more than 10 percent to 5.4 million members. As credit unions have switched to more expansive fields of membership, the number of potential members has increased even more significantly—by 157 percent in the Tenth District.

Credit unions' earnings generally appear to be less than banks', and most credit unions are smaller in size. But, nationwide credit union asset and deposit growth is higher than banks'. During the last decade, credit unions' asset and deposit growth increased by an annual compound rate of 8.4 percent and 8.1 percent, respectively. Commercial banks averaged 7.7 percent and 6.9 percent, respectively.

"Competition will likely continue to increase as more credit unions expand their fields of membership and enter the business lending market," Robbins says.

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

CREDIT UNION GROWTH IN THE TENTH DISTRICT,
BY ERIC ROBBINS
www.KansasCityFed.org/TEN

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

After building his small enterprise from scratch the past 20 years, John Hutto wants to further expand the family farm now that his two sons are nearly ready to join the business. There's just one problem.

Hutto keeps getting outbid.

Although he's willing to pay even more than the already high asking prices for acreage near his farm in rural southeast Kansas, his offers get trumped—but not by other farmers.

"Every property seems to have someone who wants to hunt on it, fish on it or build a house on it," Hutto says. "We just can't compete."

During the last few years, farmland values around the nation have been booming. While this increase in value may be advantageous for long-time landowners, soaring values make purchasing land difficult for new farmers or those wanting to expand, says Nancy Novack, an associate economist with the Center for the Study of Rural America at the Federal Reserve Bank of Kansas City.

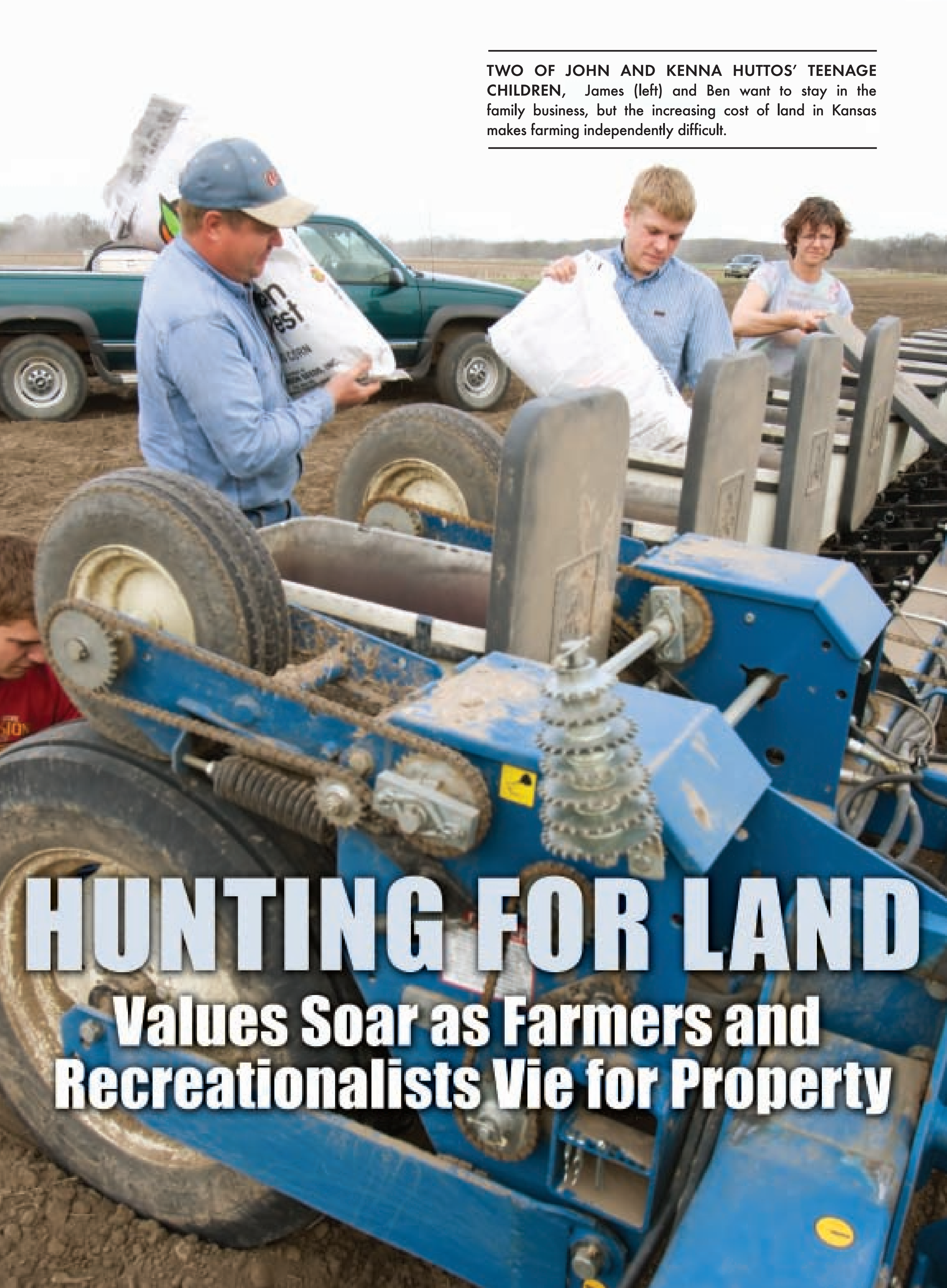
Novack recently researched surveys of agricultural credit conditions conducted by several Federal Reserve Banks. The surveys targeted areas around the country that account for the majority of the nation's agricultural cash receipts, including the Tenth Federal Reserve District.

Last year, farmland values around the country saw their highest increase in a one-year period since 1981. Farmland in the Tenth District jumped an average of 10 percent to about $820 per acre, according to the U.S. Department of Agriculture's Land Values and Cash Rents 2005 Summary. This increase was in line with the nation's 11 percent hike. Around the country, land averaged $1,510 per acre, according to the USDA.

Gains in quality farmland in major agriculture areas ranged from 7.2 percent to 17.4 percent in late 2005, according to the

PHOTOS BY SCOTT INDERMAUR

TWO OF JOHN AND KENNA HUTTOS' TEENAGE CHILDREN, James (left) and Ben want to stay in the family business, but the increasing cost of land in Kansas makes farming independently difficult.



HUNTING FOR LAND

Values Soar as Farmers and Recreationalists Vie for Property

Federal Reserve surveys. Ranchland values continued to post double-digit gains in many areas. And despite high energy prices, irrigated farmland values remained solid, according to the surveys.

Driving values upward are: strong farm income, tax advantages, low interest rates and an increasingly high demand for nonfarm use of land.

"A variety of factors are influencing these gains, depending on the location of the land," Novack says. "But nonfarm demand has emerged as a dominant force."

Setting the scene

Bob Kahnk doesn't know much about the corn crops growing on a portion of his land in Anselmo, Neb. Kahnk isn't a farmer, but rather a doctor who recently purchased almost 600 acres of farmland with a business partner, Ted Brown. Kahnk hopes claiming a stake in central Nebraska will benefit his pocketbook and enhance his family's free time.

"There's only so much land, so it's a good investment," he says. "And certainly recreation is a big part of it."

Kahnk was looking for a safe, long-term venture, as well as a way to spend time outdoors with his three young sons hiking and hunting the turkey, deer, pheasant and quail there. He leases out about 50 acres to a local farmer and eventually may lease the remaining pastureland to urbanites looking for a hunting getaway.

"It certainly has the potential to cash out," Kahnk says. "That would be nice."

This is quite possible, says Troy Langan, manager of the Hunting Lease Network, an Omaha-based company that leases recreational land around the country.

Landowners, many of whom are farmers, realize that renting portions of property to hunters is a lucrative way to supplement their income, Langan says. The Hunting Lease Network, which acts as the middleman between the landowner and hunter, has seen rapid growth in business in the past few years. Nationwide, hunting, fishing and other outdoor activities are becoming increasingly popular, especially among those who don't live near wildlife or undeveloped land. These urbanites are willing to pay large amounts to enjoy outdoor recreation—whether it's buying the land themselves or leasing it from others.

In addition to recreational use, other conditions also have fostered the boom, Novack says. In 2004, net farm income set a new record high. Although incomes retreated somewhat in 2005, they were still the second-highest on record. Healthy crop receipts, continued government payments, strong cattle prices and widespread drought relief aided the boost in incomes.

Several factors have triggered land purchasing, according to Novack's research. The volatility of the stock market in recent years has left investors looking for a safe place to grow their money. Low interest rates and tax benefits have added support for increased land values. Mortgage rates for farmland purchases have been at historic lows in recent years. But the steady rise in short-term interest rates

BOB AND JANEEN KAHNK bought farmland in central Nebraska in part for recreational use. They spend most weekends there with their sons (from left) Riese, 2; Cole, 8; and Jared, 5.

during the past two years, as well as stronger stock market performance recently, could somewhat offset this, Novack says.

Tax benefits are another incentive. Tax-deferred exchanges under section 1031 of the tax code allow property owners to sell land and delay capital gains taxation, if similar property is purchased. Farm real estate brokers report that such exchanges often occur at strong prices, in part because tax code rules give buyers a short time span to complete the purchase.

Implications

Soaring farmland values are favorable for some and pose challenges for others, Novack says.

For many older landowners, their farmland is their retirement, and the stronger the gains, the better. The boost in equity for landowners with debt on their properties is welcomed by bankers. However, bankers also realize new loans for land at high prices are risky and often cannot be serviced with farm income alone. Granting loans for land that may not be used solely for farming adds a new challenge for lenders.

Farm credit conditions are solid, and two years of strong incomes helped improve farm loan portfolios. Repayment rates on farm loans have risen in the past few years, according to the Federal Reserve surveys. And the number of requests for renewals or extensions on farm loans also has improved; most bankers reported less requests.

Although overall debt levels have been on the rise in recent years, farmers seem to be in a favorable position to service this debt, Novack says. Another indication of strong farm finances is the low debt-to-asset ratio.

Meanwhile, high prices make it difficult for those wanting to enter or expand the farming business. There are barriers, especially for young farmers with limited credit histories.

Farmland Value Gains

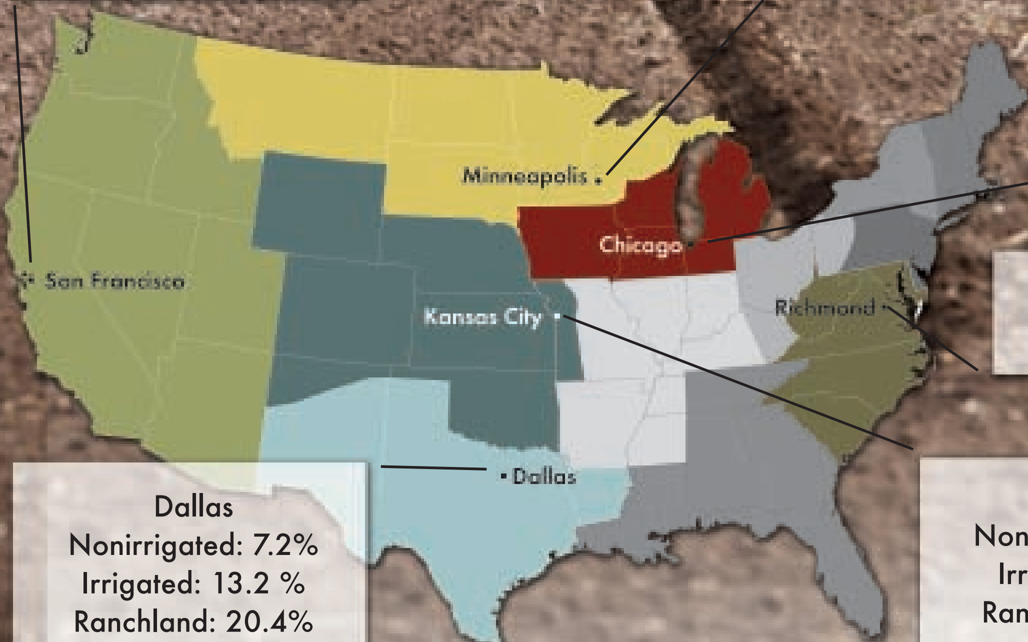
FEDERAL RESERVE DISTRICT AGRICULTURAL CREDIT SURVEYS

San Francisco *
Nonirrigated: 17.4%
Irrigated: 15.5 %
Ranchland: 1.8%

Minneapolis
Nonirrigated: 15.5%
Irrigated: 12.5 %
Ranchland: 16.4%

Chicago
All 10.0%

Richmond *
All 57%



Dallas
Nonirrigated: 7.2%
Irrigated: 13.2 %
Ranchland: 20.4%

Kansas City
Nonirrigated: 9.2%
Irrigated: 6.1 %
Ranchland: 12.5%

Federal Reserve Banks in half of the 12 Districts recently surveyed agricultural bankers for insight into agriculture credit conditions. The percent changes in land values were measured from the end of the fourth quarter of 2004 through 2005. The surveys were conducted by the Kansas City, Chicago, Dallas, Minneapolis, San Francisco and Richmond Districts, which account for roughly three-fourths of the nation's agricultural cash receipts. Results show conditions vary greatly from one region of the United States to another. Increases in the Tenth District are average for the country's rising land values.The strong gains reported by the Federal Reserve surveys are in line with those conducted by other industry analysts.

* The San Francisco and Richmond surveys are based on a smaller sample than the other District surveys.

Dave Davis has noticed this trend in Broken Bow, a town of 3,900 in the heart of Nebraska, where he's worked as a farm and ranch real estate agent for 22 years.

"There's just as much (real estate) activity, but it's only in a few hands," Davis says. "There's a lot of outside money (coming into town). … It's difficult for first-time buyers."

"Pretty darn high" land values and competition with out-of-town investors is forcing some farmers into renting land—often from outside investors—rather than buying it, Davis says. And other farmers opt to purchase land in more remote and often less desirable areas.

This nonlocal demand can be beneficial to long-time landowners. But in central Nebraska, many of these farmers are reluctant to sell because of the attachment to their land, which they don't want to see taken out of production even after they retire, he says.

"Urban sprawl remains a major force behind the demand for farmland near metropolitan centers," Novack says. "As suburban areas expand, productive farmland is taken out of production at high prices."

Taking farmland out of production for recreational use does not seem to have an impact on food production in the District, Novack says, adding it certainly could in other areas of the country. Rising values do make U.S. farm commodities less competitive, and therefore, some producers are looking for higher-value products to reap more returns from the land.

Agriculture outlook

This past year in particular, John Hutto has realized just how difficult it will be for his children to enter the farming industry. Conditions are different than when he started; land that Hutto purchased to farm corn, soybeans and wheat is now worth more than six times its original value.

He knows his sons won't be able to start farming on their own.

"It would be necessary to do it together," Hutto says. "There's just so much capital needed to start."

Expansion has been slow, competitive and expensive. He was lucky to have secured a price a few years ago for the 300 acres he purchased last spring. And he's thankful that he started looking for that land years ago—it's the couple's retirement and their children's future.

"To buy land, at least short-term, is unprofitable," Hutto says. "It will be a cash flow drain to us for a couple years. … I'm not going to get out of debt. It's just not going to happen."

But, he says, "Things are cyclical. I think we're pretty close to the top of it (the land market boom)."

With this in mind, Hutto endorses his children's career choice to farm.

Novack's research shows the farm financial picture overall remains healthy.

Net farm income posted a record high in 2004, and last year was the second largest on record as a result of steadily strong livestock prices, according to Novack's research. However, crop prices dipped because of large supplies. As a result, nearly one-third of farm income was derived from government payments, which reached a record $23 billion last year.

Farm income is expected to fall this year, but remain above the long-term average, according to the USDA's February farm income report. Bankers are concerned about the impacts of rising energy prices on their farm customers. Costs of fuel, fertilizer, irrigation and transportation all have risen significantly in recent years.

It's not possible to predict when this boom in land values will actually level off, but it's almost certain that it will, Novack says. Although changes in the agriculture industry are certain, the overall outlook is promising.

"It's an interesting time to be in farming," Hutto says.

T

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

AGRICULTURAL CREDIT CONDITIONS: BOOMING FARMLAND VALUES, BY NANCY NOVACK
www.KansasCityFed.org/TEN

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

PHOTO BY JOSHUA LAWTON

PUTTING THE PIECES IN PLACE

CINDY LIVELY is a machinist at Ross Reels Inc., a small company in Montrose, Colo., that produces fly fishing reels. Lively and her co-workers attended financial education courses offered there. Research shows a company's bottom line can be affected by employees' financial knowledge.

Financial Education in the Workplace
Is it Good for the Bottom Line?

Last Christmas, Charity Littleton ended up with an unexpected item on her shopping list: a dishwasher.

In the midst of all the holiday chaos, the Littletons' kitchen appliance broke beyond repair. But the cost of purchasing a new dishwasher, in addition to toys, gifts and holiday meals, was hardly a crisis. Littleton was financially prepared for the surprise expense without having to rely on a credit card, like she would have in the past.

"How many people can walk out of the store with a $400 dishwasher, especially around the holidays? We were able to pay (cash)," Littleton says.

Saving money is just one aspect of her newly adopted financial plan. Littleton recently completed financial education classes offered through her workplace—Ross Reels Inc. in Montrose, Colo., where she has helped produce fly fishing reels for nearly nine years. Now, the family of three (and one on the way) has a financial plan; lives on a budget; and, most importantly, is whittling down their credit card debt.

"Our research so far has established a link between financial knowledge and behavior," says Kelly Edmiston, a senior economist in the Community Affairs Department at the Federal Reserve Bank of Kansas City. Edmiston and colleagues Kate Fisher and Sharon Oamek studied the relationship between financial knowledge and financial behavior, with a special focus on the importance of financial education in the workplace.

Lately, more employers are offering financial education courses to their workers. Meeting good-faith responsibilities to their employees under the Employee Retirement Income Security Act (ERISA) or passing 401(k) nondiscrimination tests against lesser-compensated employees are often motivating factors for employers. Another goal is for employees to become better equipped at handling personal finances, which may reduce stress and, in turn, increase productivity on the job.

"Sometimes people make bad decisions because they don't know any better," Edmiston says. "Financial knowledge is critical for good financial behavior. Better personal financial outcomes can lead to better workers and we are seeking ways to confirm this linkage, too."

The American way

"As a country," Edmiston says, "we're spending more than we take in."

Many Americans are living on credit and not saving. According to the most recent edition of the Federal Reserve's Survey of Consumer

Finances, less than half of the respondents, about 41 percent, save money regularly. The personal savings rate in the United States has been declining since the 1970s and, by the end of 2005, dropped to -0.7 percent. It's our culture: living in the moment and not planning for the future, Edmiston says.

Often people start their adult lives in debt from post-secondary education, whether it's from loans, credit card spending or both. Further spending perpetuates debt as people live beyond their means and forgo their future personal security.

"People think saving is harder than it is," Edmiston says. "They don't understand how fast it can build up. If they did, they would save."

Only about 26 percent of respondents in a recent national survey believed they could save $200,000 during their lifetime, and 21 percent of respondents said winning a lottery is the most practical strategy to accumulate that amount. In reality, saving $200 per month in an account earning 6 percent annually would yield $200,000 in 30 years.

Not saving adequately can lead to significant financial problems, Edmiston says. Many don't budget, and their expenses exceed their incomes. This can lead to paying bills late, which racks up finance charges and weakens creditworthiness.

> "People think saving is harder than it is. They don't understand how fast it can build up. If they did, they would save."

Personal consequences of bad financial behavior may include high stress, which can overlap into the workplace and hinder the employee's performance. For this and other reasons, it may be advantageous for employers to offer financial education in the workplace.

Learning on the job

A few years ago, Dan Clark, CEO of Ross Reels and a past member of the Bank's Community Development Advisory Council, took notice of a few disturbing habits some of his employees had developed. Many were participating in the company's payroll advance program, designed to help workers in a pinch. However, most were asking for advance paychecks regularly. Even more were not participating in the company's retirement plan. And others were having their wages garnished to pay off outstanding expenses. Clark asked his roughly 30 employees if they would be interested in attending a one-day class on financial education and optional follow-up courses.

"There wasn't a single employee who said 'no,'" Clark says.

His motivation was simple: "If an employee has a personal financial problem, they're distracted on the job."

Since completing the course, the number of workers taking advance pay has dropped by 60 percent, the company retirement plan has 100 percent participation and the level of emotional distress among employees has declined significantly. Clark is certain his employees are better workers now—they're more focused and they're happier.

"There's been a difference," Clark says. "There's no question about that."

Like Ross Reels, employers can potentially "reap enormous benefits" from workplace financial education, Edmiston says. Research shows stress negatively affects the bottom line. A study of about 80,000 employees published in the American Journal of Health Promotion found that employees consider financial problems to be a major contributor to their stress levels, second only to the job itself.

In recognition of the potential benefits, the Federal Reserve Bank of Kansas City offered its employees financial education last fall. Participants were from a variety of backgrounds and worked in a range of the Bank's departments. Nearly 80 employees in Kansas City and Denver participated in a group class, and more than half attended individual financial counseling sessions. Credit scores were collected by the class facilitator to better assess financial behavior in these one-on-one meetings.

Based on existing research, the Bank's Community Affairs staff first developed a set of

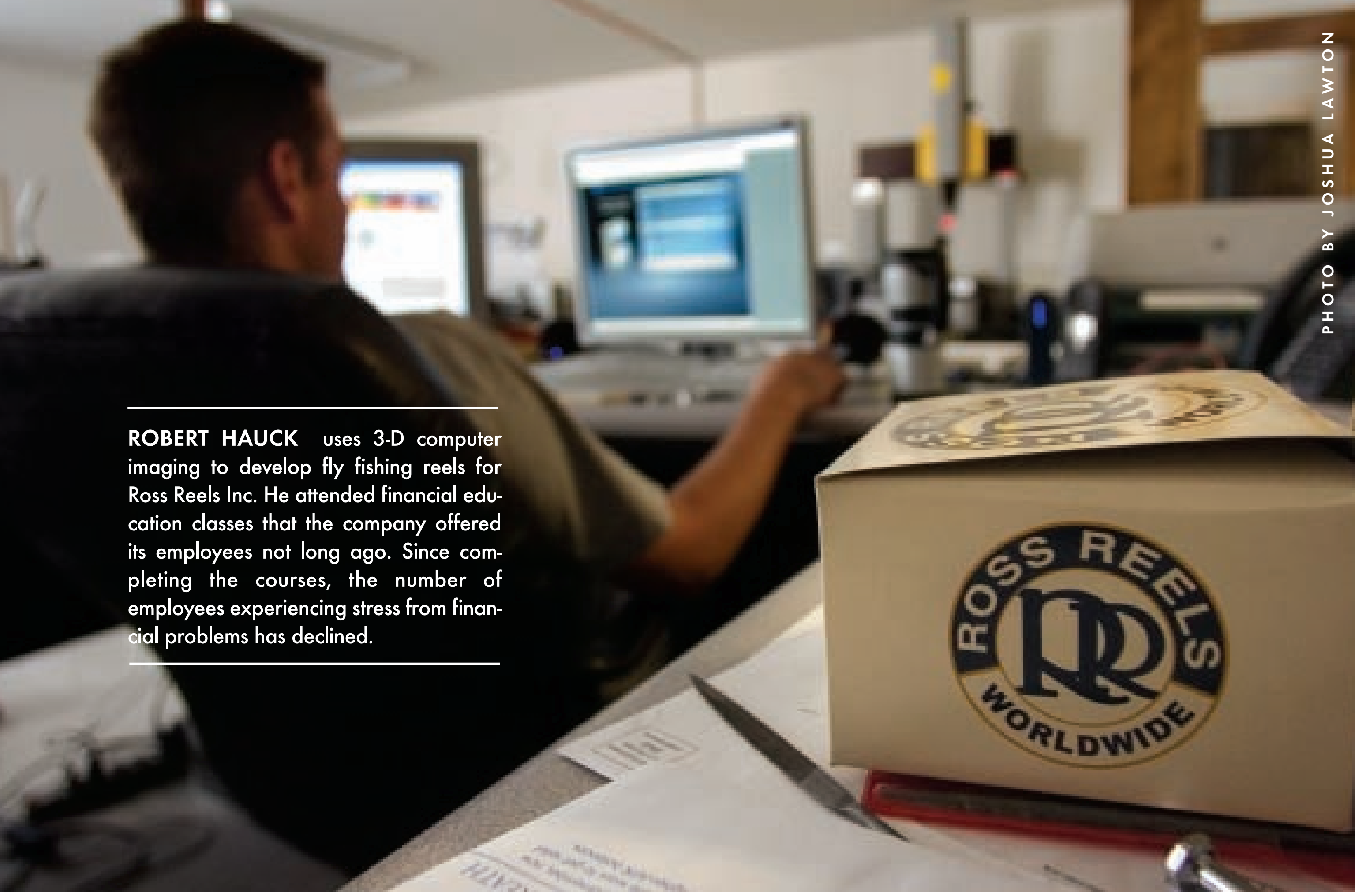


PHOTO BY JOSHUA LAWTON

ROBERT HAUCK uses 3-D computer imaging to develop fly fishing reels for Ross Reels Inc. He attended financial education classes that the company offered its employees not long ago. Since completing the courses, the number of employees experiencing stress from financial problems has declined.

components necessary for an effective workplace-based financial education course. Staff then anonymously surveyed participants before and after the courses. Participants will be surveyed again one year later to measure any change in financial behavior. Questions focused on personal finance knowledge and behavior, workplace behavior, and past experience with financial training.

Additionally, other Bank employees who did not participate in the financial education classes were surveyed to measure their personal financial knowledge and behavior against those who did participate.

The study shows those with greater financial knowledge tend to have no or low credit card balances relative to their credit limit and more often have a sufficient "emergency fund." In contrast, those with lower levels of financial knowledge tend to have higher credit card balances relative to their credit limit and inadequate or no emergency funds. And more than 40 percent of people with a high level of financial knowledge were in the top third of retirement savers, while only 12 percent of those with low financial knowledge fall into that same category.

"Financial satisfaction is likely to be closely tied to stress levels, and financial knowledge is likely to affect financial satisfaction," the Bank's study says. "If (financial) satisfaction does indeed reflect stress levels, the results would suggest that those with higher levels of financial knowledge have lower levels of stress."

Personal financial problems can affect the workplace in a number of ways, including absenteeism, high turnover, wage garnishment (compliance with regulations are costly to employers), drain on employee-assistance programs, theft or embezzlement, and low productivity, Edmiston says.

In addition to possibly reducing stress and increasing productivity, research shows that, in many cases, financial education at work increases participation in employer-sponsored savings plans and leads to lower personal debt, Edmiston says.

Offering this education within the workplace is vital for a few reasons. The setting is optimal—employees on the clock are a captive audience, Edmiston says. Additionally, it may be the only opportunity for many to take a financial education class.

It hasn't been until recently that financial training has become increasingly prevalent in public school districts. In 2003, Congress passed the Financial Literacy and Improvement Act, and the Financial Literacy and Education Commission was created to improve financial knowledge nationwide. In the Tenth District, Kansas and Colorado recently passed laws requiring their schools to teach finance curricula. And last year, Missouri mandated the completion of a personal finance course as a high school graduation requirement.

PHOTO BY CHRIS SCHOENHALS

"Financial knowledge is critical for good financial behavior. Better personal financial outcomes can lead to better workers..."

"While the movement encouraging personal finance instruction in high schools is critical, a major challenge is providing financial education to American adults who have completed their formal education," the Bank's study says. "Financial education at the workplace, included as part of an employer's compensation and benefits package, may provide such an opportunity."

Back in the classroom

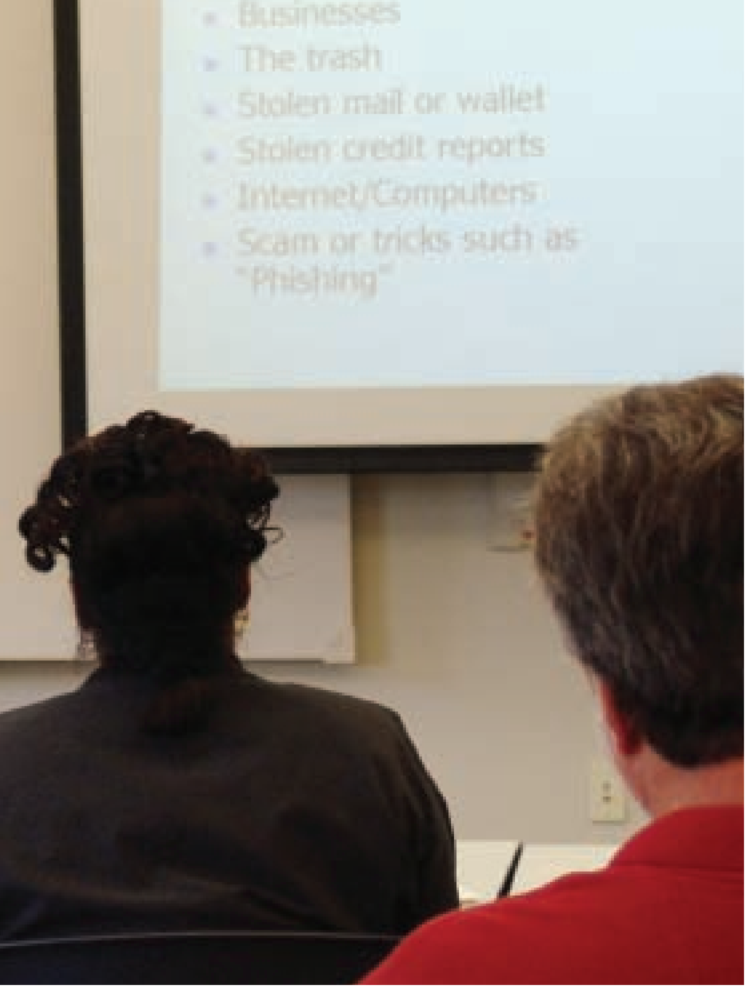
Nancy Nauser describes financial education in the workplace quite simply.

"It's a gift," says Nauser, president of the Kansas and Missouri division of Consumer Credit Council Service of the Midwest Inc., a nonprofit agency that partners with companies and organizations to provide financial education.

Last year, Nauser gave more than 100 presentations in schools, churches, community organizations and companies, including the Bank's Kansas City office and Denver Branch. Her message: "Build wealth not debt."

Getting this into play can be challenging for educators, according to the Bank's study. Personal money management is growing increasingly complex with the number of financial products and services offered by banks, credit card companies and employers. So many options coupled with little knowledge can be overwhelming. Edmiston says often individuals don't realize their current financial lifestyle is a problem with the potential to get worse—possibly leading to inadequate retirement funds or even bankruptcy.

Nauser's teachings compete with the marketing of materialism, she says, which is a tough battle. But it's a fight to which she's willing to devote her efforts. In time, results are evident.



NANCY NAUSER, OF CONSUMER CREDIT COUNCIL SERVICE, teaches financial education classes at businesses and organizations predominately in Kansas and Missouri. She advocates both saving and restrained spending in her basic lesson plans. For many adults today, their only option to increase their financial knowledge is through the workplace.

"The more you hear something, the more you're likely to use it," Nauser says.

Growing up, Charity Littleton's father warned his children against accumulating debt. But at 19 years old, Littleton was approved for her first credit card. More cards arrived through the years, peaking at half a dozen. Financial debt followed, peaking in the tens of thousands of dollars.

"It was overwhelming," she says.

Littleton's experiences are comparable to those of other class participants, and the sessions are tailored to meet their needs. The classes range from basic practices, such as money management and getting loans, to more advanced topics, such as investing.

Material can be presented in either a group or one-on-one setting. Most programs offer the fundamentals for the class as a whole and more advanced sessions and individual counseling sessions at a later time.

Attendance rates are high, Nauser says, and the sessions attract a variety of participants. At Ross Reels, participants in the program ranged from single 20-somethings to those nearing retirement age, Clark says. Many of his employees attended follow-up courses. Littleton did.

"I'm doing so much better for my family," she says. "I feel like a lot of burden is lifted off my shoulders."

All of the family's bills are paid on time. Money is regularly stashed away for the future. And any extras, such as dining out or shopping, are paid for with cash.

The Littletons are financially prepared for the arrival of their second child this summer, and recently they've done what was once the unthinkable: taken a family trip without racking up any credit card debt. A little financial knowledge helped them travel a long way—to Alaska for two weeks last summer.

"We can enjoy a vacation and not have it follow us home," Littleton says. "It's financial freedom." T

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

THE RELATIONSHIP BETWEEN FINANCIAL KNOWLEDGE AND BEHAVIOR: EVIDENCE FROM A SURVEY OF FEDERAL RESERVE BANK OF KANSAS CITY EMPLOYEES, BY MARY C. GILLETT FISHER AND KELLY D. EDMISTON

PERSONAL FINANCIAL EDUCATION RESOURCES FROM THE FEDERAL RESERVE

www.KansasCityFed.org/TEN

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About...

PHOTOS BY JOSHUA LAWTON

The GLOBAL Classroom

INSTRUCTORS TRAVEL ABROAD, HOST PARTICIPANTS IN THE UNITED STATES

Changes in Russia's government nearly two decades ago inadvertently brought Iliya Svechnikov and Vladimir Kulikov to the Tenth Federal Reserve District last spring.

The men, who work for divisions of the Central Bank of Russia, studied bank policies, procedures, regulation and supervision during their month-long visit to the Federal Reserve Bank's Denver Branch.

In 1992, the Central Bank of Russia set up a system of supervision and inspection for commercial banks, which had become privately owned. The goal was to maintain a stable banking system.

The men hope "to take the best things from here" and apply them in Russia to improve current methods, Svechnikov says.

Svechnikov and Kulikov are just a few of the foreign officials who have visited the United States as a part of the Federal Reserve System's International Training and Technical Assistance program. Two other program participants also from Russia visited the Federal Reserve Bank in Kansas City in May.

The program is twofold. In addition to hosting participants, instructors from the Bank travel abroad to offer training and technical assistance to staff from foreign central banks as well as cultivate working relationships. There are three instructors from the Tenth District: Ron Sisneros, an examiner at the Denver Branch; Brad Beytien, a senior examiner in Kansas City; and Joe Van Walleghem, a policy economist in Kansas City. Sisneros and Beytien both have instructed internationally for five years, teaching bank analysis and technology risk supervision, respectively. Van Walleghem's first class is this fall in Mexico City, where he will teach interest rate risk management.

An international mission

The Federal Reserve Bank of Kansas City has been an early participant in enhancing banking knowledge worldwide. In 1990 and 1992, Bank President Tom Hoenig traveled to China as an instructor in bank supervision and discount operations.

"We think it is essential to global economic stability to support emerging market economies' efforts to develop a useful and safe banking framework," Hoenig says.

In the past 10 years, instructors have visited roughly 30 countries, such as Peru, Australia and Egypt, teaching more than a dozen courses ranging from bank analysis and examination to anti-money laundering to management skills, says Sarkis Yoghourtdjian, program adviser, who is based at the Federal Reserve Board of Governors in Washington, D.C.

"The Federal Reserve program is highly regarded throughout the world, and highly sought-after from all corners of the world," Yoghourtdjian says.

The goal of the program is to elevate supervisory practices and standards in developing and emerging markets. By assisting in this advancement, the Federal Reserve also benefits by learning about other countries' systems and culture.

Generally, technical assistance has been provided to other central banks and supervisory authorities where there is a mutuality of interest—either banks from the foreign country have a banking presence in the United States, or U.S. banks have a presence in that country.

Requests for technical assistance and training that do not meet these criteria are often fulfilled in cases where U.S. international interests could be better served by the Federal Reserve's participation, Yoghourtdjian says.

Federal Reserve instructors are sent to sites that have been chosen based on the surrounding region's needs. Often surrounding countries will send staff to the country hosting the instructors to attend the week-long courses, too.

There is a pool of 100 instructors from the Federal Reserve who travel abroad; some go as often as several times a year, Yoghourtdjian says.

VLADIMIR KULIKOV (LEFT) AND ILIYA SVECHNIKOV traveled from Russia recently to the Bank's Denver Branch to study policies and procedures. They accompanied their host, Federal Reserve Bank examiner Ron Sisneros (pictured page left), on a bank examination in the area.

"Instructors are chosen based on subject-matter expertise coupled with their teaching abilities," Yoghourtdjian says, adding that teaching in this capacity is quite an honor.

Going abroad

Before they became instructors for the Federal Reserve's international program, neither Sisneros nor Beytien had traveled outside of North America. Neither is fluent in a foreign language.

While both men acknowledge at first being slightly intimidated by the unfamiliar, they say there was a driving force to participate in the program: sharing knowledge with those who need it.

THE MEN, WHO WORK FOR THE CENTRAL BANK OF RUSSIA, studied various Federal Reserve methods during their month-long visit in hopes of improving methods back home. The Federal Reserve also sends instructors abroad to teach.

"I've always been interested in teaching," Sisneros says. "I like helping people. I think it's very important that we have people that understand what we (the Federal Reserve) do."

Sisneros and Beytien travel abroad about twice a year to instruct. Sisneros has taught classes in Thailand, Guatemala and Armenia, among other places. His first assignment was in Lebanon. Beytien's first teaching trip was to the Philippines. Since then, he's been to a handful of other countries including Russia and Thailand.

Although English is the international business language, there are some barriers in countries where it is not primarily spoken. In these instances, the instructors speak into a microphone that's wired to interpreters who translate into the country's common language. The class participants hear the translation over headsets. When a question is asked, the process is reversed.

The instructors stand in front of the group and often use computer slide shows, flip charts and marker boards as teaching tools. The topics covered are specific to the class, but generally include methods used in the United States that can be applied to supervisory systems abroad.

"Our goal is to show them our processes and procedures to help implement new methods to better supervise banks," Sisneros says.

Both say they have been welcomed into each country, adding the Federal Reserve is held in high regard around the world. They know their instruction is well-received.

"Participants come across very hungry for information," Beytien says.

The value

The international instructors agree the program is rewarding, but also essential.

"I think this is something the Federal Reserve needs to do," Beytien says.

Based on his experiences, Beytien sees the value not only for the participants, but also for the Federal Reserve. While other countries are gaining supervisory and regulatory knowledge, the Federal Reserve is acquiring a multinational perspective on economics, he says. For participants and providers, a network is built.

Yoghourtdjian says while it's difficult to quantify the program's results, they are apparent. As banking systems in these countries progress, their practices become more advanced and relations with the United States strengthen.

"The only true indicator you have is the countries' repeated success," Beytien says.

Dana Rankine, an analyst in the banking supervision division with the Cayman Islands Monetary Authority in Grand Cayman, participated in a week-long course last year when instructors from the Federal Reserve traveled to one of the islands to teach participants from around the Caribbean.

"It's comforting to know you can learn, share and understand each other's line of work," Rankine says. "Overall, it's very useful."

Greetings from Denver

Sisneros, who recently taught in Russia, hosted Svechnikov and Kulikov during their visit to Denver. The Russian men accompanied him and others on a bank examination in the area, toured the U.S. Mint and attended classes on fraud, among other activities.

Svechnikov works in Moscow as an examiner, leading teams who research information for the Central Bank. Kulikov works in St. Petersburg, where he is head of the inspections department for one of the 78 regions, which are similar to the Federal Reserve's 12 Districts here.

The Central Bank of Russia, charged with bank regulation and supervision, is a relatively new entity in the country and still refining its practices. Svechnikov and Kulikov would like to streamline bank supervision procedures in Russia and are looking at the Federal Reserve's process for guidance. Additionally, the men are studying the bank-rating system and record keeping here to possibly make improvements back home, Svechnikov says.

These hands-on experiences and classroom tutorials are a chance to further his job training with instruction that he otherwise wouldn't receive in Russia, Kulikov says.

"We're growing and building," Svechnikov says. "This (program) is a very good opportunity for us."

BY BRYE STEEVES, SENIOR WRITER

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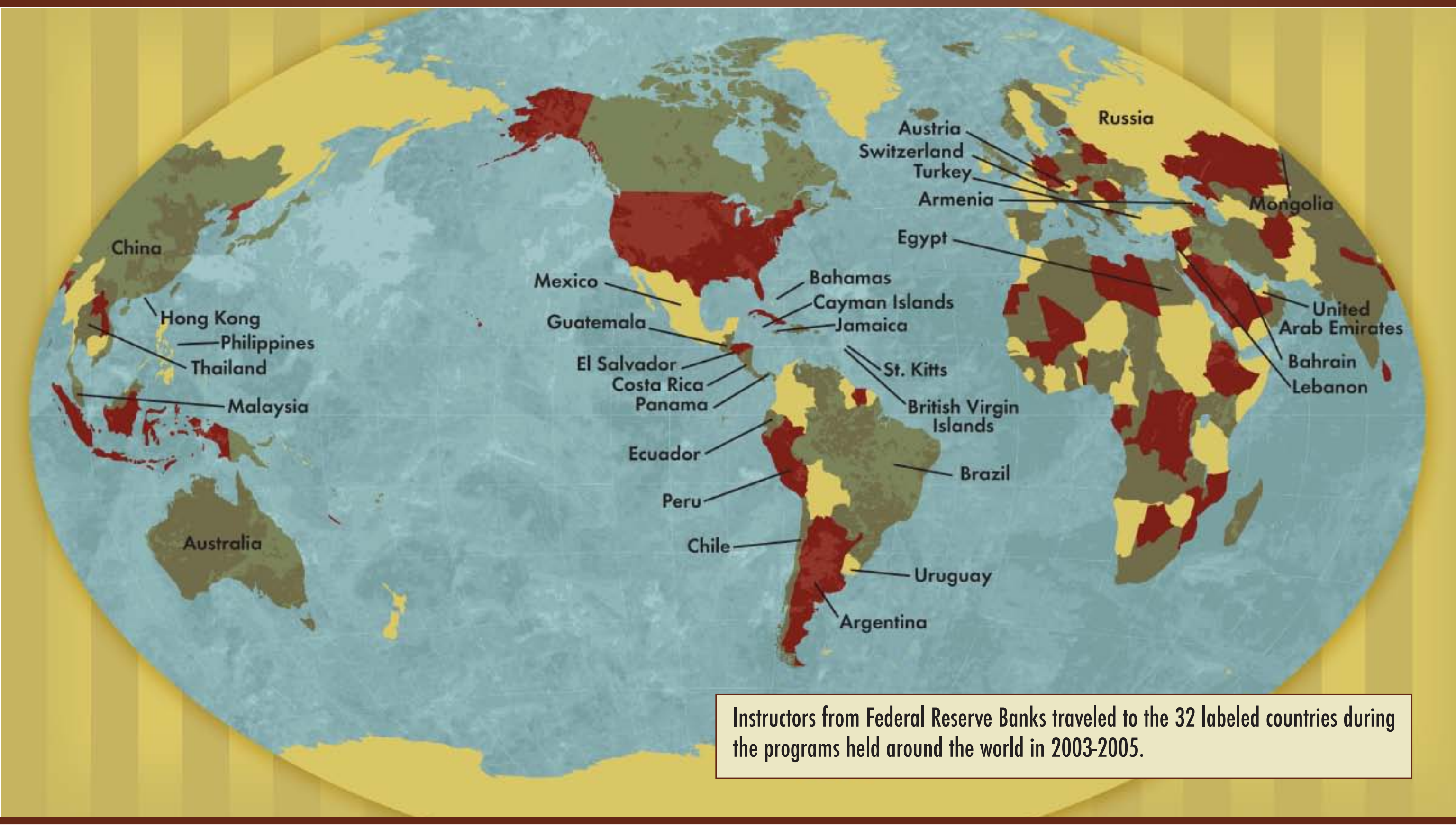
THE FEDERAL RESERVE: GLOBAL CONNECTIONS



Instructors from Federal Reserve Banks traveled to the 32 labeled countries during the programs held around the world in 2003-2005.

Notes

Students' challenge policy, each other at annual competition

THE BOULDER HIGH SCHOOL TEAM won this year's Regional Fed Challenge. They are (from left): Richard Trinker (teacher), Fleet White, Joey Baum, Sarah Stein, Laura D'Ippolito and Connor O'Steen.

Students from Boulder (Colo.) High School won the 2006 Regional Fed Challenge in May.

Each year, the Federal Reserve hosts Fed Challenge—an academic competition where students vie for a first-place trophy; scholarships, grants and awards; and the opportunity to compete in the nation's capital. The goal is to promote economic education.

The Boulder students went head-to-head with three teams: Eisenhower Senior High School, Lawton, Okla.; Lawrence Free State High School, Lawrence, Kan.; and Millard North High School, Omaha, Neb. Each previously had won preliminary events.

The five-member teams presented a 15-minute analysis on the economy and monetary policy, just like the Federal Open Market Committee does during its eight meetings each year. Following a question-and-answer session, a panel of judges scored the teams based on the students' understanding of subject matter, research, teamwork and presentation skills.

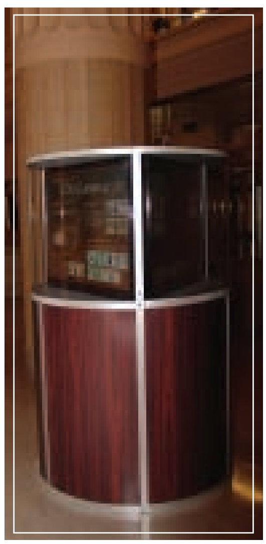
The judges included: Senior Vice President Alan Barkema, Senior Vice President and Director of Research Craig Hakkio, and Senior Economist Jonathan Willis.

The students, along with other Districts' winners, advanced to the national level at the Board of Governors in Washington, D.C. There, the team competed in the semi-finals, but was not one of the four that advanced to the final competition. It was the team's first time competing at the local, regional or national levels.

Fed Challenge was first organized at the Federal Reserve Bank of New York in 1994. By 2004, schools in all seven states in the Tenth District were offered the chance to compete.

Historic currency display available to financial institutions

The Federal Reserve Bank of Kansas City is offering its traveling exhibit of U.S. historic currency to banks and depository institutions in the District for temporary display.



The exhibit showcases currency from the Colonial period through present day. It focuses on items of historical significance, such as State Bank notes, Fractional notes and Gold certificates. The display also features silver and gold coins, Confederate notes, and Demand notes, which are often referred to as "greenbacks."

There is no charge to host the exhibit, but institutions must have at least $5,000 in liability insurance and must pay the shipping costs to transport the display to its next location.

The exhibit needs at least a 6- by 6-foot space to stand. It ships in two cases and weighs about 130 pounds.

Scheduling is on a first-come, first-served basis. To reserve the exhibit, contact the Bank's Public Affairs Department at (800) 333-1010 ext. 2554.

Bank hosts annual regulatory update seminars

The Federal Reserve Bank of Kansas City's Supervision and Risk Management Division hosted its annual regulatory update seminars in the spring.

Staff held seminars throughout the Tenth District to discuss regulatory and supervisory issues, plus get feedback from bankers about obstacles that come their way.

The 10 sessions, themed "Keeping Connected," drew more than 400 attendees from state member banks, including presidents, chief executive officers and senior staff from the banks and bank holding companies. Representatives from local state banking agencies in the District also attended many of the seminars.

Bank President Tom Hoenig, Denver Branch Executive Michael Orlando, Oklahoma City Branch Executive Chad Wilkerson, and Economist Jason Henderson provided economic updates.

Other presenters included SRM Division officers, managers and examiners. Topics ranged from banking conditions to fundamentals of loan portfolio management to compliance programs in community banks.

Participants' feedback was positive, says Tara Anders, SRM manager.

"The bankers enjoy speaking with their regulators face-to-face," Anders says. "They also appreciate the opportunity to interact with their peer bankers."

El Dorado student wins economic essay contest

Kimberly Logue, of El Dorado, Kan., was named the grand prize winner in the Federal Reserve Bank of Kansas City's economic essay contest.

Logue, a senior at El Dorado High, was awarded a $1,000 savings bond for her paper on making post-graduation decisions. She wrote about how economic factors helped her choose to enroll at a nearby university. Students were given an essay topic: "To Be or Not to Be: The Economics of Your Future."

Logue and four other winners, who received savings bonds ranging from $100 to $500, were recognized by Senior Vice President Alan

KIMBERLY LOGUE from El Dorado Kan., was recognized at an awards presentation at the Federal Reserve Bank of Kansas City by Senior Vice President Alan Barkema. Logue was named the winner of the economic essay contest for high school students.

TOM HOENIG, president of the Federal Reserve Bank of Kansas City, recently taught a third-grade class as part of Teach Children To Save Day. Hoenig and other bank volunteers gave 45-minute lessons on money management and saving to a total of about 1,200 area children.

Barkema, and other Bank officials, at an awards presentation in May. Each student was given a framed certificate and a special publication of all winning essays. Logue's economics and English teachers also attended the awards presentation.

The contest was introduced last spring in Kansas schools and will be implemented throughout the Tenth District next year. Its goal is to promote economics, writing and critical thinking, says Mark Hays, economic education coordinator at the Bank.

Entries were judged by Bank staff on criteria such as comprehension, organization, conclusions, creativity and writing style. Essays must reflect students' own research, writing and thinking.

Five other Federal Reserve Banks sponsor a similar contest: Cleveland, Dallas, Minneapolis, Richmond and St. Louis.

Lessons promote financial education

More than 30 employees from the Federal Reserve Bank of Kansas City volunteered in classrooms around the Kansas City metro area in April.

The employees taught financial lessons to about 1,200 first-, second- and third-graders at nearly two dozen elementary schools as a part of Teach Children to Save Day—a nationwide program designed to highlight money management skills and the value of saving.

Representatives from several commercial banks partnered with Federal Reserve Bank volunteers to deliver the 45-minute tutorials to about 56 classes. The Center for Economic Education at the University of Missouri-Kansas City provided books and other materials for classrooms.

Lessons were developed by the Center for Economic Education and Entrepreneurship at the University of Missouri-St. Louis.

Based on this year's success, future participation will increase throughout the District, says Trudie Hall, program coordinator.

Annual conference boosts economic, financial education

The Federal Reserve Bank of Kansas City hosted the 2006 Midwest Economic Education Conference, or MEEC, in May.

More than 30 attendees from state and national economic education councils and centers from around the Tenth District gathered along with Federal Reserve Bank staff. The councils and centers partner with the Bank to promote economic education and financial literacy.

The goal of the annual meetings is to discuss and share topics relative to economic education.

This year's theme was "International Economics and Globalization," chosen because of current outsourcing and immigration issues spotlighted by the media.

Topics at the two-day event included offshoring in the service sector and technology-based programs.

Educators' resources are available online at www.FederalReserveEducation.org.

Bank Anniversaries

Third Quarter Bank Anniversaries: Bank Milestones (year 1,5,10 and 20 or more) as Federal Reserve Members:

UINTA COUNTY STATE BANK	Mountain View	Wyo.	86
WAHOO STATE BANK	Wahoo	Neb.	74
GUNNISON B&TC	Gunnison	Colo.	66
FARMERS STATE BANK	Stanberry	Mo.	65
UNION STATE BANK	Clay Center	Kan.	64
BANK OF HOLYROOD	Holyrood	Kan.	63
FARMERS BANK OF LINCOLN	Lincoln	Mo.	61
SECURITY STATE BANK	Basin	Wyo.	58
PREMIER STATE BANK	Lenexa	Kan.	27
BANK OF CUSHING & TC	Cushing	Okla.	26
MONTROSEBANK	Montrose	Colo.	22
FARMERS STATE BANK	Wallace	Neb.	10
AMERICAN EXCHANGE BANK	Elmwood	Neb.	5
SALINE STATE BANK	Wilber	Neb.	5
ROCKY MOUNTAIN BANK	Rock Springs	Wyo.	1

Bank hosts Economic Forums, plans for fall events

Economists from the Federal Reserve Bank recently visited Kansas and western Missouri as part of the Bank's Economic Forums program.

Area business people and bankers attended forums in Garden City, Pittsburg, Salina, and Wichita, Kan. and in Kansas City, Mo.

Economists from the Bank gave presentations on the economic outlook, U.S. savings rate and immigration. The program, which started more than 50 years ago, also includes informal discussions and question-and-answer sessions.

The events provide Bank economists with insight into the local economy while offering attendees an opportunity to learn more about the Federal Reserve's perspective on economic issues.

The program is on a two-year cycle—Bank economists and staff visit all regions of the seven-state District at least every two years. This fall, the program will travel to Nebraska, New Mexico and Wyoming.

Invitations will be mailed to bankers and business and community leaders. For more information or to request an invitation, e-mail teneditors@kc.frb.org. There is no charge to attend.

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BY BRYE STEEVES, SENIOR WRITER

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

Update...

What a difference a year makes.

In May 2005, the Federal Reserve Bank of Kansas City hosted a conference on interchange fees, which are a part of credit and debit card transactions.

Featured on the cover of TEN's Summer 2005 edition, the conference was organized by the Bank's Payments System Research Department as a forum to explore what role, if any, public authorities should play in regulating these fees. A mix of industry participants, antitrust authorities, central bankers and academics gathered to discuss an issue that was rapidly becoming a heated topic for merchants, banks and card associations.

In the year since, it is an issue that has gone from heated to boiling.

Participants barely had returned home from the conference site in Santa Fe, N.M., when several small businesses filed a class action lawsuit against the card associations and large banks in June alleging interchange fees were illegally fixed. A group of supermarket chains and pharmacies filed a similar suit in July, and a group of retail store associations followed with their own class action suit in September. By October, there were 47 pending antitrust cases related to interchange, and all were consolidated into a single case. In the meantime, the issue was the focus of a Congressional subcommittee hearing.

"Given what we heard in Santa Fe, I don't think anyone is especially surprised at the developments of the past year," says Stuart Weiner, vice president and director of Payments System Research at the Federal Reserve Bank of Kansas City. "We heard a lot of impassioned arguments at the conference, and these arguments, if anything, have become even more pronounced since the conference."

In the past year, Weiner and Fumiko Hayashi, senior economist, have made a dozen presentations about interchange fees to various groups, including the European Central Bank and the Bank of Finland.

The presentations, as well as additional ongoing research by the Bank's staff, stem from the Federal Reserve's concerns about the efficiency and safety of the payments system from a public policy standpoint. When it comes to interchange fees, the Federal Reserve holds a unique position—a neutral party with no financial stake.

Interchange

Although debate over the otherwise-obscure fees has started receiving mainstream media attention in recent months, consumers who are not regular readers of industry trade publications may be unaware of the fees that have been levied by the card associations for decades.

The MasterCard and Visa card networks are what are known as four-party systems because each card transaction involves four parties: the consumer, the bank that issued the card to the consumer, the merchant and the merchant's bank.

When a purchase is made in a four-party system, the merchant sends the card information to its bank, which then, via networks such as MasterCard or Visa, contacts the card-issuing bank. The card-issuing bank then will bill the consumer for the amount of the purchase and send payment to the merchant's bank.

However, the payment will not reflect the full amount of the purchase. The card-issuing bank will retain a fee, known as interchange, which currently averages a little less than 2 percent in the United States.

Although the fee may sound nominal, the increasing use of debit and credit cards has caused the total amount paid in interchange fees to approach an estimated $30 billion annually. Merchants have argued that the fees cost the average U.S. household more than $200 a year.

In testimony to a Congressional subcommittee earlier this year, the president and chief executive officer of the National Association of Convenience Stores said card companies charge about five cents in interchange fees on a gallon of gas.

"These fees have actually been of concern for a number of years and have now escalated to the point that they are the third-highest operating cost to my industry—behind only payroll and rent," Henry Armour told the Subcommittee on Commerce, Trade and Consumer Protection during a February hearing.

Armour's comments came only weeks after The Washington Times published a guest column by William Sheedy, executive vice president of Visa USA, which said card sales provide merchants with such benefits as faster and more efficient sales; simpler bookkeeping; and, on average, larger customer tickets.

"Merchants, not consumers, pay the cost of card acceptance because they benefit from the value and services they receive from the global payments system, to keep the infrastructure strong and secure and support critical fraud detection technologies," wrote Sheedy, who also participated in a panel discussion at the Bank's Santa Fe conference.

Two-sided market

Credit and debit card industries are examples of two-sided markets in that they contain two sets of end users, each reliant on the other for the market to operate: in this case, cardholders and merchants.

The interchange fee is an instrument that card networks such as MasterCard and

Visa can use to achieve a desired balance of cardholder usage versus merchant acceptance. They transfer revenues from one side of the market to the other to generate the desired level of card activity.

Merchants pushing for regulation of interchange argue that the fees amount to collusion by the banks and card associations. Visa has more than 20,000 member financial institutions that issue the cards and market Visa products. MasterCard, which is offering a 46 percent stake in the company in a public stock offering, has more than 23,000 financial institution members.

In testimony to the Congressional subcommittee on behalf of a coalition of card networks and banks during the February hearing, Timothy J. Muris argued that the fees serve an important purpose.

"The early emergence of the interchange fee and its continued presence in the payment card industry testify to the inherent logic of interchange fees in equilibrating the two sides of the market, and not, as critics contend, to harm consumers," said Muris, a former chairman of the Federal Trade Commission.

Worldwide

Developments in the issue of interchange have not been limited to the United States.

In March, Mexican banks, under pressure from that country's central bank, agreed to lower credit card interchange fees to about 1.84 percent from 2.16 percent a year ago. It was the second such move in Mexico within an 18-month period. The first move was discussed by Mexico's central bank Governor Guillermo Ortíz during comments at the Santa Fe conference. Prior to the first move, fees were averaging more than 2.4 percent in Mexico.

In November 2005, Australia announced new standards for interchange fees that will take effect this November to bring all credit card schemes under the same fee cap. Currently, Australia does regulate interchange fees, but under three different caps.

Philip Lowe, the Reserve Bank of Australia's assistant governor of financial systems, also participated in the same panel with Ortíz, telling attendees his Bank was confident that fee caps put into effect in November 2003 would flow through to lower prices for goods. The Australian Bank's calculations suggested the Consumer Price Index would be 0.1 to 0.2 of a percentage point lower under the new fees than would have been otherwise expected.

In January, a Wall Street Journal editorial focused on the issue of interchange fees was critical of regulation in Australia and other nations.

"Studies indicate that lower retail prices haven't materialized. Instead, retailers have mostly pocketed the savings, while Visa and other card companies have withdrawn the popular rebates and bonus awards while increasing the annual fees they charge to cardholders," the editorial said.

As for the situation in the United States, The Journal's editorial quoted research from the Federal Reserve Bank of Kansas City that found rising interchange fees in the United States have corresponded with increasingly lucrative incentive packages and reward programs.

"Higher interchange fees allow issuers to provide more generous reward programs to cardholders," Hayashi and Weiner wrote, "but of course, reward programs are costly."

That might be one of the few statements upon which all sides can agree.

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BY TIM TODD, EDITOR

FURTHER RESOURCES

SANTA FE CONFERENCE PROCEEDINGS

COMPETITION AND CREDIT AND DEBIT CARD INTERCHANGE FEES: A CROSS-COUNTRY ANALYSIS,
BY FUMIKO HAYASHI AND STUART E. WEINER

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