

# FALL 2011 **CENTRAL** Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

**FEATURED IN THIS ISSUE:** Earnings Growth Stalls | Local House-Price Changes Now Following National Trends

## Agriculture Banks Are Outperforming Their Peers, But How Long Will It Last?

By Gary S. Corner

The domestic agriculture industry has been thriving over the last decade. According to the U.S. Department of Agriculture (USDA), six of the past eight years rank among the top 10 income-producing years for the industry (adjusted for inflation) since 1980. As commodity prices and farm incomes soared, farmland prices

also surged. Ancillary agricultural businesses, such as farm equipment manufacturers and dealers, have also benefited from recent farm prosperity.

As a result of strong industry conditions in recent years, agriculture banks have generally outperformed community banks without an agricultural focus. The level of problem

*continued on Page 7*

### Agriculture Bank Performance Assessment

	District Ag Banks (137) <sup>1</sup>		District Non-Ag Banks (483)		U.S. Ag Banks (1,517)		U.S. Non-Ag Banks (4,381)	
	2011	2010	2011	2010	2011	2010	2011	2010
ROA	1.05%	0.73%	0.80%	0.77%	1.06%	0.96%	0.49%	0.29%
Nonperforming Loans + OREO / Total Loans + OREO <sup>2</sup>	2.39	2.37	4.27	3.71	2.51	2.56	5.66	5.38
Tier 1 Capital Ratio	10.31	10.41	9.70	9.44	9.91	9.93	9.69	9.44
Net Interest Margin	3.97	4.00	3.88	3.80	3.91	3.99	3.84	3.79
Average CAMELS Rating <sup>3</sup>	1.89	1.84	2.18	2.16	1.89	1.86	2.44	2.39
Provision Expense / Average Assets	0.36	0.64	0.39	0.45	0.24	0.41	0.54	0.77
Loan Loss Reserve / Nonperforming Loans	95.21	86.74	68.29	70.38	93.12	79.87	54.71	50.27
Ag Production Loans / Total Loans	11.60	12.09	1.94	2.04	20.96	21.75	1.40	1.42
Farmland Loans / Total Loans	25.17	25.46	5.21	5.21	21.26	20.33	3.00	2.88
Total Ag Loans / Total Loans	36.77	37.55	7.15	7.26	42.22	42.08	4.40	4.30

SOURCE: Reports of Condition and Income for Insured Commercial Banks. This assessment covers only banks with less than \$1 billion in assets.

NOTES: <sup>1</sup> The Federal Reserve's Eighth District has 137 agriculture banks, with most having less than \$1 billion in assets. The average asset size of an agriculture bank nationwide is \$128 million. A bank is defined as an agriculture bank if the combined agricultural production and farmland loans account for 25 percent or more of its total loans.

<sup>2</sup> The nonperforming loans + OREO (other real estate owned) ratio measures the percentage of problem loans and real estate property held by banks after foreclosure. High percentages of these types of assets undermine a bank's health and severely impair earnings.

<sup>3</sup> CAMELS stands for the composite supervisory rating for Capital, Asset Quality, Management, Earnings, Liquidity and Market Sensitivity.

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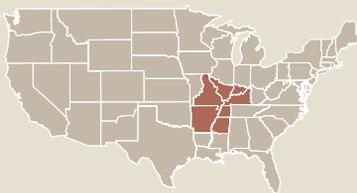
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The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



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[www.research.stlouisfed.org/fred2](http://www.research.stlouisfed.org/fred2)

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## CENTRAL VIEW

# Much More To Come with the Dodd-Frank Act

By Julie Stackhouse

July 21 marked the one-year anniversary of the passage of the Dodd-Frank Act. Since enactment, several key rules have been finalized. However, the majority remain to be written. Some accounts suggest that 122 rules will be released across federal banking and other agencies in the third quarter of this year.

What have we seen over the past 12 months? The following are some of the rules and other provisions of Dodd-Frank now in place:

- As of Oct. 1, 2011, banks with more than \$10 billion in total assets may only charge an interchange fee of 21 cents plus a 5-basis-point ad valorem charge on all debit card transactions. (See related article on Page 4 of this issue.)
- Banks may now pay interest on demand deposits based on the Dodd-Frank requirement that the Fed's Board of Governors terminate Regulation Q restrictions.
- De novo banks may branch into any state regardless of their charter type or charter location as long as a state allows its own state-chartered de novo banks to branch within the state.
- The Consumer Financial Protection Bureau (CFPB) is now officially in business—albeit without a confirmed director—and will supervise banks with \$10 billion or more in total assets, as well as nonbank financial firms. However, when the CFPB begins to write rules, those rules will most likely apply to banks of all sizes. Until a director is confirmed, the bureau is limited in its ability to supervise nonbank financial institutions.
- Organizations with \$1 billion or more in total assets will have their incentive compensation structures for senior management reviewed as part of the supervisory process.

Over the next year, I anticipate that the impact and costs of Dodd-Frank to community banks will become more evident. I also expect we will see changes in products and services offered by community banks as they inevitably work to offset those costs. We will continue to follow these developments and update you on changes.



*Julie Stackhouse is senior vice president and managing officer of banking supervision, discount window lending and community affairs at the St. Louis Fed.*

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[www.stlouisfed.org/rrr](http://www.stlouisfed.org/rrr)

# Earnings Growth Stalls in Second Quarter, Asset Quality Is Steady in District

By Michelle Neely

After a large increase in the first quarter of 2011, earnings growth at District banks came to a standstill in the second quarter. Return on average assets (ROA) dropped 3 basis points to 0.74 percent at District banks, while it increased 4 basis points to 0.67 percent at U.S. peer banks (those with average assets of less than \$15 billion). Still, earnings ratios at both sets of banks are up substantially from their year-ago levels.

The drag on earnings was the result of a 5-basis-point increase in noninterest expense, and a 4-basis-point decline in noninterest income. The other main components of earnings—net interest income and loan loss provisions—had little effect. On the positive side, net interest income rose, while loan loss provisions fell.

The net interest margin (NIM) increased slightly at both sets of banks in the second quarter, rising 1 basis point to 3.98 percent in the District and 3 basis points to 3.91 percent at U.S. peer banks. The District's ratio is up 20 basis points from its year-ago level, and is at its highest level since the start of the financial crisis. The NIM is being boosted especially by the performance of the District's larger institutions; District banks with assets of less than \$1 billion recorded a slightly lower average NIM of 3.94 percent.

## Nonperforming Loan Ratio Is Down

Asset quality has yet to improve at District banks and is an even larger problem at U.S. peer banks. The ratio of nonperforming loans to total loans decreased slightly in the second quarter to 3.26 percent in the District, but is still up 29 basis points from its year-ago level. The nonperforming loan ratio fell 16 basis points in the second quarter at U.S. peer banks and is down 30 basis points from its year-ago level; however, at 3.72 percent, it remains well above the District's average.

## Not Much To Cheer About<sup>1</sup>

	2010: Q2	2011: Q1	2011: Q2
<b>RETURN ON AVERAGE ASSETS<sup>2</sup></b>			
District Banks	0.52%	0.77%	0.74%
U.S. Peer Banks	0.26	0.63	0.67
<b>NET INTEREST MARGIN</b>			
District Banks	3.78	3.97	3.98
U.S. Peer Banks	3.84	3.88	3.91
<b>LOAN LOSS PROVISION RATIO</b>			
District Banks	0.83	0.61	0.59
U.S. Peer Banks	1.09	0.61	0.61
<b>NONPERFORMING LOAN RATIO<sup>3</sup></b>			
District Banks	2.97	3.27	3.26
U.S. Peer Banks	4.02	3.88	3.72

SOURCE: Reports of Condition and Income for Insured Commercial Banks.

- NOTES: <sup>1</sup> Because all District banks except one have assets of less than \$15 billion, banks larger than \$15 billion have been excluded from the analysis.  
<sup>2</sup> All earnings ratios are annualized and use year-to-date average assets or average earning assets in the denominator.  
<sup>3</sup> Nonperforming loans are those 90 days or more past due or in nonaccrual status.

The increase in the District's nonperforming loan ratio in the second quarter was driven by deterioration in the commercial and industrial (C&I) loan portfolio, rather than the real estate portfolio, as has been the case for most of the past three years. In the C&I portfolio, 2.49 percent of loans were nonperforming as of June 30, a 22-basis-point increase from the level at the end of the first quarter.

The ratio of nonperforming real estate loans to total real estate loans declined slightly in the second quarter in the District to 3.73 percent. This ratio remains very high by historical standards and is the major determinant of the overall nonperforming loan ratio.

Within the District's real estate portfolio, the proportion of nonperforming residential mortgage as well as construction and land development loans declined, while the proportion of

*continued on Page 7*

# Board Approves Final Debit Interchange Fee Rule

Debit card issuers may charge merchants a maximum interchange fee of 21 cents per transaction plus 5 percent of the transaction value under the Board of Governors' final rule issued on June 29, 2011.

An issuer may charge an additional 1 cent per transaction if it develops and implements fraud prevention programs. To illustrate the impact of the new rule, the maximum interchange fee that a nonexempt debit card issuer will be able to charge a merchant on a \$40 debit transaction is 24 cents (21-cent base component, 5 percent of the value—2 cents—and 1-cent fraud adjustment). The fee cap is effective Oct. 1, 2011.

Issuers with \$10 billion or less in total assets are exempt. To assist in determining which issuers are subject to the fee standards, the Board is publishing lists of institutions that are above and below the exemption asset threshold. As of July 12, 2011, there were about 15,000 exempt financial institutions.

The Board also clarified that prepaid cards meet the definition of debit cards and would be subject to the debit interchange fee restrictions unless the issuing bank qualifies for the exemption.

## >> READ MORE

### Small Issuer Exemption

[www.federalreserve.gov/paymentsystems/debitfees.htm](http://www.federalreserve.gov/paymentsystems/debitfees.htm)

### How We Arrived at the Debit Card Interchange Fees and Routing Proposals

[www.stlouisfed.org/debitcardfees](http://www.stlouisfed.org/debitcardfees)

# Statewide Bank Conditions for Second Quarter 2011<sup>1</sup>

Compiled by Daigo Gubo

	2010: Q2	2011: Q1	2011: Q2
<b>RETURN ON AVERAGE ASSETS<sup>2</sup></b>			
All Eighth District States	0.40%	0.62%	0.60%
Arkansas Banks	0.78	1.00	1.10
Illinois Banks	0.21	0.44	0.40
Indiana Banks	0.40	0.41	0.57
Kentucky Banks	0.96	1.28	0.87
Mississippi Banks	0.52	0.56	0.69
Missouri Banks	0.23	0.65	0.68
Tennessee Banks	0.32	0.37	0.24
<b>NET INTEREST MARGIN</b>			
All Eighth District States	3.72	3.84	3.85
Arkansas Banks	4.07	4.21	4.27
Illinois Banks	3.61	3.68	3.69
Indiana Banks	3.75	3.81	3.83
Kentucky Banks	4.09	4.36	4.17
Mississippi Banks	3.87	3.83	3.93
Missouri Banks	3.40	3.64	3.69
Tennessee Banks	3.77	3.83	3.86
<b>LOAN LOSS PROVISION RATIO</b>			
All Eighth District States	0.94	0.69	0.69
Arkansas Banks	0.75	0.50	0.52
Illinois Banks	1.22	0.89	0.94
Indiana Banks	0.94	0.82	0.66
Kentucky Banks	0.54	0.52	0.52
Mississippi Banks	0.79	0.67	0.60
Missouri Banks	0.92	0.51	0.51
Tennessee Banks	0.82	0.60	0.70
<b>NONPERFORMING LOAN RATIO<sup>3</sup></b>			
All Eighth District States	3.79	3.82	3.78
Arkansas Banks	2.92	3.45	4.01
Illinois Banks	5.19	5.19	5.06
Indiana Banks	3.21	3.26	3.03
Kentucky Banks	2.43	2.45	2.41
Mississippi Banks	2.77	2.92	2.80
Missouri Banks	3.76	3.17	2.99
Tennessee Banks	3.11	3.73	3.95
<b>NONPERFORMING LOAN + OREO RATIO<sup>4</sup></b>			
All Eighth District States	5.16	5.44	5.44
Arkansas Banks	4.49	5.58	6.09
Illinois Banks	6.50	6.79	6.75
Indiana Banks	3.80	4.02	3.80
Kentucky Banks	3.43	3.72	3.61
Mississippi Banks	4.05	4.64	4.56
Missouri Banks	5.62	4.88	4.74
Tennessee Banks	4.88	5.75	6.04

SOURCE: Reports of Condition and Income for Insured Commercial Banks.

NOTES: <sup>1</sup> Because all District banks except one have assets of less than \$15 billion, banks larger than \$15 billion have been excluded from the analysis.

<sup>2</sup> All earnings ratios are annualized and use year-to-date average assets or average earning assets in the denominator.

<sup>3</sup> Nonperforming loans are those 90 days or more past due or in nonaccrual status.

<sup>4</sup> OREO stands for other real estate owned.

# Unlike Prior Decades, House-Price Changes in Largest District Cities Are Following National Trends

By Julia Maués, Daigo Gubo and William Emmons

Before the recent housing boom and bust, changes in local house values appeared to be a localized phenomenon. Knowing how much house prices were changing on average nationwide, or in any other city, wouldn't help us predict local changes.

Although some areas of the country had experienced declines in the past, few people thought a nationwide decline in house prices was likely. However, all national indexes of house prices did fall significantly in recent years. And if the current trend of synchronized weakness continues, then problems in housing markets nationwide should be seen as potential problems for markets in our District.

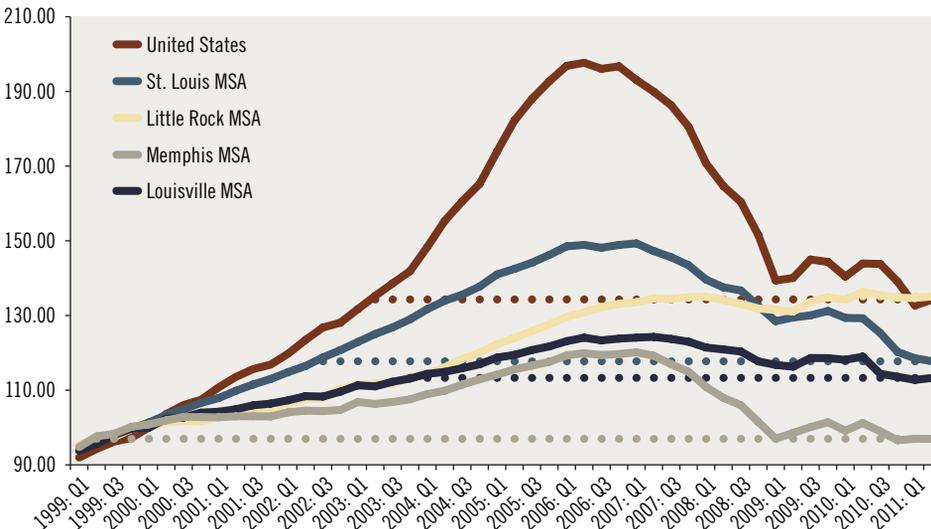
As shown in Figure 1, during the build-up of the housing bubble, the St. Louis, Little Rock, Louisville and Memphis markets did not experience increases in prices as large as those seen in the nation as a whole.<sup>1</sup>

Nevertheless, between January 2000 and the quarter of each Eighth District MSA's peak, prices increased about 50 percent in St. Louis, 35 percent in Little Rock, 25 percent in Louisville and 20 percent in Memphis. While the amplitude of increases over the same period for the United States on average was much higher, the pattern of growth and decline was similar.<sup>2</sup>

It might seem logical to assume that markets that experienced the highest appreciation in house prices consequently saw the largest declines. However, as seen in Figure 1, while Memphis experienced the lowest appreciation among the four metropolitan areas, home prices in Memphis are back to second quarter 1999 levels. In St. Louis, prices are down to second quarter 2002 levels, and in Louisville they are back at fourth quarter 2003 levels. Little Rock is the exception in the District; prices there have recently reached all-time highs. The better performance of

*continued on Page 6*

**FIGURE 1**  
**U.S. and Eighth District MSA CoreLogic House-Price Index**



SOURCE: CoreLogic. Figures are seasonally adjusted, quarterly and indexed, with 2000 = 100. Last observation was 2011: Q2.

NOTE: The dotted lines match 2011: Q2 house-price levels with the corresponding levels from previous years.

## House-Price Changes

*continued from Page 5*

Little Rock's housing market compared with other cities in the Eighth District can be attributed to, among other factors, a lower unemployment rate and higher population growth.

FIGURE 2

### Correlation between National and MSA CoreLogic House-Price Index

Quarter-over-Quarter Change, 1980 to 2011: Q2

	U.S.	St. Louis	Memphis	Louisville	Little Rock	Miami
<b>1980-1989</b>						
U.S.	1.00	0.31	0.18	-0.15	-0.12	0.41
St. Louis	0.31	1.00	0.13	-0.06	-0.03	0.02
Memphis	0.18	0.13	1.00	-0.04	-0.09	-0.04
Louisville	-0.15	-0.06	-0.04	1.00	-0.16	-0.41
Little Rock	-0.12	-0.03	-0.09	-0.16	1.00	0.24
Miami	0.41	0.02	-0.04	-0.41	0.24	1.00
<b>1990-1999</b>						
U.S.	1.00	0.53	0.17	0.04	0.04	0.20
St. Louis	0.53	1.00	0.35	0.04	0.10	-0.06
Memphis	0.17	0.35	1.00	-0.02	0.42	0.13
Louisville	0.04	0.04	-0.02	1.00	0.46	0.41
Little Rock	0.04	0.10	0.42	0.46	1.00	0.29
Miami	0.20	-0.06	0.13	0.41	0.29	1.00
<b>2000-2011: Q2</b>						
U.S.	1.00	0.86	0.83	0.67	0.68	0.85
St. Louis	0.86	1.00	0.81	0.76	0.64	0.81
Memphis	0.83	0.81	1.00	0.72	0.71	0.77
Louisville	0.67	0.76	0.72	1.00	0.68	0.70
Little Rock	0.68	0.64	0.71	0.68	1.00	0.75
Miami	0.85	0.81	0.77	0.70	0.75	1.00

SOURCE: CoreLogic

### Eighth District Cities and a "Poster Child"

We examined the degree to which house prices in Eighth District cities and across the U.S. vary together. To pick a city with very different economic fundamentals than those in the Eighth District, we also included Miami. As a poster child of the housing boom and bust, Miami plausibly would have experienced very different house price movements than cities in the Eighth District. Figure 2 depicts the correlation coefficients for these relationships during the previous three decades (1980 through 2011: Q2).<sup>3</sup>

Because of the important role that local indicators played prior to the 2000s, the correlation among house prices across

different regions of the country was very low. During the 1980s and 1990s, the correlation among house prices in major Eighth District MSAs and Miami was quite low, ranging from -0.41 to 0.41. More recently, however, the boom and bust in house prices affected all major regions of the U.S., albeit with different magnitudes. In the 2000s, house prices in the District's four largest metro areas moved much more closely with those in Miami. Correlations increased significantly, ranging from 0.70 to 0.81.

### To Summarize

Loosening and then tightening credit standards affected the whole country and conceivably contributed to similar movements in prices. Although it is not clear why house-price correlations among such distinct cities are so much higher in the most recent decade, the largest Eighth District cities are following the national trend in house prices more closely than before. Therefore, even if economic fundamentals in the Eighth District suggest that our house prices are likely to stabilize, downward house-price trends in other regions of the country may continue to negatively affect prices here.

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#### A Closer Look at House Price Indexes

[www.stlouisfed.org/priceindexes](http://www.stlouisfed.org/priceindexes)

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### ENDNOTES

- <sup>1</sup> This article uses the CoreLogic Home Price Index.
- <sup>2</sup> St. Louis peaked in 2007: Q1, Little Rock peaked in 2010: Q2, Louisville peaked in 2007: Q1 and Memphis peaked in 2007: Q2.
- <sup>3</sup> Perfect positive correlation (a correlation coefficient of +1) implies that as house prices in one area move, either up or down, prices in the other area will move in the same direction. Alternatively, perfect negative correlation means that if prices in one area move in either direction, prices in the area that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of prices in the two areas are said to have no correlation; they are completely random.

## Agriculture Banks

*continued from Page 1*

assets at agriculture banks has, by and large, remained manageable, resulting in lower loan losses. Moreover, given their business model, agriculture banks have generally had lower exposures to the weak commercial real estate sector compared with other community banks. As illustrated in the table on Page 1, agriculture banks exhibit stronger asset quality, capital protection and earnings levels than their nonagricultural counterparts.

Despite strong conditions in the agricultural sector, farm debt has remained moderate. In 2010, combined farm debt held by all U.S. banks and the Farm Credit System (FCS) increased 2.01 percent from the prior year, down from a 3.51-percent increase in 2009. According to the USDA, banks and the FCS supply 80 percent of farm credit outstanding. As such, it appears the surge in land values and capital expenditures are primarily funded by cash derived from farm profits.

Data also suggest that debt repayment ability of farmers continues to improve. According to Federal Reserve agricultural credit surveys, agriculture banks reported higher loan customer repayment rates and fewer loan extensions in 2010.

### Risk Factors for Agriculture Banks

The soaring commodity prices and farm incomes that have strengthened the sector are not without risk. Escalating farm incomes and low interest rates have led to a recent surge in

farmland values. The sustainability of higher farmland values depends on this trend continuing.

The Page 1 table also highlights another risk facing agriculture banks: the potential for over-relying on collateral values when making credit decisions. Since loans secured by farmland constitute more than twice the amount of credit extended for agricultural production, the majority of agricultural loans on an agriculture bank's book are secured by farm real estate. In an environment of surging farmland values, lenders must therefore exert additional caution when underwriting these loans.

### To Summarize

Overall, industry factors remain favorable for agriculture banks. However, because a concentration in any economic sector can result in volatility, bankers should ensure that strong risk management practices are in place.

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*Gary S. Corner is a senior examiner at the Federal Reserve Bank of St. Louis. The author thanks Daigo Gubo, senior research associate in the Supervisory Policy and Risk Analysis unit, for contributing to this article.*

## Earnings Growth

*continued from Page 3*

nonperforming multifamily and non-farm nonresidential real estate loans increased.

The average loan loss coverage ratio declined somewhat at District banks in the second quarter. District banks have about 62 cents reserved for every dollar of nonperforming loans, down a penny from the first quarter level. The coverage ratio for U.S. peer banks

stood at 58 percent at the end of the second quarter.

Despite the slight downtick in earnings in the second quarter of 2011, the average tier 1 leverage ratio increased 16 basis points to 9.26 percent at District banks. Buoyed by the increase in profits, the average tier 1 leverage ratio climbed 23 basis points to 9.86 percent at U.S. peer banks.

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