

RESEARCH BUZZ



BOTTOM LINE: INDIANA TOLL ROAD NOT WORTH \$3.8 BILLION TO STATE

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The state of Indiana passed legislation in March 2006 that allows the state to lease the Indiana Toll Road across Northern Indiana for \$3.8 billion.

The lessee is Statewide Mobility Partners, a joint venture of McQuarie Infrastructure Group of Australia and Cintra of Spain. As with any legislation involving so much money, arguments circulated from all sides and thoroughly confused the discussion with fallacious or specious arguments about the benefits or costs of the decision to privatize the road. Few, if any, on either side discussed the key issue, what is a road worth, and, in particular, is it worth more or less to a private company (at least \$3.8 billion) than it is to the state.

Did the state get a bargain?

The economic case for privatization of a road requires a comparison of what the road is worth to the state versus what the state gets if it privatizes it. If the state receives more for the asset than it is worth to the state, then the state and its taxpayers gain. If the reverse is true, that is, the road is worth more to the state than the payment by the private firm, then the taxpayer loses. And the payment by the private firm is largely determined by the value of the road to the firm.

Stephen Fidler (Financial Times, March 7, 2006) points to a new study that suggests that assets are more likely to always be worth more to the state than they are to the private sector. The study of a recent French sale of a 50.4 percent interest in a franchise called ASF that already managed French toll roads was "absurd," according to the authors of the study, and according to Fidler, called into question "all privatizations by credit worthy governments that are driven by purely financial concerns."¹ The authors of the study note that there are exceptions to the case against privatization, but in their

view there are compelling reasons why privatization is poor public policy.

In their particular case, the management and control of ASF was already in private hands, so there were no cost saving or revenue increases that were likely that

the annual toll revenue less the costs of operating and maintaining the road.² Suppose that the net cash from the asset grows at rate p annually reflecting a steady pace of general price inflation in road costs and other prices and a pace of increase in the relative price of the toll to keep road use in line with its capacity from now on. The value of the asset is the present value of all the future net cash flow from the road.

To find the present value in this case, one divides the initial net cash

Foulquier emphasize, the discount factor for a private firm is going to be much higher than for most states and this sets up a fundamental presumption that any asset is likely to worth more to a state than to a private firm, an obviously more questionable proposition for reasons described below.

Investors in private firms take on bankruptcy risk that is not shared by most states or that is typically much higher than the bankruptcy risk of a state. Second, investors face volatility in future values of private assets so there is a risk premium associated with the value of their claims on assets, for which they will also demand to be compensated. Third, private firms are not able to borrow all of the value of the assets of their firms because lenders demand that firms have some "skin in the game" along with the lenders investment in the firm. This reduces the risk to lenders that the firm's owners will take excessive risk with the assets of the company and it increases the collateral available to lenders should the firm fail. Thus the cost of capital includes higher cost equity capital, a higher rate of return than the interest cost of debt, as well as the cost of debt, which, in turn, is also higher for a private firm. For both reasons, private firms must earn a higher rate of return to secure and hold capital than a state would.

There is another key difference that sets up a presumption that an asset is worth more to a state. That difference is taxation. A private firm has to pay taxes so that even if it earns the same net cash flow ignoring taxes, R in the equation, it does not receive all of it. Instead it receives $R(1-t)$ where t is the tax rate. If the tax rate is one-third, for example the same stream of profit for a private sector firm will be worth one-third less to a private firm because the owners of the private firm lose one-third of the annual value of the asset to the tax collector. For a state that is exempt from federal taxation, the same pro-

Many voters would bristle at the idea that there is an inherent advantage of state ownership. And usually there is not such an advantage, because the powerful advantages of state ownership are overwhelmed by inefficiencies of ownership and management by state bureaucrats. But tax differences and differences in the cost of capital have huge effects on the value of the same asset, depending on whether it is owned by the state or by a private firm. The lower cost of capital alone would suggest that virtually all economic activity is cheaper and if taken over by states that borrow to pay existing market prices of private sector assets.

could boost the annual return from the toll roads, which is the major exception (actually the rule in privatizations).

But their implicit case against privatization does not hold up as a generalization. To see why, we can examine what a road or other asset is worth to the state as compared with its value to a private sector firm to focus on the key determinants of the value difference.

To keep it simple, suppose that there is an asset, in this case a road, that has an initial net cash flow or profit to the owner of $\$R$ per year and the asset lasts forever. The annual net cash flow in this case is

flow by the "discount rate" (d) less the rate of growth of annual net cash flow (p). A formula for the value of the asset (V) to the state is:

$$V = R/(d - p)$$

The formula shows the key factors that influence the value of an asset and makes it easy to see why the same asset might have different value to another owner.

What is the value of asset to the private firm? The valuation process is the same and the value would also be the same if the inputs in the equation are the same, but that is not likely.³ First, as Amenc and

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ject or asset is worth 50 percent more than it would be to a private investor, ignoring other factors (\$1 versus \$0.67, per dollar of before-tax net cash flow R). In the Indiana Toll Road case, the tax in question is the federal income tax, which is not levied on the state's income from the toll road, but would be levied on the income of a private lessee.

Thus the case against privatization rests on the fact that the discount factor or cost of capital (d) is higher for a private firm than a state and the net cash flow of a private firm is lower because of taxation of its profits [(1 - t) R instead of R in the equation above]. But the other two terms in the valuation equation are also not likely to be the same for a private firm and economic theory suggests that the differences in the net cash flow and its growth rate will favor private sector ownership. Indeed it is the difference in net cash flow that favors privatization.

First, net cash flow is likely to be higher for a private firm than a state-owned asset. The reason is that a private firm will minimize cost and will determine prices or output so as to obtain the biggest excess of gross revenue over cost.³ State-owned assets are managed with other considerations in mind, especially increasing the reelection chances of state officials. Thus states tend to have excessive costs in delivering services, especially labor costs because of excessive levels of employment and sometimes excessive wage levels. States also do not set prices at levels that maximize the market values of assets. Political pressures, including concerns for availability of state services to low-income voters, and voter discontent with the perception of high prices of state services usually hold prices down and slow the pace of price increases. Thus costs are higher, gross revenue is lower and so net cash flow is lower, as is its growth rate. Successful privatization

rests on improving the efficiency of use of assets and pricing services in accordance with the value to users. The popularity of privatization rests on delivering greater value at lower cost to voters and other consumers. And the gains in net cash flow, R, and secondarily its growth rate, p, are sufficiently large in many cases to make the value of an asset to a private firm greater than it is to the government, notwithstanding the tax and cost of capital difference that private firms must pay and earn, respectively. As a result, the key characteristic of market transactions holds with privatizations: the buyer of the asset gains, as does the seller of the asset, the state and citizens.

Many voters would bristle at the idea that there is an inherent advantage of state ownership. And usually there is not such an advantage, because the powerful advantages of state ownership are overwhelmed by inefficiencies of ownership and management by state bureaucrats. But tax differences and differences in the cost of capital have huge effects on the value of the same asset, depending on whether it is owned by the state or by a private firm. Indeed, the lower cost of capital alone would suggest that virtually all economic activity is cheaper if taken over by states that borrow to pay existing market prices of private sector assets. Some voters also benefit from the inefficient use of state assets, through obtaining higher paying jobs than they would have otherwise, or obtaining services that would be more expensive or unaffordable if they were not provided through the use of state-owned assets.

At the end of the day, however, these advantages of state ownership typically are dominated by the ability of private firms to use the same assets to generate more value relative to cost. The breakdown of socialist states over the past 20 years and continuing shift of

state assets to the private sector reflect the dominant economic performance of private enterprises and actual realization, in many cases of the bankruptcy of state ownership.

The evaluation of particular state privatizations depends on the facts in each case. The Indiana Toll Road privatization may or may not have been a bargain for the state. There is strong evidence that the state did not price the toll economically because the toll had not changed in 20 years despite a near 90 percent rise in other prices over the period. Costs were inflated as well, as the state relied on antiquated technology to collect tolls and maintain the road. Another possibility is that the private sector bidders for the road may have made a mistake. In particular, they may have paid too much for the road, that is, more than the road is worth to their investors. The bottom line is that under a broad range of plausible economic assumptions about the future net cash flow from the road under continued state ownership, the road was not worth \$3.8 billion.

Tatom is director of research at Networks Financial Institute.

(1) See, Noel Amenc and Philippe Foulquier, "The issue of the discount rate for motorway franchise holders: the case of ASF," Edhec Risk Management Research Centre, March 2006, Nice, France.

(2) In practice, the net cash flow is a measure of economic profit that differs from taxable profits because of differences in economic depreciation from tax depreciation and other accounting differences. Those differences are ignored in the discussion.

(3) The discussion of the value to a private company here assumes that the road is purchased instead of a purchase of a 75-year lease. There is little difference, however, in valuation and the purchase of the road is simpler to value and simpler to compare to state ownership. For example, at a discount rate of 10 percent, the value of a given fixed annual cash flow from the road that is owned outright is less than 0.1 percent larger than if the lease is held for 75 years. On a \$3.8 billion lease, that difference is about \$3 million, or a rounding difference for customary reporting.

(4) If net cash flow in any period is dependent on net cash flow in other periods then the decisions required to make value (V) as large as possible will be a little more complicated, but the point is essentially the same.

NFI ADVOCATING EARLY FINANCIAL LITERACY EDUCATION

BY DAVID GODSTED and MARTHA HENN McCORMICK

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The National Foundation for Educational Research defines financial literacy as the ability to make informed judgments and to take effective decisions regarding the use and management of money.

Networks Financial Institute views financial literacy as a “subset” of literacy itself, a discrete skill set that it is important for people to become proficient in so that they reach a level considered to be functional in our society.

Other types of literacy that have become better known include health literacy, media literacy and technological literacy.

Grover Whitehurst and Christopher Lonigan allude to “changing conceptualizations of what constitutes literacy; . . . recent years have seen the concept of literacy extended to any situation in which an individual negotiates the environment through the use of a symbolic system.”¹

By this definition of literacy, the relationship of the individual to money

issues is most certainly part of the rubric of literacy.

It has become widely recognized that literacy, as the foundation for virtually all other subject areas, needs to be taught from the very earliest ages; this focus on early childhood literacy is known as emergent literacy.

“Currently, emergent literacy has superseded the concept of reading readiness in early childhood education. Emergent literacy is encouraged by the developmental theory of Lev S. Vygotsky and indicates that children do not learn to read immediately after they are believed to be ready. Instead, the process of learning to read develops and drags out loosely over an extended duration as children accumulate knowledge of and experience with the spoken and written language.”²

Ritchie and others also contend that there is no clear distinction between reading and non-reading in the emergent literacy phase but that the transition from being a non-reader to a reader happens on a develop-

mental continuum.³ Following this premise, NFI contends that, similarly, the core concepts that undergird financial literacy (delayed gratification, goal setting, philanthropic giving, earning, spending) also need to be emphasized and supported from the very earliest ages, if students are to transition into financially literate consumers. Addressing financial literacy as early as grades K-2 lays the groundwork for more advanced studies of financial literacy that typically appear in the later years of K12 education, through the subjects of economics, business education, family and consumer sciences, and mathematics. Research in emergent literacy shows that “children need to learn mainstay concepts . . . from which more complex and elaborated understandings and motivations arise.”⁴

As a subset of literacy, then, parents, teachers, school districts, boards and departments of education and our entire nation must come to terms with the fact that students cannot afford to wait until middle or high school to begin learning about financial literacy. “Educators need to adopt and meaningfully apply the view of consumer education as a lifelong process, which should be initiated early to ensure responsible consumer behavior that will continue into adult-

hood.”⁵ NFI is preparing a position paper advocating early financial literacy education; it will debut at NFI’s 2006 Indiana Financial Literacy Conference on April 10 in Indianapolis and will subsequently be available on NFI’s website.

For more about the conference, visit NFI online: networksfinancialinstitute.org.

□ Godsted is director of outreach and McCormick is research coordinator at Networks Financial Institute.

(1) Whitehurst, Grover J. and Christopher J. Lonigan. “Emergent Literacy: Development from Prereaders to Readers.” In Neuman, Susan B. and David K. Dickinson, eds., *Handbook of Early Literacy Research*. NY: Guilford P, 2001: 11-29, 12

(2) Saracho, Olivia N. and Bernard Spodek. “Recent Trends and Innovations in the Early Childhood Education Curriculum.” *Early Childhood Development and Care* 173(2-3) 2003: 175-183, 180

(3) Ritchie, Sharon, Jolena James-Szanton, and Carollee Howes. “Emergent Literacy Practices in Early Childhood Classrooms.” In Howes, Carollee, Ed. *Teaching 4- to 8-Year-Olds: Literacy, Math, Multiculturalism and Classroom Community*. Baltimore: Paul H. Brookes Publishing Co., 2003: 71-92, 75

(4) Roskos, Kathleen A., James F. Christie and Donald J. Richgels. “The Essentials of Early Literacy Instruction.” *Young Children* 58(2) Mar 2003: 52-60, 55

(5) Cohen, Stewart. “Consumer Socialization: Children’s Saving and Spending.” *Childhood Education* 70(4) Sum 1994: 244.

NFI GRADUATE FELLOW ATTENDS ANNUAL INSURANCE SUMMIT

BY REBECCA SHORTER

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Two very different positions on the issue of an optional federal charter for the insurance industry emerged during NFI’s third annual Insurance Reform Summit in March. One argument supports the optional federal charter that puts the federal government in the regulatory driver’s seat. The other favors passage of the State Modernization and Regulatory Transparency Act, which would leave the primary power in the hands of the state with the option of deferral to the federal government.

As the search for a regulatory solution continues, optimists anticipated action by Congress this year while others say it might take years.

The purpose of this year’s 3rd Annual Insurance Summit in Washington D.C. on March 1, 2006 was to review, discuss, and debate the cur-

rent regulatory system for the insurance industry and plans for the future. Currently, insurance is regulated by individual states. As Dr. Scott Harrington, the Alan B. Miller Professor, in the Health Care Systems and Insurance and Risk Management Departments in the Wharton School of the University of Pennsylvania pointed out, this is causing some major issues and inefficiencies in the system.

For example, insurance companies must adhere to 50 different sets of regulation if they want to sell insurance in all 50 states, creating confusion for the insurance company. Dr. Harrington also pointed out there are extra costs and delays in approval of policies and forms with the current state-based regulatory system. Another important factor is there are many underwriting and rate classifi-

cation restrictions placed on companies by the states.

The current proposal of an optional federal charter includes leaving the state regulator system in place and adding a federal chartering and regulatory regime so that insurance companies can decide who their regulator will be. This proposal would help eliminate a lot of the extra costs and inefficiencies associated with the current state-based system. It would also allow for a more open and competitive market.

However, Allesandro Iuppa, the current President of the National Association of Insurance Commissioners, presented a different point of view. He pointed out that if optional federal charter were enacted, this would add confusion for consumers. For example, if a consumer buys life insurance through a federally-char-



Shorter

ter company and auto insurance through a state-charter company, they could get confused between the different regulations. Another problem is how would customer complaints about a federally-chartered insurer be handled? Since they are currently handled by the state, would new federally regulated agencies be set up to handle complaints on federally chartered insurance companies? Iuppa and the NAIC feel that an optional federal charter would create problems and pitfalls for the system. He believes that creating more uniform regulation at the state level, the current aim of the NAIC, is a better option to go with instead of federal charter. Overall, I learned a great deal from this summit. The most important fact that I took away from this summit is that almost everyone agreed that there needs to be change and modernization in the current system. The argument is, what form this change should take. Time will tell and it will be interesting to watch as the future of the insurance regulatory system evolves in the upcoming years.

STATE'S BANKING INDUSTRY EXPERIENCES RECENT CHANGES

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The banking sector plays a very important role in the state economy. In 2005, there were a total of 35,580 employees (full-time equivalent) working for both savings institutions (5,039) and commercial banks (30,541) in Indiana. Commercial banks are the source of most of the jobs in the industry. Although the number of savings institutions and commercial banks declined over the past 10 years, total number of employees working in the industry is higher than what it used to be in 1995 by 3,180 jobs.

Savings institutions and commercial banks had total assets of \$15.9 and \$85.8 billion, respectively, in 2005. Total assets of commercial banks peaked in 2002 with \$114.1 billions. Compared to 2005, this represents a 24.7% drop.

Savings institutions have seen their total assets peak in 2000 with \$16.9 billion. In the following year, total assets dropped sharply to \$14 billion.

However, since 2001, it has steadily increased.

The number of commercial banks in Indiana declined to 131 from 140 in 2005. In the same period, the number of savings institutions declined to 55 from 57.

Mostly due to consolidation in the banking industry, the number of commercial banks and savings institutions dropped almost every year beginning in 1995.

Business lending by Commercial Banks peaked in 2001 with \$12.7 billion. After 2001, business lending by Commercial Banks continued to decline until 2005. However, in 2005, it increased by 7.43 percent to \$9.5 billion.

In 2005, Savings Institutions provided \$801 million to the business sector. Considering that business lending by savings institutions was only \$330 million in 1995, this represents a significant increase.

Financial institutions performed very poorly in 2005. Except for 2000, when the nation economy skidded into recession,

2005 was the worst year in over a decade. Commercial banks received the best return on the equity investment in 2003 with 21.6%. It was the highest for Savings Institutions in 1998 with 13.0% percent. For the last two years, return on equity declined for both Savings Institutions and Commercial banks.

However, the percentage of unprofitable institutions in the industry also declined in 2005 to 7.27% and 2.29% respectively. In 2004, there were 7 unprofitable commercial banks in Indiana. In 2005, the number declined to 3. The number of unprofitable savings institutions has been declining since 2002. There were 4 unprofitable savings institutions in 2005, down from nine in 2002. Thus for both banks and savings institutions, the decline in profitability was very widespread.

Over the last 10 years, the average percentage of unprofitable institutions in Indiana was 3.28% which is lower than nation's average of 6.04%. However, Savings and Loans Institutions in Indiana performed poorly compared to the nation with 8.01% vs. 7.05%.

Commercial banks in Indiana had a higher average return on equity over the past 10 year with 15.17% compared to nation's average of 14.23% for the same period. Especially during 2003 and 2004, Indiana banks significantly outperformed national commercial banks in regards to return on equity.

For the both these two years, return on equity of Indiana banks were over 20% compared to national commercial banks return on equity of 15.31% in 2003 and 13.74% in 2004.

Although commercial banks in Indiana were doing relatively better than commercial banks in the rest of the country, savings and loans institutions were behind both in terms of return on equity and percentage of unprofitable institutions. Over the past year, average return on equity of Savings and Loans Institutions in Indiana were 8.76% compared to nation's 11.13%.

On the decline

The number of savings institutions and commercial banks in Indiana has declined since 1995.

Year	Savings Institutions	Commercial Banks
1995	79	211
1996	76	204
1997	71	185
1998	69	169
1999	68	158
2000	66	153
2001	63	154
2002	59	151
2003	58	148
2004	57	140
2005	55	131

Source: Federal Deposit Insurance Corp.

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The percentage of unprofitable institutions

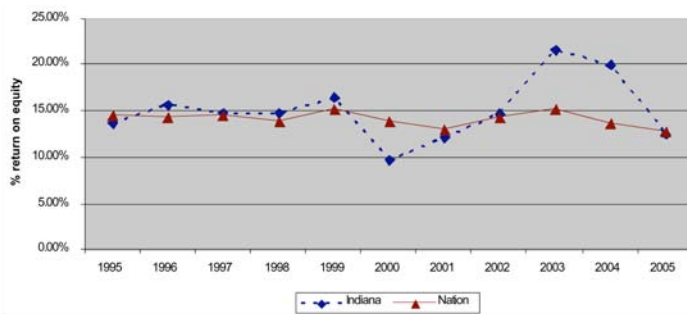
Over the last 10 years, the average of percentage of unprofitable institutions in Indiana was 3.28 percent lower than the national average of 6.04 percent.

Year	Commercial Banks		Savings and Loans Institutions	
	Indiana	Nation	Indiana	Nation
1995	1.42%	3.55%	1.27%	5.86%
1996	2.45%	4.29%	10.53%	12.05%
1997	3.24%	4.85%	1.41%	4.10%
1998	5.33%	6.11%	5.80%	5.27%
1999	3.80%	7.52%	8.82%	8.28%
2000	3.92%	7.34%	7.58%	8.56%
2001	3.90%	8.13%	11.11%	8.80%
2002	1.32%	6.64%	15.25%	6.82%
2003	3.38%	6.01%	10.34%	5.81%
2004	5.00%	5.87%	8.77%	6.47%
2005	2.29%	6.15%	7.27%	5.52%
Average	3.28%	6.04%	8.01%	7.05%

Source: Federal Deposit Insurance Corp.

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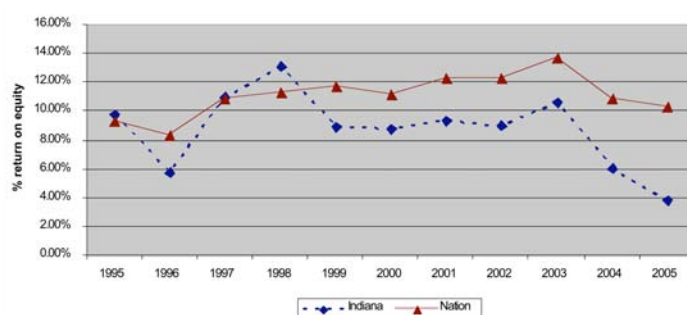
Return on equity for commercial banks



Source: Federal Deposit Insurance Corp.

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Return on equity for savings institutions



Source: Federal Deposit Insurance Corp.

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■ The Top 10

The top 10 commercial banks and savings institutions in Indiana ranked by assets size in 2005.* These banks made up about 70 percent of total employment and 65 percent of total assets of all commercial banks in the state. The top 10 savings institutions made up about 66 percent of total employment and 59 percent of total assets of all savings institutions in the state.

Commercial banks

RANK	NAME	CITY	TOTAL ** ASSETS	EMPLOYEES
1	National City Bank of Indiana	Indianapolis	26,271	12,585
2	Old National Bank	Evansville	8,340	1,905
3	Irwin Union Bank and Trust Company	Columbus	6,180	2,202
4	1st Source Bank	South Bend	3,430	1,056
5	Integra Bank National Association	Evansville	2,701	843
6	First Financial Bank, National Association	Terre Haute	2,045	725
7	First Indiana Bank, National Association	Indianapolis	1,963	542
8	Lake City Bank	Warsaw	1,634	434
9	Centier Bank	Whiting	1,532	590
10	MainSource Bank	Greensburg	1,447	425

Savings institutions

NAME	CITY	TOTAL ** ASSETS	EMPLOYEES
Bank of Indianapolis	Indianapolis	3,329	1,671
Citizens Financial Bank	Munster	1,241	347
Mutual Federal Savings Bank	Muncie	970	257
Lincoln Bank	Plainfield	844	230
Peoples Bank SB	Munster	627	150
MFB Financial (The Savings Bank)	Mishawaka	530	163
Irwin Union Bank, F.S.B.	Columbus	507	95
Ameriana Bank and Trust, SB	New Castle	449	147
First Harrison Bank	Corydon	438	132
First Federal Savings Bank	Rochester	413	125

Source: Federal Deposit Insurance Corp.

* As of December 2005 ** \$ million

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ADULT FINANCIAL LITERACY EVENT TO FOCUS ON GROWING PROBLEM

BY DR. JOHN A. TATOM

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Financial literacy is becoming widely recognized as a fundamental problem everywhere. Up to 40 million Americans do not use mainstream banking services. According to a survey conducted by FleetBoston in September 2003, only 27 percent of U.S. adults feel well-informed about managing their own household finances.

NFI has organized a conference focusing on issues surrounding adult financial literacy.

The March conference in Indianapolis will focus on the broad issues of what constitutes adult financial literacy, how it is assessed, how it can be improved and why adult financial literacy matters.

Among other topics, the conference will discuss what every adult should know or be able to do to consider himself or herself financially

literate and able to make sound financial decisions; what consumers know about the financial requirements of daily life, financial services opportunities and how to make effective decisions; how standards are changing; what the role of our educational institutions is in making students and young adults literate; and whether better regulation is needed.

A panel of national experts on finance and financial literacy at the conference will include:

- Zvi Bodie, professor of finance at Boston University, one of the nation's leading experts on finance and a well-known author of the leading textbook on investments;
- Lewis Mandell, professor of finance at the State University of New York at Buffalo, author of numerous studies on financial

literacy and developer of a high school test of financial literacy that has been used for more than 10 years to assess the nation's financial literacy;

- Annamaria Lusardi, professor of finance at Dartmouth College and a national expert on financial literacy;
- Robert Lerman, professor of finance at American University; and
- John Caskey, a professor of economics at Swarthmore University.

Also at the conference, financial researchers will take a look at the financial service opportunities available to low-income, often financially illiterate consumers.

Professor Gregory Elliehausen of the Credit Research Center at Georgetown University will review what is known about the customers of sub-prime lenders, pawn shops, payday lenders and other providers of high-cost credit services.

Two other papers will provide a more detailed look at the experience with payday lending, who borrows, the growth of the industry, its

profitability, the extent to which it may have excessive rates of return and whether excessive returns are related to highly-dependent repeat customers.

Dr. Katherine Samolyk of the Federal Deposit Insurance Corp. will discuss her recent research with Prof. Mark Flannery on payday lending.

And Prof. J. Ronnie Phillips will present results of his ongoing research with Dr. Robert DeYoung of the Federal Deposit Insurance Corp. on payday lending in the first comprehensive look at payday lending within one U.S. state — Colorado.

REGISTRATION REQUIRED

Registration is required to attend NFI's Adult Financial Literacy Conference, which starts at 8:30 a.m. March 28 at the Columbia Club in Indianapolis. Space is limited. To register, visit NFI online at networksfinancialinstitute.org or call 800.603.7113.