Mr. Chairman and members of the Committee, my name is John (Skip) Bright, President of the Keokuk Savings Bank & Trust Co., Keokuk, Iowa. I am pleased to appear before you today to present my testimony on "Preserving and Protecting Main Street USA."

Keokuk Savings Bank & Trust is a $92 million community bank that serves primarily individual, small business, and agricultural customers. Our bank has been serving the citizens of Keokuk for 132 years.

Community banks are small businesses that serve individuals and small business customers. Because of our unique role in America's communities, and the unique needs of our bank customers, the legitimate competitive concerns and special needs of community banks warrant special attention. On Main Street U.S.A., community banks are as much a part of the economy and growth of a local community as any other small business. Therefore, the special needs of all small businesses, including community banks, should be better appreciated and preserved.

In my statement today, I would like to emphasize three key points:

Most banks are small businesses trying to meet the needs of our communities -- particularly the other small businesses that are the heart and soul of our economic livelihood.

The most critical challenge today for businesses is funding. Without access to deposits, banks cannot possibly meet the needs of our customers.

Legislative changes would protect and preserve small businesses.

Although I am testifying today on behalf of myself, through my involvement with the Iowa Bankers Association and the American Bankers Association, I know that my views are widely shared among other community banks.

MOST BANKS ARE SMALL BUSINESSES THAT LEND TO SMALL BUSINESSES

Small businesses, farmers, rural customers, and rural leaders look to their hometown bankers for leadership to help them survive and thrive. The banking industry is the primary source of credit to small businesses throughout this country. Today, banks have more than $230 billion in loans outstanding to small businesses – almost a 10 percent increase from the prior year's level – and we continue to meet the needs of small businesses. Moreover, according to the U.S. Department of Agriculture, banks are the primary source of credit for farmers.

Most banks are small businesses that lend to small businesses. Nationally, over half of the banks in the U.S. can be classified as small, rural businesses, and over 40 percent have less than 25 full-time employees. In Iowa, over 60 percent of all banks have less than 25 employees.

Keokuk Savings Bank & Trust is a small business with 42 employees. The small business customers that we generally lend to are not typical according to any standard Washington definition, but are certainly typical in rural America. While the Small Business Administration definition of small business generally includes those firms with up to $5 million in sales, my typical business borrower has between $350,000 and $400,000 in annual sales. The typical loans our bank would have to such a customer would include a $50,000 to $60,000 operating line of credit and a $100,000 to $200,000 loan for equipment.

While direct agricultural lending represents only 20 percent of our bank's loan portfolio, every employer in our community is a value-added industry to agriculture or a service provider dependent on these businesses and agriculture for their survival. These customers are our lifeblood, as we are theirs. Our officers drive by their front doors every day. We take care of them, and they take care of us. They leave their deposits with us and we use them to fund other small businesses. With additional funding opportunities, we could do much more.

THE MOST CRITICAL CHALLENGE TODAY FOR BUSINESSES IS FUNDING

Finding funds to support loans is the number one challenge facing banks today. During periods of diminished liquidity, small business loans are at a disadvantage relative to other more liquid investments. The funding side is where banks presently need the most assistance in lending to small businesses, making this the ideal time to explore new options to ensure that lenders have a reliable, dependable source of funds to meet small business borrowers' credit needs. Such efforts are crucial to assisting banks in their continued role as engines of local economic development.

Banks have seen strong demand for credit from the businesses and consumers in their districts, but we are struggling to attract deposits to fund loans. The past two decades have seen major changes in the financial services industry, with many new competitors vying for the consumer's dollar. Our biggest funding competition is Wall Street, not the bank across Main Street. Growth in money market funds, stock prices and mutual funds has lured core deposits away from us. Chart 1, which is included at the end of this testimony, demonstrates that depositors are shifting funds out of bank checking accounts ("demand deposits") and into money market funds. Similarly, Chart 2 shows that the money that used to be in savings accounts ("time deposits") at banks is increasingly going into mutual funds.

The November 2000 *American Bankers Association 2000 Farm Credit Survey Report* found that this problem is especially acute for rural banks. In urban areas, our banks are struggling to attract deposit funds, and are successful only at rates that squeeze earnings. Our rural banks, on the other hand, are finding that money has left the community and is simply not available. Of the rural banks that responded to the survey, 57 percent said that their deposits did not grow fast enough to meet loan demand, up from 33 percent a year earlier. Moreover, six percent of the rural banks surveyed recently reported that they have had to turn down good loans because they could not get deposits.

Although Wall Street competes with us for funding, it is not funding the small business customer. That job is left to the bank. Over the last decade, bank loan growth has surpassed core deposit growth. As the following chart shows, loan-to-deposit ratios continue to rise at rural banks. The run-off of deposits has left us struggling to maintain the flow of credit. So far, we have been able to continue making loans, but we are running out of funding mechanisms and searching for deposits so that we can continue to make good loans to small businesses, farmers, and others in our communities. This has placed pressure on bank liquidity and the ability of banks to meet the credit demands of small businesses.

These funding demands are very personal. Last week, just outside of Keokuk, I was at an event announcing the expansion of a small business who had been a customer for 26 years. It didn’t take a committee or a week to approve this loan, instead it took me a few minutes of conversation with the owner to understand his needs and agree to help. It is this personalized treatment of our customers that preserves the business next door.

LEGISLATIVE CHANGES WOULD PROTECT AND PRESERVE SMALL BUSINESSES

The following tax-related incentives would help preserve small business and protect local communities:

- Create FFARRM accounts
- Strengthen “Aggie” bonds
- Improve and expand Subchapter S for community banks

Create FFARRM Accounts. I would like to commend Chairman Charles Grassley (R-IA) and Ranking Member Max Baucus (D-MT) for introducing S. 313, the Farm, Fishing and Ranch Risk Management (“FFARRM”) Act. FFARRM bank accounts will be an important tool to help farmers, ranchers and fishermen manage the inherent financial risks of their businesses.

FFARRM accounts would help keep lendable funds in rural communities. Farmers, ranchers and fishermen would deposit funds in FFARRM accounts, and the deposits would be stored in banks for longer periods to be ready for harder times. These deposits would then be available for the banks to lend locally.

Mr. Chairman, I wholeheartedly support S. 313. FFARRM accounts would benefit local communities, both by helping farmers, ranchers and fishermen manage financial risk and by bringing credit back into rural areas. FFARRM accounts would provide a badly needed source of funding for all types of lending.

Strengthen Aggie Bonds. Aggie bonds should be made more widely available. These bonds represent a cost-effective method of providing reduced interest rate loans to young and beginning farmers for capital purchases of farmland and equipment.

Unfortunately, aggie bonds are subject to a federal volume cap on industrial revenue bonds (IRBs) and must compete with industrial projects for bond allocation. This results in insufficient volume for aggie bond programs. In many states, aggie bond availability is severely limited, and deserving young farmers and ranchers are not able to benefit from these bond programs unless they are at the right place at the right time. Opportunities that may exist for a beginning farmer at one point in time may not exist six months later or during the next fiscal year. Arbitrary allocations have real impacts in terms of providing equal opportunity for beginning farmers and impose unequal hardship conditions on otherwise eligible beginning farmers. Timing of finance is often a critical factor in the acquisition of agricultural property.

The IRB volume cap is often allocated to larger manufacturing and multi-family housing projects. Therefore, small beginning young farmers and startup businesses in rural and under-served areas are often left without adequate access to aggie bonds. Aggie bonds should be exempt from the state bond volume caps. This would encourage states to start aggie bond programs and provide more beginning farmers with low-cost capital.

Improve and Expand Subchapter S for Community banks. Various innovative forms of business organization, such as Subchapter S corporations and limited l iability companies, are available to a wide range of businesses. In order to create greater opportunities to raise capital and preserve small business lending, banks should be provided greater flexibility and choice concerning organizational structure. Legislation is needed to help community banks compete on a level playing field with non-bank competitors. By improving the Subchapter S laws, Congress has an opportunity to help protect America's communities, preserve small businesses and remove many of the competitive barriers now facing community banks.

In order to survive in this intensely competitive market, community bankers, like any other small business, must continually look for ways to improve efficiencies, operations and tax savings. Non-bank competitors, such as farm credit system lending institutions and credit unions continue to enjoy significant tax advantages, which make it even more difficult for banks to compete in their local communities. Therefore, tax changes, such as the improvement and expansion of the Subchapter S tax laws for banking institutions, are a particular interest to community banks.

For the first time in January of 1997, the Small Business Job Protection Act of 1996 permitted eligible banks to become S corporations. Subchapter S of the Internal Revenue Code allows eligible small businesses to be taxed similar to partnerships for federal tax purposes. All earnings, deductions and credits are generally passed through and taxed at the shareholder level rather than being taxed at both the business and shareholder level.

A 1999 American Bankers Association Subchapter S Survey of community banking institutions confirms the need for changes in the Subchapter S laws and identifies obstacles banking institutions face, whether or not they have elected Subchapter S status. In addition, the June 2000 U.S. General Accounting Office (GAO) report entitled "Implications of Proposed Revisions Governing S Corporations on Community Banks" acknowledges that proposed Subchapter S changes would cause an increase in Subchapter S elections, thus impacting the overall competitiveness of the banking community. My bank is currently prevented from taking advantage of this unique tax status due to overly strict eligibility standards.

To help small businesses, the following changes to Subchapter S are recommended:

An expansion in the shareholder threshold from 75 shareholders to 150. Currently, for a small business to be eligible for Subchapter S status, it can have no more than 75 shareholders. Expanding Subchapter S eligibility to more small businesses would eliminate an artificial constraint on small businesses to raise capital My bank currently has 35 shareholders. As with many other small businesses, the shareholders are Keokuk citizens interested in investing in their community. The soundness of community banks, as with other small businesses, requires reaching out to many investors. Thus, many smaller banks find it difficult to operate as S corporations within the current 75 shareholder limitation.

An expansion in the type of shareholders. Currently, Subchapter S eligibility requirements exclude many types of institutional shareholders, such as family limited partnerships and individual retirement accounts. Because banks could only be a C-corporation prior to 1997, they are particularly harmed by shareholder decisions made long before the law change. My own bank is affected in this way; a significant shareholder has a non-qualifying corporate status.

The ability to issue a second class of stock. Currently, Subchapter S businesses can only issue one class of stock. This restriction on stock offerings constrains the ability of small businesses to raise capital. Allowing small Subchapter S businesses to issue a second class of stock would alleviate this regulatory capital constraint on small businesses and help raise lendable funds.

A modernization of the passive income rules. Currently, Subchapter S businesses are subject to a corporate-level tax on excess passive investment income. Further, their S election will terminate if the corporation receives excess passive income for three consecutive years. Modernizing the passive investment rules would encourage the growth of small businesses and alleviate unnecessary investment costs, especially for regulated Subchapter S banks.

A liberalization of the unanimous shareholder consent rule. Currently, for a small business to elect Subchapter S status, there must be 100 percent approval among all shareholders, which permits one individual shareholder to thwart the efforts of the remaining shareholders to opt for Subchapter S status. Liberalizing the unanimous consent rule will introduce more fairness into the election process.

CONCLUSION

I appreciate having this opportunity to present my views during the hearing today on “Preserving and Protecting Main Street USA.” We look forward to working with you in the future on these most important matters.