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Date: March 12, 2019  
To: Senator Julia Lynn – Chair  
Senate Commerce Committee  
From: Kurt A. Knutson  
Re: Support for House Bill 2006 – Economic Incentive Review Process

Madam Chair and members of the committee, my name is Kurt Knutson and my appearance here today is as a Kansas taxpayer and private citizen. In an effort to give context on my knowledge of the subject of the economic incentive review process, the following information is offered for your consideration. My banking experience began in 1983 and after serving in a variety of roles in the industry, I founded Freedom Bank with a group of local investors in 2005. Freedom Bank is a community bank in Overland Park.

Freedom Bank serves our local neighborhood and privately held businesses throughout the Kansas City metropolitan area. We received a Kansas state charter and opened our doors in 2006. The time period shortly after opening was the most tumultuous time for banking in my lifetime. Freedom Bank has survived the storm which claimed over 500 banks across the country. We have created 31 jobs in Overland Park, and those employees paid taxes on over \$14,000,000 in income. Our bank has paid in excess of \$4,500,000 in state and federal taxes. The site where Freedom Bank sits was an empty grass field in 2005.

Governor Brownback appointed me to the Kansas State Banking Board in 2011 and reappointed me in 2013, and again in 2017, where I continue to serve. Thank you to those of you present who may have played a part in confirming my appointment. In 2016 I served on the Consensus Revenue Estimating Working Group to conduct a comprehensive review of the Consensus Revenue Estimating process. That experience affirmed my belief that a citizen legislature is composed of hardworking citizens from all walks of life serving their state. I am appreciative of your service to all Kansas citizens understanding the amount of time you spend away from your families. Many citizen legislators however, do not have experience in business ownership, financial analysis, the budget process or the flow of capital.

Last August, my industry peers elected me to serve as Chairman-Elect of the Kansas Bankers Association (KBA). The KBA is a voluntary, non-profit trade association founded in 1887

governed by its membership and represented by a 21-member board of directors. KBA's membership includes 98% of the banks headquartered in Kansas and six savings and loans.

Last December I joined the board of directors of the Kansas Chamber of Commerce. The mission of the Kansas Chamber is to improve the economic climate for the benefit of every business and citizen as well as safeguard our system of free, competitive enterprise. The vision of the Kansas Chamber is to make Kansas a top state to do business.

Again, the reason for providing my background is to offer context to my ability to speak to the topic of the economic incentive review process. The views expressed today are my own and are not necessarily those of Freedom Bank, the State Banking Board, Consensus Revenue Estimating Working Group, the Kansas Bankers Association or the Kansas Chamber.

House Bill 2006 is attempting to audit tax incentive programs used by the state. The audit provides transparency to the legislators to make sure that taxpayers are receiving the benefits anticipated when incentives were granted to specific projects.

Capital comes in many forms, such as debt or equity or a combination of the two. Debt is to be repaid within a certain time period and at a specified rate of interest. Equity is not paid back – the equity provider is compensated by a return on the equity provided. When reviewing debt, you are looking for historical cash flow because only cash repays loans (collateral is taken only for worst-case scenarios). So with debt you are looking at the rear view mirror to make your decision to lend. The rate of return is lower on debt capital because it is typically a safer risk. You have a successful track record of historical cash flow and scheduled payments – so it carries a lower rate of return to reflect the fact the risk is lower. Owners of companies like debt better because it has a lower cost and they are not giving up any ownership to get it.

In contrast, equity is betting on a yet-to-be-tested idea or project. When analyzing equity risk you are typically looking out the front window of the car because there typically isn't a historical cash flow to analyze. You are looking to the future. You are looking to projections and the underlying assumptions the projections are driven by. Because there isn't a repayment schedule, or a prescribed interest rate, equity risk is much higher and therefore the expected returns are higher.

To date, the existing incentive programs do not provide transparency as to the flow of capital and in this case the capital is in the form of tax incentives – there is no scheduled repayment or prescribed rate of interest, so therefore the tax incentives are equity. The tax incentives are equity investments being made with taxpayer dollars.

Transparency should provide a picture as to what the state's investments (with taxpayer dollars) are. Transparency should give the dollar amount now outstanding in tax incentives and what the exposure is associated with those incentives (total incentives granted less the amount outstanding). As example of what I am talking about here, let's consider a bank provides a line of credit in the amount of \$2 million to a company. The risk exposure to the bank is \$2 million.

The company is only borrowing at the time \$1,250,000 so that would be the amount outstanding on the line of credit. The remaining amount of the line, \$750,000 would be the amount that has been committed and still remaining available to borrow.

At present, without the transparency provided by an audit, we do not know the total amount of tax incentives committed to all projects, we do not know how much is outstanding and we therefore do not know what is still available as incentives. That is for a sum of all of the tax incentive programs. We also do not have transparency into how much is committed to each individual project, how much is outstanding and how much is available either.

We also do not know if the tax incentives are in the proper hands or perhaps in the hands of authorities not statutorily entitled to grant them, or being used by non-statutorily allowed entities (similar to Kansas State Department of Education's (KSDE) use of education tax dollars to non-statutorily permitted parties as discovered by an audit). An effective and transparent audit program is necessary to prove to the legislature that the program is running smoothly and to make certain that the bad things just mentioned are not taking place.

It could be highly likely that tax incentive capital is not flowing safely and soundly. I can tell you in the banking world, if capital is not flowing safely and soundly, the providers of that capital (depositors and shareholders) move their capital elsewhere and our capital flow dries up. The market dictates we are unfit to properly use the capital and we lose the confidence of the providers and therefore the ability to have access to that capital.

The audit function that we go through regularly, by the state or federal regulators (depending on whether it is a state or national charter we are operating under), by the FDIC (as their role is to protect the insurance fund) and by our financial auditors, all follow the same process. They review our policies then test our practices to make sure we are following our policies. If they find that we either have out-of-date or incomplete policies or that our policies are too broad, we are then cited and tasked to correct the policies and/or practices to make certain they are complete, current and as specific as they should be to mitigate the risk of misuse of that capital. The board of directors are tasked with ensuring that our communities' depositors' interests are protected. In the event that a bank does not operate safely and soundly, there are consequences that come into play such as classifying the bank and limiting our access to capital until the deficiencies are corrected. If the board and management do not correct the deficiencies in a timely fashion, the bank is then subject to a run on the deposits or closure by the regulators.

Translating this process to the State and its use of tax incentives, the **Legislature is the Board of Directors**, the **Commerce Department** granting the use of the incentives are the **Management**, and the **Depositors are the Taxpayers**. The missing element here is an effective audit function or the Regulators (the Kansas Legislative Post Audit "LPA"). "Effective" is the key term.

The Legislature may argue that everything is statutorily driven, so logically the program *must be* running correctly – but there is no regular independent, non-partisan view into the metrics

determining if, in fact, what was expected to happen with the tax incentives has actually happened. Has a particular tax incentive program been successful and a wise use of the taxpayers' money? Or has the program underachieved in comparison to what was anticipated when the use of taxpayers' money was granted? Remember, equity is being provided in the form of taxpayers' dollars as tax incentive programs – are they providing an adequate return? These are questions that need to be considered and can be found through an effective audit tool.

Again, comparing the process to the banking world, if loans (another form of capital) are being granted on the basis of the projections provided, and there is no follow-up to find that the results are tracking with the projections, in the event the actual results are underperforming when compared to the projections, problems begin to develop and the ability of the borrower to repay the loan very likely becomes a problem. If management is doing their job effectively, they are picking up on variances in the actual results compared to projections and communicating quickly with the borrower to decide if there is a valid reason for the variance. There may be either overall general economic issues causing the variance(s), industry-specific issues or management issues. Ideally, good borrowers are proactively contacting bank management to lead them through the variance(s), with accompanying solutions to get the projections back on track. Less ideally, bank management is proactively approaching the borrower's management to decide if the borrower is indeed aware of the issue and if there are acceptable remedies available to correct the problems. If the borrower is not aware or is hiding the deficiencies, more stringent corrective action is likely necessary. Auditors and regulators are spot-checking these relationships when they conduct their audit to determine if bank management is monitoring the loans effectively and according to policy. If bank management is following policy and managing the relationships properly – the audit or exam goes without criticism. If management is not following policy and/or not monitoring the loans the audit or exam provides criticism of management and the board then needs to determine a corrective course of action to take to get the bank into operating safely and soundly again. The board of directors face criticism and the possibility of personal financial liability if they fail to correct to problems.

House Bill 2006 provides for the effective and regular audit of the programs in place. Realistically, the audit needs to begin with determining if the tax incentive programs are operating under current statute. Going forward, the bill provides for specific metrics of the program to be audited as well. The audit should include the projections of what was anticipated to occur, prior to the tax incentives being granted. Those projections should be reviewed by the auditors comparing the actual results of the use of the tax incentives for a particular project. The audits should make sure that the projects are being monitored regularly by the granting authorities deciding if the projected benefits of the project are being met. If so, the project continues as prescribed. If not, the future use of committed but unused tax incentives need to stop until the project gets back on track. If, over time, the projects are not being managed properly the granting authorities' use of the incentives needs to stop until such time the

leadership and/or management of the granting authority takes corrective action. This type of audit function will determine if there is a rogue team member that needs to be removed or if the entity needs wholesale reform prior to resuming any tax incentive programs. The bill also provides for direct reporting to the legislature by the commerce secretary. In the event the report is delayed, incomplete, incorrect or refused, the use of tax incentives are suspended until a satisfactory report is made and the legislature lifts the suspension.

Thank you for the important work being performed by this committee. On a related note, it would be beneficial, at some point in other future legislation, to consistently audit the amount of state tax revenue being lost when a government sponsored entity like Farm Credit (the one and only government sponsored entity competing with private business) or non-profits like credit unions competing with taxpaying private community banks on business loans and services. The revenue from Farm Credit and credit unions moves tax collection from state taxpayers (community banks) outside of state taxation without benefit being passed along to the Kansas customer. An audit, and I stress to you and audit, of this type would be beneficial for the legislature to understand what is being lost in tax revenue. I would be happy to stand for questions. Also, please feel free to contact me at [kurtknutson@gmail.com](mailto:kurtknutson@gmail.com) or (913) 530-6842 if you have any questions or need additional information.