



**TESTIMONY OF TODD MCCRACKEN, PRESIDENT  
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*“Perspectives from Main Street on Small Business Lending”*

**Before the U.S. Senate Committee on Small Business and  
Entrepreneurship**

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Good morning Chairwoman Landrieu and Ranking Member Snowe; thank you for inviting me here today to discuss the effect having credit lines cut has on small businesses.

My name is Todd McCracken and I am the president of the National Small Business Association (NSBA), America's oldest small-business advocacy organization.

### **SMALL-BUSINESS CHALLENGES IN FINANCING**

The United States in the midst of the worst financial crisis since the Great Depression and America's entrepreneurs—existent and aspiring—are suffering through a crippling credit crunch. Given that accessing capital is one of the largest and most persistent obstacles facing America's small-business owners, this is especially worrisome. Even in the best of times, the small-business members of NSBA consistently have identified access to capital as one of the top-10 issues impacting their firms—as they did again this February, during NSBA's biennial Small Business Congress.

This perennial problem is greatly exacerbated during troubled economic periods. According to a nationwide survey of small- and mid- sized business owners, commissioned in 2008 by the NSBA (henceforth: NSBA Survey), 55 percent of small- and mid- sized business owners had difficulty securing credit in the previous six months—and this finding was consistent across firm size and revenue. It stands to reason that credit is even more elusive today. This is true globally as well as locally. In a November 2008 survey of eight emerging markets, 85 percent of entrepreneurs reported having already felt the impact of the credit crisis and 88 percent thought the worst was yet to come.

One of the biggest barriers to small-business financing is the requirement that debt be secured by equity in fixed assets. Many small and startup businesses lack the kind of equity necessary for traditional bank loans. This gap in debt-equity financing especially hinders startup and growing businesses, as these entrepreneurs typically do not have the assets necessary to acquire sizeable loans.

Another barrier to capital for small businesses is that banks too often shy away from the small-business community. Smaller loans generally are less-profitable for banks and typically have higher default rates. Additionally, the proper valuation and credit worthiness of small businesses

are notoriously difficult to determine. Ongoing bank consolidation has led to fewer community banks and fewer character-based loans as well.

Aggravating this state of affairs is the recent tightening of lending standards by banks. In its January 2009 quarterly Senior Loan Officer Opinion Survey, the Federal Reserve reported that the number of banks reporting having tightened their lending policies in the past three months remained “very elevated.” Nearly 70 percent of the domestic respondents to the survey reported that they had tightened their standards for commercial and industrial loans to small businesses.

In addition to tightening their lending standards, hundreds of banks have dropped out of the lending programs offered by the U.S. Small Business Administration (SBA) or have simply stopped making—or drastically reduced the number of—SBA loans. Between 2001 and 2007, there was a 47-percent decrease in the number of banks making at least one 7(a) loan. Meanwhile, there has been a massive decline in the amount of SBA lending. There were 57 percent fewer 7(a) loans in the first quarter of 2009 than during the same period in 2008 and 62 percent fewer than 2007. Additionally, total dollars loaned fell by 40 percent, to almost \$2 billion. The number of loans made through the 504 program (which finance real estate and other fixed assets) was down 46 percent from 2008.

Even those banks on the receiving end of billions of taxpayer dollars have failed to increase their small-business lending. According to an analysis by the *Wall Street Journal*, lending by the nation’s largest banks declined between the third and fourth quarters of 2008. During this time, 10 of the 13 biggest beneficiaries of the U.S. Department of Treasury’s Troubled Asset Relief Program (TARP) reduced their outstanding loan balances by an approximate total of \$46 billion, or 1.4 percent—even as they received \$148 billion in taxpayer capital that was intended to help the economy by making loans more readily available.

It should not be surprising then that the number of small-business owners who reported using traditional bank loans, during NSBA’s 2008 annual survey, was at a 15-year low—and this number has, no doubt, deteriorated in the last year. Unfortunately, the bad news for small-business owners does not stop there. Banks are raising the costs of their credit lines and the premiums they charge for higher-risk loans for those entrepreneurs fortunate enough to qualify under the tightened standards.

## **REDUCED CREDIT LINES**

Banks also are slashing lines of credit. Nearly a third (28 percent) of the respondents to NSBA's Year-End Economic Report, a survey of NSBA members, reported that they had experienced a decrease in their line(s) of credit—or a credit-card limit(s)—in the previous six months. These (sometimes arbitrary) reductions to existing credit lines—and/or credit-card limits—are having a profoundly negative affect on America's small-business community.

Small-business owners generally rely on lines of credit: (1) to manage the day-to-day operations of their firms (especially those that experience seasonal variations), or (2) as safety nets. Lenders are cutting lines of credit on both kinds of businesses.

The small-business owners who rely on lines of credit to run their day-to-day operations are in a bind. The cash-flow cycle for many small businesses has slowed. Accounts receivables are not being paid as quickly as usual and many clients are requesting 45 to 90 days, as opposed to the normal 30 days, to pay their balances. Under normal circumstances, this would not be a problem, as a small-business owner would simply access his/her line of credit to pay their vendors—many of whom will not accept these longer term periods or will interpret them as a sign that the firm cannot pay its bills on time.

For firms that rely operationally on their lines of credit, however, banks generally like to see a total zero balance for at least 30 days, as this indicates that the business is faring well and can pay down its line. When small-business owners are unable to keep their lines at zero balance for the necessary 30 consecutive days—and remember clients are requesting 45 to 90 days to pay—banks infer that the firm is either experiencing cash-flow problems or that the owner is not paying sufficient attention to his/her expenses. As a result, the banks may reduce the firm's line of credit and put the “stale” portion of the line on a term payout to ensure that it is repaid.

What is a small-business owner to do? Refuse to sell to the clients requesting additional time to pay? Or continue to run the business and hope the bank does not interpret her inability to maintain a zero balance for at least 30 days as a sign of distress?

Some small firms are having their lines of credit cut or even called, despite not having missed a payment. Such “technical noncompliance” can arise from the violation of any of the many

covenants or promises a borrower agrees to in a loan agreement, such as a certain “current assets” to “current liabilities” ratio. Technical noncompliance frequently results in a monthly fine or fee (until the proscribed ratio is achieved, for instance), but banks also can decide to use the occasion to cut or call a credit line—despite the owner being up-to-date on his/her loan payments.

Firms that rely operationally on their lines of credit are not the only ones getting hit by reduced credit lines. Credit lines also are being cut on small-businesses owners who use them for emergencies and have not been late in paying down their lines. Why? Because banks are experiencing their own liquidity difficulties right now and the fewer lines that a bank may need to fund, the less liquidity it needs to fund its daily business. The rationale behind these arbitrary reductions is of little comfort to the small-business owners of these firms—which tend to be mature and self-financing—who rightfully fear that their lines of credit randomly will be reduced just as they need to access their “emergency” capital.

With lines of credit usually renewed after income-tax season—banks know that firms will have their income tax materials and end-of-year financials prepared—this state of affairs puts small businesses in an extremely vulnerable situation in the coming months. Should they draw upon their available lines of credit, stock the money away until after the renewal season—incurring unnecessary interest expenses—and hope that the bank will not reduce their lines? Or should they pay down their lines to demonstrate to the banks that they can manage their cash flow and hope that that the banks will not cut their “unused” lines?

#### **SMALL BUSINESSES’ RELIANCE ON CREDIT-CARD FINANCING**

Credit lines are not the only source of capital currently at risk of being cut—so are credit-card limits; and credit cards happen to be the most common source of financing for America’s small-business owners. According to the NSBA Survey, 44 percent of small-business owners identified credit cards as a source of financing that their company had used in the previous 12 months—more than any other source of financing, including business earnings. In 1993, only 16 percent of small-business owners identified credit cards as a source of funding they had used in the preceding 12 months.

This dramatic increase does not represent emergency or short-term usage either. Of the small-business owners who use credit cards as a source of funding, 71 percent report carrying a balance

month-to-month. This is up from 64 percent in 2000. Twelve percent of small-business owners are carrying a balance of more than \$25,000, and 33 percent are carrying a balance of more than \$10,000.

Many small-business owners first turned to credit cards as their primary source of working capital in the early years of this decade—when a multitude of banks last tightened their lending standards. Bank regulators require business borrowers to have either equity in hard assets or historic cash flow to support their loan requests. Rapidly-growing service or technology companies that are not traditional brick and mortar have neither and are forced to use bank credit lines which, if not secured with equity in a home, are increasingly credit-card accounts.

#### **THE TROUBLE WITH SMALL-BUSINESSES' RELIANCE ON CREDIT-CARD FINANCING**

Under current law, credit cards are permitted to have significantly higher and more volatile rates and payment structures than traditional bank loans. According to Professor David Walker, of the McDonough School of Business at Georgetown University, “Small firms that rely on debt secured by credit cards usually pay more than twice the interest rate that large firms pay when borrowing at the prime rate.”

This fact is not lost on most small-business owners. Although they are increasingly turning to credit cards to finance their business ventures, more than two-thirds of surveyed small-business owners report that the terms of their cards are worsening.

This is not good news for America's economy, which is heavily reliant on a robust and thriving small-business community. Small businesses comprise 99.7 percent of all U.S. employer firms and more than half of all private-sector employees. Over the last 20 years, they have generated 93.5 percent of all net, new U.S. jobs. The billions of dollars generated from outlandish retroactive interest rates hikes, the escalating imposition of undisclosed fees, and unilateral and unforeseen interest-rate increases is money diverted from economic development.

America's small-business owners are not in the habit of advocating the passage of increased federal regulations, preferring free enterprise and market solutions, but the current practices of the credit-card industry defy the principles of a competitive market.

One of the basic tenets of free-market capitalism is the sanctity and insolubility of contracts, but somehow the credit-card industry has managed to insulate itself from adherence to this principle, retaining the right to unilaterally change the conditions of their contracts at any time. For instance, the retroactive application of penalty interest rates effectively increases the purchase price of products and services for which consumers are already committed. This *ex post facto* application undermines business plans and easily can threaten many firms' very existence.

Imagine trying to run a business when one's carefully-constructed business plan is upended by a retroactive interest rate hike. How can a small-business owner be expected to maintain—let alone grow—her business when the capital she already has used is no longer subject to the 12 percent interest rate she agreed to but an egregiously punitive 32 percent?

A free-market system also relies on actual competition, but there is no longer real competition in the credit-card industry. In 2005, the top 10 U.S. banks controlled 83 percent of the small business credit-card market (understood as their proportion of outstanding credit-card debt), according to a report by research firm TowerGroup (which is owned by MasterCard). It is worth noting, by the way, that according to *BusinessWeek* these same banks were responsible for just 32 percent of the SBA loan market and only 14 percent of other small-business lending.

Free market competition also is based on informed consumers, but the business practices of the credit-card industry appear geared more toward obfuscation than illumination. A recent Government Accountability Office report found that the required disclosures of credit cards “often were poorly organized, burying important information in text or scattering information about a single topic in numerous places. The design of the disclosures often made them hard to read, with large amounts of text in small, condensed typefaces and poor, ineffective headings to distinguish important topics from the surrounding text.”

Improved disclosure—which must not be construed as simply *more* disclosure—is of paramount importance to the small-business community. America's small-business owners are capable of following the rules governing their credit cards but the rules must be clearly established, and they must be consistent and predictable.

Improved disclosure is not enough, however. America's entrepreneurs are not naïve or uninformed consumers. They are accustomed to dealing with myriad complex financial and regulatory

frameworks. The current rules governing the credit-card industry are simply stacked against them. Accordingly, NSBA urges Congress to enact comprehensive credit-card reform legislation that codifies the “Unfair and Deceptive Acts or Practices” (UDAP) rule recently adopted by the U.S. Federal Reserve Board, the Office of Thrift Supervision at the U.S. Department of the Treasury, and the National Credit Union Administration

As the small-business owners, who serve as the engine of America’s economy and the backbone of its communities, suffer along with the rest of the country through an economic crisis not witnessed in seventy years, it is unconscionable that Congress would allow issuers to perpetuate—with impunity—practices recognized as “unfair” and “deceptive” for 16 more months.

### **REDUCED CREDIT –CARD LIMITS**

Credit-card issuers’ recent proclivity for reducing existing credit-card limits also is highly problematic. Although the issuers already have reduced the credit limits of an untold number of small-business owners, lenders may cut \$2.7 trillion in credit-card lines by the end of 2010, according a report released last week by the Meredith Whitney Advisory Group. It is not surprising that many entrepreneurs live in fear that their limits will be reduced—possibly even below their current outstanding balances!

The effect of having a credit-card limit cut below a small-business owner’s existing balance can be devastating. In addition to being liable for an over-the-limit fee (seriously, this happened!), a small-business owner suddenly could discover his/her existing balance being charged at a default interest rate, which could be 30 percent or more.

Although the UDAP rule will require lenders to give cardholder 45 days notice before reducing their credit lines, the rule does not go into effect until July 2010. This is, of course, completely unacceptable and further underlines the need to pass comprehensive credit-card reform legislation.

### **VICIOUS CYCLE**

Even if the reduction in a small-business owner’s credit limit does not take him below his current outstanding balance, it can have a significantly negative effect on his ability to run his business. Entrepreneurs need capital to run—and grow—their businesses. When this capital is suddenly



retracted, it makes the already complicated task of running a small business all the more difficult. It also renders the task of garnering additional capital almost impossible

Card issuers use the FICO scores of their small-business customers to decide how much credit to make available to them and at what cost. Roughly 30 percent of one's FICO score is based on her credit utilization ratio, which is the total amount of debt owed in relation to the amount of credit available.

If a cut to a small-business owner's credit line results in too little available credit, then her FICO score could decrease by 50 points or more, according to a spokesman for FICO, the company that calculates and issues the credit score that most lenders use. Of course, this drastic decrease makes it that much more difficult and/or expensive for the small-business owner to obtain a new credit-line or credit-card, which makes maintaining her business a Sisyphean task.

#### **CONCLUSION**

Unexpected cuts to existing credit lines, credit-card limits, and even home equity lines are causing grave harm to U.S. small businesses, many of which already are struggling to survive. Capital is the lifeblood of small business and without it, the heart of America's economy—its millions of small businesses—stands poised to fail.

I thank you for your time and welcome any questions.