NSBA
National Small Business Association

TESTIMONY OF TODD MCCRACKEN, PRESIDENT

NATIONAL SMALL BUSINESS ASSOCIATION

"H.R. 627, the Credit Cardholders' Bill of Rights Act of 2009; and H.R. 1456, the Consumer Overdraft Protection Fair Practices Act of 2009"

Before the U.S. House Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

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Good afternoon, Chairman Gutierrez, Ranking Member Hensarling, former Chair Maloney, and members of the subcommittee; thank you for inviting me here today to discuss the *Credit Cardholders' Bill of Rights Act* and the dire need for broad credit-card reform from the perspective of America's small-business community.

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, yet they continue to be subjected to practices recognized as "unfair" and "deceptive" 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. This should be troubling to all.

Historically, small businesses have led America's resurgence out of periods of economic distress and uncertainty. As *The Economist* recently pointed out, "Microsoft, Genentech, Gap, and The Limited were all founded during recessions. Hewlett-Packard, Geophysical Service (now Texas Instruments), United Technologies, Polaroid and Revlon started in the Depression."

The renowned economist Joseph Schumpeter explained that economic downturns could serve as a "good cold shower for the economic system," releasing capital and labor from dying sectors. While America certainly is languishing through an economic cold shower, the prospect of a refreshing revitalization remains foggy—and the egregiously anti-competitive and anti-market practices of the credit-card industry are playing no small role in this haziness.

Previous small-business led economic recoveries were based less on the sudden expansion of existing small businesses than they were on the creation of millions of new, small firms. Suddenly out-of-work employees—many of them laid-off from big businesses—identified a niche they thought they could fill, a product they thought they could improve, or a service they thought they could enhance and decided to start their own firms. During these troubled economic times, millions of other small businesses failed. In the aggregate, however, there were many more small businesses in existence after the recessions and Depression than there were before it.

How did these aspiring small-business owners do it? Besides possessing an entrepreneurial streak, they were able to finance their dreams through a number of means, most of which are currently unavailable: (1) they borrowed from themselves; (2) they borrowed from their friends and family; and/or (3) they borrowed from a bank.

Aspiring business owners would be hard pressed in the current environment to self-finance their entrepreneurial dreams. With the S&P/Case-Shiller U.S. National Home Price Index reporting the largest drop in its 21-year history, it is unlikely many aspiring small-business owners are in a position to take a second mortgage on their homes. And with the stock market flirting with lows not seen in over a decade, it also is unlikely that aspiring entrepreneurs will turn to their retirement savings. The aforementioned circumstances also make it improbable that many aspiring small-business owners will seek loans from their friends and family, who have suffered just as acutely from plummeting stock and home values. And banks simply are not lending right now.

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—at least as many—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 dollars of taxpayer dollars have not increased 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 was at a 15-year low, according to NSBA's 2008 nationwide survey of small- and mid- sized business owners (henceforth: NSBA Survey)—and this number has, no doubt, deteriorated in the last year.

Where does this leave the aspiring entrepreneurs that will lead the nation out of its recession? Increasingly reliant on their credit cards.

SMALL BUSINESSES' RELIANCE ON CREDIT-CARD FINANCING

Credit cards are now 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-businesse 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. This suggests that credit cards have replaced term loans to fund expansion needs.

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

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 for 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 free 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."

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THE NEED TO CODIFY CREDIT-CARD REFORM NOW

While welcoming the recent voluntary discontinuation of certain practices by individual card issuers and the enactment of the "Unfair and Deceptive Acts or Practices" (UDAP) rule, NSBA believes that it is necessary to codify these rules and enact them well before July 2010. Accordingly, NSBA is pleased to support *H.R. 627, the Credit Cardholders' Bill of Rights Act of 2009*.

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" against them for 16 more months.

Additional Credit-Card Reforms Measures Needed

While NSBA unreservedly supports the enactment of *H.R. 627*, there are two major aspects of credit-card reform the bill does not address: (1) interchange fees and (2) the exemption of small-business cards. NSBA urges Congress to address both.

Interchange fees

Interchange is the fee paid by a merchant's bank every time a credit or debit card is used to pay for a good or service to the bank that issued the consumer's credit card. The fees—which vary depending on the type and size of the merchant's business, the way the transaction is processed, and the specific kind of card used—are set by Visa and MasterCard and the issuing banks and are not subject to negotiation. As much as $2 of every $100 in credit or debit card receipts goes to the card issuers, which inflates the cost of nearly everything consumers buy—since merchants are prohibited from surcharging the customers who use the most high-fee cards. It is important to note, especially as states across the U.S. raise their state sales taxes to meet budgetary shortfalls, that these interchange fees are based on the *total* transaction amount, including taxes.

As Professor Adam Levitin, of Georgetown University Law Center, has noted, since "interchange is transaction-based revenue; the issuer doesn't incur the consumer's credit risk. That means that issuers can risk greater credit losses because they've already made a nice bit of money via interchange with virtually no risk. Not surprisingly, interchange has increased over the last decade from being about 13 percent of card issuer revenue to being 20 percent." In total, Americans paid more than $42 billion in interchange fees in 2007—about twice as much as they paid in credit-card late fees.

Interchange fees originated in the 1960s as a way to cover the real cost of a credit-card transaction. Despite vast technological advancements, which have led to greatly diminished processing times and manpower requirements, interchange fees have more than doubled since 2001 alone. According to one recently study, Visa and MasterCard spend only 13 percent of the interchange fees they collect on the actual processing of credit-card transactions. Most of the rest of the collected fees is either profit or spent via the cards' rewards programs and mail solicitations.

Visa and MasterCard force merchants to sign a contract when they decide to accept credit cards, agreeing to all current and future operating rules. Merchants rarely have seen these rules and are prohibited from disclosing their terms to consumers, preventing merchants from alerting their customers to the true cost of accepting credit and debit cards. Many argue that Visa and MasterCard, which control roughly 80 percent of the credit-card market, and their card network function like "price-fixing cartels," operating in collusion and in violation of federal antirust laws by using their market power to impose non-negotiable rates and terms on merchants.

NSBA urges Congress to adopt legislation similar to *The Credit Card Fair Fee Act (H.R. 5546/S. 3086)* or *The Credit Card Interchange Fees Act of 2008* (*H.R. 6248*), which were introduced during the 110th Congress.

Business-card exemption

The largest loophole in *H.R. 627* is the absence of explicit protection for small-business owners who use their card(s) for business purposes. Since *H.R. 627* amends the *Truth in Lending Act* (*TILA*)—which, except for a few provisions, does not apply to business cards—its protections are limited to consumer credit cards. Although the credit cards of many—if not most—small-business owners are based on the individual owner's personal credit history, it is conceivable that issuers could legally consider them exempt from *H.R. 627*'s vital protections.

TILA defines a "consumer" as a "natural person who seeks or acquires goods, services, or money for personal, family, household use other than for the purchase of real property." While a small-business owner who opens a personal credit-card account and uses it occasionally for business should be covered under *TILA*, it is far from clear that this legislation would protect a small-business owner who used his card exclusively or even primarily for business purposes.

Although in the past, issuers appear largely to have kept most of their cards in compliance with *TILA*, there is no guarantee this convention will continue, especially when one considers that its basis appears to have been practicality and not legal obligation. Since issuers were able to subject consumer cards to the most egregious of practices, there was little incentive to distinguish between consumer and small-business cards. An unintended consequence of *H.R. 627*—if it remains un-amended—is that it could provide just such an incentive.

Accordingly, NSBA strongly urges Congress to correct this oversight and extend the protections of *TILA*, the UDAP rule, and *H.R. 627* to the small-business cards of employers with fewer than 500 employees. It is inconceivable that Congress would knowingly allow issuers to perpetuate practices recognized as "unfair" and "deceptive" against America's small businesses, especially given their essential role in the nation's economic recovery.

CONCLUSION

As President Barack Obama said this week while announcing his new small-business initiative:

> It's about our fundamental values. All across the country, there are people who are working hard and meeting their responsibilities every day, without the benefit of government bailouts or multi-million dollar bonuses. You've got a bunch of small business people here who are struggling just to keep their credit line open -- that they are foregoing pay, as one of our entrepreneurs talked about, they are in some cases mortgaging their homes, and doing a whole host of things just in order to keep things afloat. All they ask is that everyone, from Main Street to Wall Street to Washington, play by the same rules. And that is an ethic that we have to demand.

The small-business community is not opposed to the credit-card industry nor does it begrudge it the $109 billion in revenue it made in 2005. In fact, as I previously outlined, the small-business community is increasing reliant on credit cards for its very existence. Small business simply asks the credit-card industry play by the same rules as the rest of us.

I thank you for your time and welcome any questions.