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"The Impact of the Credit Crunch on Small Business"

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Good morning, Chairman Kerry and Ranking Member Snowe; thank you for inviting me here today to discuss the impact of the credit crunch on America's small businesses. My name is Marilyn Landis and I am chair of the National Small Business Association (NSBA), America's oldest small-business advocacy organization. I also am the owner of Basic Business Concepts, a consulting and financial management company that provides temporary chief financial officer (CFO) assistance to other small businesses, primarily in Pennsylvania and Ohio—but I am expanding, or at least trying to expand.

Prior to starting Basic Business Concepts, I spent 30 years working for and with commercial lenders, banks and small businesses throughout western Pennsylvania. I worked for three of the largest U.S. Small Business Administration (SBA) lenders in the country and have continued working with my clients on securing SBA loans and myriad other sources of capital. After 37 years of working with small businesses, the one thing I can tell you without hesitation is that it is not easy to start or develop a business. Entrepreneurs must overcome a host of obstacles to create and expand their businesses.

The credit crunch currently is among the most daunting of these obstacles.

Small-Business Challenges in Financing

Even in the best of times, access to capital is one of the largest impediments facing America's small businesses, hindering both aspiring and thriving entrepreneurs. In fact, the small-business members of NSBA consistently identify access to capital as one of the top-10 issues impacting their firms.

This perennial problem is exacerbated during troubled economic periods, such as those we are experiencing now. According to a nationwide survey of small- and mid- sized small business owners, recently commissioned by the NSBA and unveiled today (henceforth: NSBA Survey), 55 percent of small- and mid- sized small business owners have had difficulty securing credit in the last six months—and this finding is consistent across firm size and revenue.

One of the biggest barriers to small-business financing is requiring 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.

It is important to note that home ownership rarely meets the equity requirements necessary to acquire a larger commercial loan. Only ten percent of small-business owners leveraged their business loans through a second mortgage, according to the NSBA Survey—yet this represents the third most popular avenue of business financing after credit cards and business earnings. Of course, many of the small-business owners who were lucky enough to leverage their business financing with their home equity are regretting it now. With home prices plummeting, many are discovering that they owe more than their homes are worth.

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 lead 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. According to the Federal Reserve Board's January Senior Loan Officer Opinion Survey, one-third of domestic banks have tightened their standards on commercial loans over the last three months. Even for those small-business owners fortunate enough to qualify under the tightened standards there is bad news, as banks are raising the costs of their credit lines and the premiums they charge for higher-risk loans.

In addition to tightening their lending standards, more and more banks simply are dropping out of the lending programs offered by the U.S. Small Business Administration (SBA). In fact, 368 banks have quit the programs in the last two years, and there has been a 47-percent decrease since 2001 in the number of banks making at least one 7(a) loan. Much of this withdrawal is due to the SBA's increased fees, which are at their statutory limit for the 7(a) program. Furthermore, although the SBA likes to tout that the number of 7(a) loans is rising, the dollar volume of those loans is shrinking, decreasing by 14 percent compared to last year. Government guaranteed loans overall have shriveled by as much as 23 percent compared to last year.

SMALL BUSINESSES' RELIANCE ON CREDIT-CARD FINANCING

While insufficient access to capital has long been a lament in the small-business community, the current capital vacuum has created a new predicament for small-business owners: Use credit cards or bust. According to the NSBA Survey, credit cards are a primary source of financing for America's small businesses. In fact, 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 businesses owners identified credit cards as a source of funding they had used in the preceding 12 months.

It is important to note that this dramatic increase does not represent only emergency or short-term usage. 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. This hardly is surprising when one considers that the "credit card industry is typically the most profitable in the banking sector, earning a return on assets since 1995 that is more than three times greater than that for commercial banks overall," according to Travis Plunkett, legislative director at the Consumer Federation of America.

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, like mine, have neither. We are forced to use bank credit lines which, if not secured with equity in a home, are increasingly credit-card accounts. I can personally attest to this phenomenon, as not long ago I applied for a "line of credit" with Wells Fargo and instead received a new credit card. The same was true more recently when National City Bank offered a credit line and sent a credit card.

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 increasingly reliant on credit cards for financing, most small-business owners do not think they are getting a good deal. In fact, among those using credit cards for financing, 57 percent think that the terms of their cards have worsened over the last five years. This perception only appears to be growing. Two-thirds of the respondents to a very recent NSBA quick poll reported noticing an increase in the fees associated with their credit cards in the last three months. The same quick poll revealed that 56 percent of respondents had experienced an increase in their credit card interest rates in the last three months or had received notice that their issuer planned to increase them in the near future.

I, personally, can speak to another problem: The credit-card industry's underwriting practices and their reliance on "risk analysis" are an imperfect answer for small businesses' access to capital needs; and I would like to illustrate this point with an example from my own experience. I have been an American Express customer since 1989. In January 2007, American Express increased my credit limit, based on my "responsible credit history." The letter I received announcing this increase stated, "Effective immediately, your new credit line is $7,000.00 and it will appear on your next statement. This new line will be valid on your account as long as your credit is in good standing." Later in the year, this line of credit was further increased—to $11,400.00.

This increase was helpful, as I spent most of 2007 trying to expand my business. I hired 2 more people and opened 2 more offices. I also began expanding the zone of business into New England. Having primarily focused on Pennsylvania and Ohio in the past, I began traveling regularly (I would say, exhaustively) to the northeast region. As a result of my increased traveling and efforts to expand my business, I began to run much higher monthly balances on the Bank of America credit card I use for business. I still paid on time, mind you; I just gradually acquired more debt.

Despite being told that this line would "be valid … as long as your credit is in good standing," I received a letter early this year—dated January 2, 2008—informing me that as a result of a review of my account, American Express was changing my Line of Credit. My $11,400.00 line of credit was reduced back to $4,200.00. I was informed that this action was being taken for the following reasons:

- "Information received from a consumer reporting agency."
- "Our analysis of the credit risk associated with customers who have residential loans from the creditor(s) indicated in your credit report."

The letter elaborated that the consumer reporting agency factors that affected their decision were:

- "Too many accounts with balances."
- "Too many inquires last 12 months."
- "Too many accounts recently opened."
- "Proportion of balances to credit limits on bank/national or other revolving accounts is too high."

There was no mention—as there was no history—of slow or non-payment.

In December 2007, I received a similar letter from Bank of America for an unrelated card, informing me that effective January 2008, my annual interest rate was skyrocketing from a "promotional rate" of 3.99 percent to 27.99 percent. Thankfully, this interest hike only applied to future charges and was not retroactively applied to my outstanding balance. This increase was attributed to "information we [Bank of America] obtained from your account, as well as from information reported by a major credit reporting agency." Keep in mind, I had no record of slow or non-payment.

In other words, as a small-business owner trying to expand a service company that lacks sufficient equity to secure a traditional bank loan, I am forced to use credit cards to finance my firm's growth. If I actually use the credit cards that I am forced to turn to, however, the issuers are liable to ratchet back the credit previously promised to me. If I seek out additional capital from a different credit card, the result is likely the same.

Let me detail another personal incident that demonstrates the inconsistent and unpredictable nature of current credit card practices. I have an Advanta credit card for which I carried an average daily balance of $5,506.22, at 2.99 percent. In November 2006, I received a cash advance—for which I paid a $50 fee, interest on the fee, and 11.49 percent interest on the advance—from the card in the amount of $14,317.77, at 11.49 percent. There was no other activity and when my $455 bill arrived, I paid it on time. Therefore, I was surprised to see my cash advance interest rate swell from 11.49 percent to 20.01 percent in my December bill. Equally surprising was that my average daily balance, for which I was paying 2.99 percent, had dropped to $1,779.86, while the rest of my outstanding balance, for which I was paying 19.99 percent, jumped up to $17,333.50 with no explanation. One can imagine how difficult it is to adhere to a business plan with this sort of unpredictability lurking in every expenditure.

This unpredictability does not end with unexpected interest-rate hikes. Let me share with you another story—this one dealing with a Bank of America credit card I opened in November 2006. For this card, Bank of America promised a zero-percent interest rate until September 2007. Unfortunately, it did not quite make it. I received my December bill on Jan. 3, 2007. It was dated Dec. 26, 2006—the day after Christmas—and due on Jan. 20, 2007, which was only 17 days away. I mailed my payment on Jan. 5. Bank of America said they received my payment on Jan. 22 so I was charged a $49 late fee. Oh, and my zero-interest rate credit card suddenly sported a new and improved 22.24 percent interest rate. Thankfully, I am only being charged $1 a month on my existing balance for this card, but any new expenditure is being charged at the new interest rate and any remaining balance would be charged at that rate come September. In the meantime, I am stuck with a card that I cannot and will not use, while the mere existence of the card hinders my ability to garner additional capital.

There is one predictable aspect of my Bank of America card: the monthly payment due dates are never the same, fluctuating by several days in the last seven months, from 12/19/06 to 1/20/07 to 2/20/07 to 3/23/07 to 4/20/07 to 5/21/07 to 6/19/07. The statement cut-off has remained the same during this time. The same can be said of my MBNA card, since it was sold to Bank of America. Previously, the due date was the 27th of the month. Between December 2006 and April 2007, the due dates for this card fluctuated greatly, from 12/28/06 to 1/27/07 to 2/24/07 to 3/22/07 to 4/22/07. Again, the statement cut-off has remained the same during this time.

This inconsistency makes running a business more challenging and perilous. I practice and I instruct my clients to use debt wisely, plan carefully for that repayment, and stick faithfully to that plan. Without a consistent, predictable debt instrument small businesses like mine without home equity based loans are often caught in financial turmoil. Now, with the recent mortgage crisis, even the previously fortunate entrepreneurs who had home equity based loans are facing turbulence.

RECOMMENDATIONS

America's small-business owners recognize that the current credit crunch cannot be legislated away—as much as we, and the Congress, might wish the opposite. There are, however, a number of steps that we think Congress can take to help alleviate its effects.

Strengthen the SBA's lending programs and other federally-backed loan programs for entrepreneurs. The fees the SBA charges both lenders and borrowers must be reduced; and the Microloan program must be funded. *S. 2612, the Small Business Lending Stimulus Act of 2008*, recently introduced by Sen. Kerry, is a good starting point. The lending process itself must be streamlined as well. While securing a new credit card no doubt will remain regrettably easier than securing a 7(a) loan, the disparity can be reduced.

Reform the practices of the credit-card industry. 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. For small businesses, it means less money to advertise or invest in new equipment or hire new employees. Almost a third of small- and mid-sized businesses say that they would hire additional employees if more capital were available to them. More capital might be available if so much of it was not being siphoned off by the unacceptable business practices of the credit-card industry. In order to address the practices that are making running a small business increasingly difficult and hindering the economic development of the nation's small businesses, NSBA supports the following credit-card reforms:

- Prohibit the practice of universal default,
- Prohibit the practice of double-cycle billing,
- Prohibit the retroactive application of interest rate hikes—interest rate increases only should be applied to future card usage,
- Limit the interest rate percentage increases that card issuers can impose on holders,
- Require card issuers to apply a customer's payments to the card balance with the highest interest rate first,
- Prohibit extra interest charges on card debt that the cardholder already paid in full,

• Prohibit interest charges on transaction fees,
• Prohibit late fees if an issuer's action caused a delay in crediting a payment, and
• Establish an industry-wide practice regarding the time on which a payment must be received or sent to be considered on time.

NSBA also urges Congress to remain vigilant of any unintended consequences arising from the enactment of credit-card reform legislation. Provisions such as those in section 6 of the recently introduced *S. 2753, the Credit Card Reform Act of 2008*, would be highly detrimental to America's small businesses and economy. This highly problematic section requires credit-card companies, before issuing a credit card, to verify an applicant's ability to pay. The ability to pay would be based on an applicant's current and expected income, current obligations, and employment status, using a formula provided by the Federal Reserve Board.

While such a provision may make sense when applied to a student or senior, it would wreak havoc on 44 percent of entrepreneurs in this country that rely on credit cards to finance their businesses. How can a small business owner verify her employment status? How will the Fed's formula project a fledgling business's "expected income?" How will an entrepreneur's potential lack of income affect her ability to finance her business? Such questions are too important to remain unanswered.

CONCLUSION

NSBA appreciates the Federal Reserve Board's recent efforts to boost the nation's sagging economy. America's small-business owners are convinced, however, that the effort to ward off financial ruin on Wall Street should be equaled by the effort to stave off economic disaster on Main Street. Slowing or reversing the impact of the credit crunch on America's small businesses will stimulate job creation and fuel the nation's sputtering economy. As this Committee well knows, small businesses are the engine of the U.S. economy. They comprise 99.7 percent of all U.S. employer firms and more than half of all private-sector employees. Perhaps most importantly, they have created 93.5 percent of all net new jobs since 1989. Spit-polishing the chrome of America's economy, while ignoring its engine, isn't going to win us any races.

I thank you for your time and welcome any questions.