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FULL COMMITTEE HEARING ON THE ROLE OF CREDIT CARDS IN SMALL BUSINESS FINANCING

COMMITTEE ON SMALL BUSINESS UNITED STATES HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

APRIL 3, 2008

Serial Number 110-81

Printed for the use of the Committee on Small Business

Available via the World Wide Web: http://www.access.gpo.gov/congress/house

U.S. GOVERNMENT PRINTING OFFICE

41–332 PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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FULL COMMITTEE HEARING ON THE ROLE OF CREDIT CARDS IN SMALL BUSINESS FINANCING

Thursday, April 3, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:00 a.m., in Room 1539 Longworth House Office Building, Hon. Nydia Velázquez [chairwoman of the Committee] presiding.

Present: Representatives Velázquez, Gonzalez, Cuellar, Ellsworth, Johnson, Sestak, Chabot, and Akin.

OPENING STATEMENT OF CHAIRWOMAN VELÁZQUEZ

Chairwoman VELÁZQUEZ. Good morning. I call this hearing to order. Today the Committee will examine the increasing role played by credit cards in financing our nation's small businesses.

In the past, 60 percent of small firms made use of private and federally guaranteed loans. In comparison, during that same period, 77 percent of entrepreneurs opted to buy new equipment and pay for other businesses using a credit card.

The reason is simple. Credit cards give small businesses access to capital they need to grow. That fact is especially crucial given the current economic climate in which small firms are finding it difficult to secure traditional forms of financing. Not surprisingly, the rate at which purchases are charged continues to rise up to 14 percent over the last 5 years. Today we will delve into what that means for small firms.

Credit cards have always been a convenient means of payment. They expedite transactions while allowing for considerable ease and security. Just as importantly, since 70 percent of small business owners pay their balances in full each month, they're gaining the equivalent of a 30-day interest-free loan.

While credit card use is on the up swing, many federal programs specifically designed to offer small firms access to capital are falling short of this goal. That is holding small businesses back and denying the economic contributions from entrepreneurs precisely when they matter most.

In the past months, members of this Committee have heard testimony from the Federal Reserve, the Small Business Administration, and a host of experts on small business lending programs. Their testimony points to the considerable gap that remains in financing.

The witnesses have also shed light on how the current economic downturn, rising foreclosure rates, and a plummeting housing market are compounding these capital challenges. In fact, just when our small businesses' economy will benefit tremendously from an infusion of capital, financial institutions are pulling back on credit.

As the availability of capital diminishes, more businesses are delaying important purchases, halting expansion, foregoing the creation of new jobs, laying off current employees altogether. Ironically this keeps small firms from doing what they do best: fueling the nation's economic growth.

In such an environment, it will make sense for the SBA's lending and investment program to step in. Sadly, the agency's largest lending initiative, the 7(a) program, is doing the exact opposite.

The SBA's mission is to raise fees and erecting new barriers to small business loans. As a result, 7(a) lending volume is down 14 percent and lending to minority-owned businesses has decreased by nearly 9 percent. Clearly this all runs counter to the program's mission.

Given these realities examining the role of credit cards in the financing of small businesses just makes sense. With the nation facing the prospect of a recession, it is also important to remember that entrepreneurs have always led the way back to economic recovery. This Committee will continue to work to ensure they have the tools to do so again. And I know my colleagues will join with me in strengthening what is working in the current system while correcting what is not.

I want to thank all of the witnesses for being here today and for offering their insights on these crucial issues. With that, I recognize Ranking Member Chabot for his opening statement.

OPENING STATEMENT OF MR. CHABOT

Mr. CHABOT. Thank you, Madam Chairman, for holding this hearing on small businesses and credit cards. I also want to thank our distinguished panel of witnesses here. I know we all look forward to hearing your testimony.

The financial services market in the United States is the most competitive, innovative, and robust in the world. This vibrant market has helped individuals, businesses, including small businesses, to meet their daily needs and achieve their dreams.

Cash management is an absolutely critical matter for small companies. Careful management of cash and credit may mean the difference between whether a business expands or doesn't or whether it succeeds or fails.

According to the Government Accountability Office, the prevalence and use of credit cards in the United States has grown dramatically over the past 25 years. In 2005, consumer held more than 691 million credit cards. And the total value of transactions in which these cards were used exceeded $1.8 trillion.

More than half of small firms rely on credit cards to help fund their operations, according to a financial services trade association. Credit cards can allow a small company to finance a purchase over time that they would otherwise not be able to make. They can be a source of short-term interest-free loans to enable a business to operate.

Credit cards can also help a company to manage cash flow or track and manage employee purchases and expenses. In addition, credit cards allow small companies to earn airline, hotel, retail, or cash-back rewards to enhance the business.

Whether a small business is well-established or just beginning, these tools can have a positive impact on business operations. They can enable a small business to weather minor disruptions to cash flow. For a newly established business, credit cards provide the opportunity to build business credit.

Especially in a time of economic uncertainty, when credit can be even more difficult to access, credit cards can make available the capital needed to maintain a company's position or expand, create jobs, and add significant value to our economy.

Like any borrower or credit card customer, small businesses must use credit responsibly and be vigilant about managing the debt. Credit is extremely valuable and is a tremendous asset when used wisely.

Again I thank the Chairwoman for holding this hearing. I look forward to hearing this testimony from our witnesses very shortly here. And I yield back the balance of my time.

Chairwoman VELÁZQUEZ. Thank you, Mr. Chabot.

And now I welcome Mr. Bill Spearman. Mr. Spearman is the President and CEO of the Mid-Hudson Valley Federal Credit Union, which draws its field of membership from Ulster, Dutchess and Orleans Counties, New York. He is testifying today on behalf of the National Association of Federal Credit Unions, a well-respected trade association that exclusively represents the interests of federal credit unions.

Mr. Spearman, you have five minutes to make your presentation. Thank you. Welcome.

STATEMENT OF MR. BILL SPEARMAN, PRESIDENT AND CEO, MID-HUDSON VALLEY FEDERAL CREDIT UNION, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. SPEARMAN. Good morning. And good morning, Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee. My name again is Bill Spearman. I am here today to testify on behalf of the National Association of Federal Credit Unions. I serve as President and CEO of the Mid-Hudson Valley Federal Credit Union, headquartered in Kingston, New York.

Mid-Hudson Valley is a community chartered credit union serving nearly 50,000 members and with assets of $590 million. MHVFCU and the entire credit union community participate this opportunity to participate in this hearing regarding credit card and small business lending.

Credit unions are not-for-profit financial cooperatives governed by a volunteer board of directors, who are elected by their members. At Mid-Hudson Valley, as with many credit unions, our membership includes small business owners and some of the businesses themselves.

Cooperative structure gives credit unions unique ability to design services to meet the needs of the membership. It also enhances the relationship that the credit unions have with their member owners,

giving them a unique working knowledge of the way the business is run.

This unique relationship leads to better lending decisions and mitigate risk for the credit union and also for the small business. Even though credit unions have been able to grow in their ability to help small businesses, many want to do more.

At Mid-Hudson Valley, we are an approved SBA lender. However, some of the cumbersome aspects of the SBA process constrain our efforts to take a more active role in the SBA 7(a) and 504 lending programs.

Moreover, the arbitrary member business lending cap that was established 1998 as part of the Credit Union Membership Access Act has also hindered the credit unions' ability to help small business. The Credit Union Regulatory Improvements Act, H.R. 1537, and the Credit Union Small Business Lending Act, H.R. 1849, would help to provide relief to credit unions from this arbitrary cap and ease the SBA process for credit unions.

Even though the credit union has been able to grow and help small businesses, business lending to our members is a very important part of the Mid-Hudson Valley Federal Credit Union. During the early 1990s, the Mid-Hudson Valley area was left reeling with the closure of the IBM Kingston plant that employed over 7,000 employees.

As a federal credit union for that IBM plant, we help many former IBM employees establish their own small business ventures. Some of the bigger financial institutions in the area were unwilling to lend to these entrepreneurs. As a result, Mid-Hudson Valley stepped in and filled this void.

Today Mid-Hudson continues to help fuel small business growth in our region. Credit card lending plays an integral role in providing much needed capital for our small business members. Currently 61 of our business members have credit card accounts with the credit union. These small business members pay their bills on time. And many do not carry balances and, thus, do not generate a large amount of interest income for the credit union.

Absent this capital provided by the credit cards, these businesses surely would not be as successful as they are today. Credit cards offer a convenient form of payment and an easy way to track expenses.

Many small companies often utilize credit cards as a main source of credit. Federal credit unions are the only federal financial institution with a statutory usury ceiling, currently at 18 percent. This helps ensure that small businesses using credit cards from their credit unions do not face predatory interest rates.

Federal credit unions have traditionally been responsible lenders and have not participated in some of the predatory practices that are engaged in today. Thankfully, double cycle billing, universal default, and hair trigger repricing are not a part of the credit union vocabulary. At

At Mid-Hudson Valley, we tend to hear the same reasons over and over again as to why our members, small businesses, prefer credit cards to assist them with their business. The ease of obtaining credit, the ability to monitor cash flow with their monthly

statements, efficiency, fair rates, and overall convenience are the main reasons why our small business owners utilize credit cards.

Knowing our members helps us put them in the proper loan products for their business needs. For example, if they needed to purchase a copier for $5,000, we would not put them in a credit card but, rather, suggest a term loan for those purposes.

MHVFCU believes that any effort to restrict credit card practices should be carefully crafted to ensure that smaller financial institutions are not burdened by unnecessary regulation and unintentionally harmed.

In conclusion, federal credit union small business lending is strong and continues to grow. However, the current regulatory framework prevents federal credit unions from doing more for America's businesses. Legislative proposals such as the Credit Unions Small Business Lending Act and the Credit Union Regulatory Improvements Act would go a long way to helping credit unions to bolster small business growth in America.

Furthermore, credit card lending plays a pivotal role in helping federal credit union business members start and grow small businesses. NAFCU urges caution and careful consideration of any legislation proposals that could simultaneously hurt credit union lending and small business development.

I thank you for your time. And I am happy to answer any questions that the Committee members may have.

[The prepared statement of Mr. Spearman may be found in the Appendix on page 37.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Spearman.

Our next witness is Mr. William Rosacker. He is the President of the United Bankers' Bank in Bloomington, Minnesota. He is testifying today on behalf of the Independent Community Bankers of America, a leading trade association representing over 5,000 community banks of all sizes and charter types throughout the United States.

Welcome, sir.

STATEMENT OF MR. WILLIAM C. ROSACKER, PRESIDENT, UNITED BANKERS' BANK, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. ROSACKER. Thank you, Chairwoman Velázquez and Ranking Member Chabot. I am Bill Rosacker, and I am President of United Bankers' Bank in Bloomington, Minnesota. I am pleased to be here today on behalf of the Independent Community Bankers of America.

On behalf of ICBA's nearly 5,000 members, I want to express our appreciation for the opportunity to testify on the important role credit cards play in supporting America's small business.

Access to credit and capital is vital in today's economy. Today I will focus on three points: first, how community banks are able to help local small businesses run and finance their operations successfully through the use of credit cards; second, how community banks as small businesses themselves benefit from the ability to offer credit card products; and, finally, the legislative and regu-

latory landscape facing community bankers and their small business customers.

Community banks play a vital role in providing capital entrepreneurs need to succeed. In fact, community banks provide nearly a third of the total dollar amount of bank business loans under $100,000, many in the form of small business credit card products.

A small business owner who chooses to do business with a community bank gains an important advantage of local decision-making. Community bankers know their customers and live and work in their neighborhoods. Should a small business find itself in a tough financial situation, both the banker and the owner have a clear interest in making the business successful.

A small business credit card holder gains a new source of capital that can help them meet their dynamic financial needs while establishing a sound business credit history. A credit card simplifies the accounting and cash flow management.

A small business can use a credit card to finance daily expenditures, freeing up assets to be reinvested in the business to help it grow, rather than tying it up in trade credit receivables and payables.

Also, it has been my experience that a large majority of small business credit card holders pay their statement balance in full at the end of each month, using it as a transaction account and almost provides them the same convenience as a regular checking account.

A small retailer accepts credit cards, improves its profitability and efficiency. For example, they are protected against many types of fraud. They do not have to keep as much cash on hand. And the business receives guaranteed funds in its account immediately.

Also, as we all know, consumers will spend more if they go to a merchant that accepts credit cards. After all, increasing customer transactions is the best way to develop revenue.

If a small merchant signs with a community bank, it is getting a tremendous value because of the benefits of the electronic payments and sophisticated payments network that a community banker can utilize to complete the transaction quickly and, most importantly, securely.

While community banks are often lumped into a broad category of bankers, it is important to keep in mind that a community bank is a small business themselves. We face our own unique set of challenges in a very competitive marketplace.

Contrary to popular belief, the consumer and business credit cards we offer are not always the source of tremendous profit. The real value lies in our basic ability to offer these products to consumers and small businesses. Offering community bank-issued credit cards creates a stronger relationship with the customer and encourages loyalty for the long run.

Credit cards are a very small margin product for many community banks, which do not issue consumer and credit cards at volumes near the larger issuers. For the small business owner, they can get the same product but with local customer service at a competitive and often better rates from their community banker.

One unique challenge facing community banks on a daily basis is the burden of government regulation, which directly affects the

ability to support small businesses. There are a number of legislative proposals which would greatly increase the cumulative regulatory burden for card-issuing community banks.

The increased regular costs and burdens could be the tripping point that will cause community banks to discontinue offering credit cards products. That said, there is also an opportunity for Congress to enact measures to make it easier for small businesses and community banks to grow and succeed. ICBA would like to thank the Chairwoman Velázquez for introducing the Communities First Act, H.R. 1869, which provides much needed regulatory burden and tax relief for community banks, their customers, and their communities.

In conclusion, even in the best of economic times, small businesses can struggle in the search of capital. Community bankers are well-positioned to meet these needs, be it through traditional loans or highly competitive business credit offerings. The support structure built on local decision-making and long-term relationships unique to the community bank model is a proven formula to help entrepreneurs succeed.

I want to thank you for this opportunity to testify. And I look forward to your questions.

[The prepared statement of Mr. Rosacker may be found in the Appendix on page 54.]

Chairwoman VELÁZQUEZ. Thank you.

Our next witness is Mr. Wayne Gatewood. Mr. Gatewood is the President and CEO of Quality Support Inc., a veteran, a minority-owned small business that provides a distinctive array of management, administrative meeting, and conference support services for its wide array of government and corporate clients.

Welcome.

STATEMENT OF MR. WAYNE GATEWOOD, JR., USMC (RET), PRESIDENT AND CHIEF EXECUTIVE OFFICER, QUALITY SUPPORT, INC.

Mr. GATEWOOD. Good morning, Madam Chairwoman and Ranking Member Chabot and members. After 21 years in the United States Marine Corps, I started Quality Support in 1989, with $600 in a small loan from my dad.

I initially used credit cards to pay for small corporate needs and personal items that would otherwise require the outlay of cash. To maximize my potential for success, I needed time. And credit cards gave me that time.

From 1989 to 1998, because of favorable terms and flexibility, American Express became our preferred source of credit. In 1999, our company was selected to support a large Department of State requirement. To take on this work, we would need a credit line of one million dollars.

Even with a substantial cash balance and an established track record, our bank turned us down flat. However, American Express worked with us and authorized a credit line up to one million dollars. By the end of our State Department contract, we had charged $1.1 million on our American Express cards.

Since 1994, we have charged more than $8 million through American Express. For calendar year 2008 alone, we are on pace to charge $2.5 million through our AmEx account.

Bank lines can be expensive and hinder business operations. Example, the following terms were offered us by a bank. We rejected the offer. No corporate cash contribution or distributions could be made while the agreement was in effect. This would be the case, whether the line of credit was used or not. We could not enter into any teaming agreements without permission from the bank, thus stunting our opportunities for future growth and stability.

In addition, Quality Support guaranteeing the loan, the bank wanted me to personally guarantee the loan. The bank would put a lien on our receivables, and the bank would be paid directly from our clients. We would maintain a net worth of $1.5 million for a $500,000 credit line. If we dipped even slightly below the $1.5 million mark, even for a short period of time, the bank could immediately call in the loan.

The bank reserved the right to call in the loan at their discretion any time. The credit line would be for one year only. And at the end of that year, all outstanding balances were due. And terms would only be extended at the bank's discretion.

At our expense, the bank could request field audits of our finances or the records any time they chose and as many times as they chose. We would pay for the preparation of all related documents and be responsible for all out-of-pocket expenses incurred by the bank, to include their attorneys' fees. This would be the case, even if we never used the credit line and was in addition to the $2,500 annual maintenance fee. To pay for these expenses, the bank could debit any accounts maintained by Quality Support without prior consent from us.

Although we now have two small bank lines of credit that do not include such harsh terms, we still prefer to use our credit card account with American Express. If we used a bank credit line for short-term credit, we would have to pay interest. If we used our cash, we would lose the opportunity of investing the money elsewhere.

By using AmEx, we have access to the credit we need. We pay no interest as long as we pay within the terms of our agreement. And we are able to invest our cash on hand in interest-bearing accounts.

AmEx is beneficial because of its simplicity. When we have a short term requirement, such as a large hotel bill, we make a phone call to Amex, explain the situation, sometimes provide basic financial information. In most cases American Express immediately increases our credit line for the short-term requirement. Even when we don't have a need for short-term credit increases, American Express offers us a healthy and ongoing line of credit.

American Express ensures international purchasing capacity for us and credibility internationally to support our operations almost anywhere in the world. As a bonus, we receive air miles for every dollar we spend with American Express.

Quality Support will continue using credit cards to enhance and sustain our corporate operations. Credit cards when used judi-

ciously can provide the small business owners with the flexible and quicker access to credit they otherwise may be denied.

Quality Support's growth and success over the past 19 years would not have been possible if access to credit had not been available to us. We thank the credit card companies, especially American Express OPEN, for giving us the capacity to form and grow our company.

Thank you. This ends my testimony.

[The prepared statement of Mr. Gatewood may be found in the Appendix on page 63.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Gatewood.

Our next witness is Dr. David Walker. Dr. Walker is the John A. Largay Professor and Director Emeritus of the Capital Markets Research Center at Georgetown University, which he directed for 17 years. Previously Dr. Walker has served as the Director of Research for the Office of the Comptroller of the Currency.

In his research, Dr. Walker has analyzed free credit availability and demand for SBA loans and has published several studies on the financing of small firms through venture capital, informal investment, and bank credit.

Welcome.

STATEMENT OF MR. DAVID WALKER, JOHN A. LARGAY PROFESSOR, GEORGETOWN UNIVERSITY, McDONOUGH SCHOOL OF BUSINESS

Mr. WALKER. Thank you. Madam Chairwoman, Ranking Member, and Committee members, thank you for the opportunity to testify in front of the House Committee on Small Business. I know we have very limited time. So I would like to offer my conclusions to begin my discussion.

I would like to urge the Committee to do whatever you can to increase the supply of funds to small firms. These firms are the growth engines of our economy, as I discuss in my testimony.

Technically we are not in a recession. We do not have the data to know whether or not GDP growth has been negative for two consecutive quarters. For the fourth quarter of 2007, growth was 0.6 percent. And we do not have data for the next quarter.

No matter what label we use, the economy is in extremely poor condition. Figure 1 on page 9 of my testimony suggests that the contrast between the credit card interest rate and the prime rate is quite similar to that during the previous recession, as identified by the prestigious National Bureau of Economic Research.

In my opinion, the stimulus package you have already enacted and the current action that you and your colleagues are working on this week to deal with the housing crisis will probably enable us to avoid what we technically define as a recession of two negative growth quarters.

My interest in small business originates from, one, experience from my family owning and operating a retail store in York, Pennsylvania for 93 years; two, working with the Small Business Administration, which this Committee oversees; and, three, extensive small business research and policy analysis, beginning 40 years ago with my Ph.D. dissertation.

Small business and consumer credit are often indistinguishable. Much of the credit available to small firms is based on the entrepreneur's personal resources, credit card loans, and lines of credit, and mortgage loans and potential home equity loans and lines.

In our recent study, Dr. Thomas Durkin and I argue that much of the consumer credit is revolving credit without a fixed payment schedule, often credit card loans from financial service firms to small business. I am pleased to submit that study to the Committee for your background.

Much of today's credit crunch has been caused by what I consider to be irresponsible mortgage lending and the unreasonable assumption that there would be no finite limit to housing prices during the current decade.

Consider, for example, a 2/28 subprime mortgage, where the loan equaled virtually 100 percent of the 2005 property appraisal. When the mortgage resets in 2008 at new rates for years 3 through 30, they reset at an interest rate that is generally above the market rate that you would find on an adjustable rate mortgage today. If the borrower has negative equity in 2008, the borrower will not be able to refinance at the market adjustable rate that he or she would otherwise find.

The adjustable rate mortgages have allowed many legitimate borrowers to purchase a home. They are not to blame for the current credit crisis, as has been claimed sometimes. The problem is the high reset rate, often above market rates, when the reset is required and the borrower has no equity in the property and no alternative but to agree to a high reset rate.

Costs of credit to small business are often very high compared to rates available to other sectors. And this is especially true during a credit crunch. Small firms relying on debt secured by credit cards usually pay more than twice the interest rate that large firms pay when borrowing at the prime.

The difference between the cost of credit for large and small American firms is at least illustrated by the difference between the prime interest rate and the rate of interest on credit card balances, the difference of costs of debt for small and large firms.

Figure 1 on page 9 shows the substantial difference in the credit card rate and the prime rate between 1994 and 2007. Throughout this period, the difference between the credit card borrowing rate and the prime rate is substantial. Small firms have incurred a much higher cost for external resources than large firms over the past 13 years.

Thank you very much for this opportunity to meet you and speak with you. I would be pleased to answer any of your questions.

[The prepared statement of Mr. Walker may be found in the Appendix on page 70.]

Chairwoman VELÁZQUEZ. Thank you, Dr. Walker.

Our next witness is Dr. Robert J. Lahm. Dr. Lahm is Assistant Professor of Entrepreneurship as well as the Entrepreneurship Interim Program Coordinator for Middle Tennessee State University. Previously Dr. Lahm has founded private entrepreneurial ventures and has held positions as an employee of other small and large businesses.

Although diverse, Dr. Lahm's research has often focused on topics with practical implications for the small business sector, particularly the issues of entrepreneurial bootstrapping and the use of credit cards in small businesses.

Welcome.

STATEMENT OF DR. ROBERT LAHM, JR., ASSISTANT PROFESSOR OF ENTREPRENEURSHIP, JONES COLLEGE OF BUSINESS, MIDDLE TENNESSEE STATE UNIVERSITY

Dr. LAHM. Thank you, Madam Chairwoman, Ranking Member, and the Committee, for allowing me to testify.

As you will note from my bio, I am not a lifelong academic. I have been an entrepreneur. I have also been an entrepreneurial bootstrapper; that is, one who has started the business from scratch with little or no capital. I know how it feels to float with my head bobbing, sometimes beneath and sometimes above the surface of treacherous entrepreneurial waters.

The credit card industry has in recent years been aggressively targeting the small business market. My research shows that credit cards, whether labelled or classified as personal accounts or as business cards, have become the surrogate for traditional sources of capital by bootstrappers.

In one of my earlier papers, entitled "Just Say Charge It: The Use of Credit in Entrepreneurial Start-ups," I estimated that somewhere in the vicinity of eight and a half million businesses with zero employees across all industry sectors were using personal credit cards as a source of capital in 2002. Usage rates as well as the total number of businesses have both increased since that time.

The subject of entrepreneurial bootstrapping has thus far not been vigorously researched. Bootstrappers do not or cannot access traditional lenders, business angels who buy ownership in their firm, or venture capital.

There are many reasons for this behavior. They may not want other owners to meddle in their businesses. They may want to prototype their business concept before jumping into selling ownership for capital or they may fear the loss of control by having other owners.

There are many dangers for would-be business or consumer credit card holders. Most of us are aware of the game that is played given the credit card companies incorporate regular change of terms provisions in applicants' contracts. Indeed, language such as we may change our terms at any time for any reason foreshadow that they can and will do so regularly.

The biggest problem with respect to credit card companies is that they can be whimsical in their treatment of credit card holders. I believe my use of the word "whimsical" is appropriate given that some issuers have added "or for no reason" to their change in terms disclosures.

Another danger is that so-called business cards are no different from ordinary credit cards relative to personal liability. Whereas, many small business owners may think that once they form a business, they are protected, they have typically never heard of veil piercing.

Credit card companies may slap an unwary borrower with high interest rates when payments are late, in addition to late fees. According to a United States Government Accountability Office report entitled "Credit Cards Increase Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers," 35 percent of their credit card issuers' active U.S. accounts were assessed late fees and 13 percent were assessed over-limit fees in 2005. Even the Internal Revenue Service uses the postmark to signify compliance with the spirit of a taxpayer's filing deadline.

Knowing that entrepreneurship is vital to the economy, we must start and find ways to study and support bootstrappers since they comprise the vast majority of all start-ups. These businesses may finally reach the cover of Inc, Fast Company, or Entrepreneur, but they are started on kitchen tables.

As policy-makers, I would invite you to consider novel approaches to disseminating formal education and training to nascent entrepreneurs. We need better disclosure agreements. When other industries have produced products that may be hazardous to consumers' well-being, they have been forced to educate consumers.

Unfortunately, personal finance has been greatly under-served as the subject for contemporary students in high schools and universities. While this may fall under the purview of the U.S. Department of Education, this Committee could advocate for increased attention to addressing the societal need for financial literacy.

I fear a proposal to require that the terms of credit be frozen at the time credit was taken would actually raise the cost of credit to all. On the other hand, lenders who are utilizing predatory lending tactics, trickery, and obviously disingenuous strategy to trap borrowers in a classic game of bait-and-switch with change in terms agreements must be stopped given that entrepreneurs are the lifeblood of the economy.

I wish you well in your quest to create policies that can nurture those businesses that deserve the opportunity to succeed. If I may be of further service in the future, I will hope you will call upon me again.

[The prepared statement of Dr. Lahm may be found in the Appendix on page 92.]

Chairwoman VELÁZQUEZ. Thank you, Dr. Lahm.

If I may, I would like to address my first question to Mr. Spearman. What are some practices that credit unions use to manage risks associated with credit, card lending to member businesses?

Mr. SPEARMAN. Well, basically what we do is we know all of our businesses personally. We are involved many times in helping them assemble a business plan. We work with them.

Generally speaking, we work with a lot of start-up businesses, and we actually have them produce a business plan. We provide them resources to do a business plan. So when they come back to us, we have a pretty good idea that we are really a partnership in this process.

And if it is a start-up business, we will probably start with a credit card, but we will start at a modest credit limit and work through that process. And generally speaking, the credit card is

perhaps the first instrument that is used in the relationship. And soon it will be followed by other relationships.

So we continue to work with them. And, really, in our portfolio, which is a credit card portfolio, which is rather small, we have about 61 accounts. We don't have any real delinquency or any issues with those cards. Primarily they are used for a payment device.

Chairwoman VELÁZQUEZ. Mr. Rosacker, would you mind to comment on some of the practices that your banks use to manage risk associated with credit card lending?

Mr. ROSACKER. I would love to. In conjunction with what Mr. Spearman said, we also develop this deep relationship with the customer. And, as I testified, you live in their same neighborhood. The kids play Little League together. You know that their goal is to succeed, and you want them to succeed.

And I think that through the sophisticated computer systems that back the business credit card, you can actually monitor their sales, their expenses, where they're spending money, how they're spending money. And you can do that almost on a day-to-day basis, where in a traditional business loan, you really don't do that and can't do that other than on a quarterly or whatever basis.

But I think, to sum it up, it is a relationship. It is the fact that you have the tools computer-wise to do it. And, finally, I think when you look at what a community bank is and that small entrepreneur is, that is the time when one owner of one business can sit down with the owner of another business and solve the problem and make it a win-win situation.

Chairwoman VELÁZQUEZ. Can you comment? How would restricting lenders' ability to price risk affect credit availability for small businesses?

Mr. ROSACKER. I think that the risk and pricing for risk are important. And I know that there are many studies that have said this is tightening or this is loosening and what have you. But I think when you look at it, credit card pricing is significantly different than the traditional loan pricing. There are significantly different risks involved in the credit card from the standpoint it is unsecured credit. It is not a collateralized line of credit, as you would in your traditional.

So you do analyze it differently. And you do look at it. But you have many more tools to use than you do in the traditional business loan.

Chairwoman VELÁZQUEZ. But will this restricting the ability to price for risk create additional costs that will passed on to—

Mr. ROSACKER. Absolutely because you are going to have to make up that limitation that you have on the risk in some other form. I mean, you can't do it for nothing.

Chairwoman VELÁZQUEZ. Mr. Gatewood, one of the reasons some individuals advocate for traditional loans is that their terms are perceived as being more fixed, thus providing businesses with greater sense of certainty and enabling them to effectively plan for the future. Do you believe that traditional loan terms are more fixed than credit cards or that they better enable businesses to plan for the future?

Mr. GATEWOOD. Well, thank you, ma'am.

Actually, I think they are fixed in favor of the banks. As my testimony revealed, the loan applications received from the banks were very restrictive. Certainly it was fixed there. So we knew how much we could get over time, but the risk was huge.

And the autonomy that the bank had to call in the loan at any time and to require us to go through them for a number of our operations was just too restrictive.

Chairwoman VELÁZQUEZ. Any of the other witnesses would like to comment on that question?

Mr. GATEWOOD. Also, ma'am, if I might, again, as I say, the credit card was our preferred means because if we paid on the terms of the credit cards, there is absolutely no finance charge. So our cost is minimal, if anything.

Chairwoman VELÁZQUEZ. Dr. Lahm, in contrast to traditional loans, most banks are willing to issue a credit card to a business without requiring personal guarantees, origination fees, or without taking a security interest in the business assets. What makes credit cards more open to these less restrictive lending terms compared to traditional loans?

Dr. LAHM. I have found the irony in the fact that banks will not often provide traditional loans until a business is established with, for example, three years of operational history and a track record. But, yet, it is banks who will turn right around and with a signature provide a credit card loan for a substantial amount of money with no paperwork whatsoever as compared to exorbitant layers of process, accounting, and so forth, incurring costs for the businesses. And I think this explains why credit cards are so popular.

I would say that credit card usage is very high with respect to personal credit cards. And those who sign both business and personal credit card agreements are, in fact, signing that they are liable for those as persons with Social Security numbers, with credit ratings, and so forth, which are subject to be damaged or, of course, enhanced positively if they perform in accordance with the bank's expectations and reporting.

Chairwoman VELÁZQUEZ. Thank you.

Dr. Walker, in the five years since the last Federal Reserve survey of small business finance, credit card use by businesses increased by 14 percent. During the same period, the use of personal credit cards by consumers increased by less than one percent. Are there factors associated with business use of credit cards that have contributed to this rapid growth?

Mr. WALKER. Well, from my knowledge, business has not found any other alternatives at a price that they could afford. Even right now the prime interest rate is 5.25 percent. The typical credit card quotation yesterday was 13.4, more than 2 and a half times.

And, yet, business cannot seem to find alternatives and particularly small business. That's why I drew that contrast in my testimony because I think it is a good indicator of what small business faces when they go looking for funds.

Chairwoman VELÁZQUEZ. Thank you.

And now I will recognize Mr. Chabot.

Mr. CHABOT. Thank you, Madam Chair.

Mr. Spearman, I will begin with you if I can. You mentioned that H.R. 1537, the Credit Union Regulatory Improvements Act, which

I support and cosponsored, would raise the business lending cap. Could you explain a bit more why this is important? And would lifting this cap increase credit card lending, do you believe, to small businesses?

Mr. SPEARMAN. Yes. Yes, it would. It would increase credit card lending and would also create additional lending to small businesses as well. The cap is a statutory cap that was created in 1998. And at this point, our credit union is dangerously close to that particular cap.

And since there is not necessarily a secondary market, much as there is in the mortgage business, where you can sell the mortgages and retain the servicing, there is no such established process here in the credit union industry at this point.

So it will create a pull-back, if you will, of financial institutions that are at that level not to be able to offer additional credit. And at this point, like I said, our institution is facing that particular hurdle at this point in time. And I know many other organizations are as well.

So it is a limiting factor. And it would also cause issues on credit cards, particularly those that are larger credit cards, say credit cards in advance of a $50,000 to $100,000 level.

The way the policy works is as long as the credit limit is at that level, we have to account for that for the cap. Whether the balance is used or not, it is the limit that is counted. And that obviously could cause a problem, and it has caused some problems there.

So we are anxious for relief and continue to work on that, but it is an issue that we are facing. And I know many of my colleagues are facing that as well.

Mr. CHABOT. Thank you.

Mr. Rosacker, what standards do most banks use to evaluate the creditworthiness of prospective small business customers?

Mr. ROSACKER. Well, I think it depends, obviously, significantly on the type of business you are going into and where they are going to be doing their business. But I think traditionally community banks use the same criteria. You are looking at the capacity of the borrower, the creditworthiness of the borrower, their business plan and when their break-even point is going to be and what does their business plan look like, and who they are going to do business with. Are they going to do business with a certain segment of the economy that is very susceptible to big swings in the economy or big swings in the business?

So there is no cut and dried criteria, but there is an overall review of the entire business plan. And strategic plan of the small business owner is very important.

And I think that banks as a rule try to find ways to say yes. That community banker lives and breaths that small entrepreneur in this community. And, as I keep saying, it's that relationship that goes in.

I think a good example of that is a young lady that graduated from the University of Minnesota with a degree in architectural design and focused primarily on landscape design. She had excellent credentials but no idea on how to develop a business plan, how to do things.

She worked with a community banker in Minnesota. They developed a business plan. They got her incorporated. They did all of the work for her and with her and set up a line of credit with her. So it's a total relationship.

Mr. CHABOT. Thank you very much.

Mr. Gatewood will be next, if I can. Your written testimony said that credit cards give you and have given you the flexibility and fund availability you need to operate, particularly compared to traditional lines of credit. Would you elaborate on that just a little bit?

Mr. GATEWOOD. Yes sir. Our credit cards give us a term to pay or a length of time to pay from the time we borrow the money. In my business, which is federal government contracting, I have to turn around my money pretty quickly. It's sometimes tough getting paid from the government.

The banks don't give us any flexibility. They have certain days you have to pay. And if you don't, you start incurring interest rates and sometimes fines and so forth and so on. And, of course, you risk default.

I appreciate Mr. Rosacker talking about community banks, but we don't deal with community banks here in Washington, D.C. We deal with some of the nation's largest banks. And they are not warm and friendly, not at all. So they have a huge risk aversion. And over the lifetime of my 19 years in business, we have really had a hard time dealing with banks.

The banks have a set date that that money has to be paid. And there is no flexibility whatsoever. So we stay away from them. We have gone, if I might say, in the federal government contracting community—and this is no kidding. As a matter of fact, some of you may have seen my e-mails to the Senate and the House. It's 444 days without getting paid by the federal government, 6 months oftentimes.

I am not saying that American Express tolerates any tardiness or that the other credit cards we hold, Visa and MasterCard, tolerate any tardiness, but they have customer service reps that work with us that understand our business. And they know they are going to be paid. And that is a huge flexibility for small businesses supporting the federal government community.

Mr. CHABOT. Thank you very much.

Dr. Walker, you have researched business start-ups all over the world. Is it common in other countries to use credit cards to begin a business and perhaps to expand business as well?

Mr. WALKER. From what I know, this is really just beginning, that lots of the rest of the world is observing the fact that so many successful small businesses in the United States have begun this way and people looking at it and thinking, gee, this may be a source of credit they never imagined.

Also banks in many other countries really are just beginning to make loans to small business and used to depend on what we call informal investment, meaning other investors, friends of the entrepreneur as well as the entrepreneur's family.

Mr. CHABOT. Thank you very much.

And, finally, Dr. Lahm, has the recent economic uncertainty and tightening of credit in the financial markets resulted in small busi-

nesses using credit cards more frequently? And do you anticipate that that would be true in the near term?

Dr. LAHM. I would not have access to usage rates as of the last several months. Most of the data that I have utilized has been from earlier reports, Census reports, SBA reports, NFIB reports, and so forth.

However, I am convinced that the credit card industry itself can tell you where you had dinner last night. They know exactly where you are, what you are spending, what you are doing, and I don't believe that there are any illusions about their ability to do data mining. And they could certainly address your question very specifically if asked.

Mr. CHABOT. Thank you.

Let me follow up with one more question, then. You once wrote that there's not a lot of academic research on the use of credit cards by entrepreneurs, despite the fact that there is widespread use of financing with them. Is this still the case, to your knowledge?

Dr. LAHM. I believe so. I can explain why if you are interested.

Mr. CHABOT. Yes. Sure.

Dr. LAHM. I don't believe that it is very sexy to study the landscaper who has five persons on a work crew as compared to some Silicon Valley start-up. Obviously when university researchers, who are independent thinkers, of course, conduct their research, they may be influenced by other factors, such as the fact that larger businesses that are established have better data sets. A landscaper might keep very minimal records.

Nevertheless, the problem is that these zero-employee businesses are extraordinary in their numbers. It is the vast majority of all businesses. But I don't think that they have been given proper attention as yet. I believe this is changing.

Mr. CHABOT. Thank you very much, Doctor. I yield back.

Chairwoman VELÁZQUEZ. Mr. Gonzalez?

Mr. GONZALEZ. Thank you very much, Madam Chairwoman.

I want to start off with a couple of observations. And the first one is that we have got credit card issuers in the form of independent and community bankers and the credit unions when we price should have, the Chase people here, the Bank of America, and so on, because they probably are the ones that have the greatest percentage of credit card holders and users and so on. But, nevertheless, we do appreciate you being here. But I think that you probably represent what are the better practices out there by those that issue credit cards.

Dr. Lahm and Mr. Walker, I want to cover a couple of basic points. The first one is—and we're not here to cut off any avenues or to access to capital and credit cards very legitimate, prudently used, and so on. I think what we are trying to explore is what is there the disproportionate use, why isn't there as great an effort by the lender to go with traditional forms of capital and financing and so on because there are some disadvantages associated with credit card use.

So the first principle I would like to establish is, is the risk so great with a small business man or woman that it does not allow a lender to promote and extend traditional lines of credit? And I

will start with Dr. Lahm and very short because I have got another one, and it will lead up to something else.

Is the risk just so extraordinary out there that the lenders just can't really treat them as they would, let's say, someone like a Bear Stearns?

Dr. LAHM. Well, I believe one of the points you raised in your remarks kind of does suggest that there are differences among lenders, the community bankers, for example, that we are dealing with. Those who I know personally I recognize that they do build their businesses on relationships, they get to know their clientele, they understand these individuals, they may have gone to church with them or otherwise been members of a community over a long period of time. And they're in a capacity such that they can assess and get to know, if you will, who it is that they're working with and they can have a very close working relationship.

The large institutions, though they may attempt to claim that they have some warmth or fuzziness, still don't get it. Even as marketers, I get letters from banks. And I love this one, "Your personal banker," but there is no signature.

[Laughter.]

Dr. LAHM. So go figure. So I do think that there are differences. And I do think that at the credit union, community bank level, relationship bank level, that the lending field is quite different in terms of the model.

I do know that in terms of the large credit card issuers, one of the things that changed, actually came from academic research several years ago, some earlier researchers decided to look at the relationship between someone's personal habits and creditworthiness as compared to the likelihood that they might be a good borrower for credit cards that are labeled as business credit cards.

While I didn't think that that was rocket science and didn't necessarily require empirical research, not to be disrespectful of the researchers, I think it is pretty evident that if someone wants to pay as a matter of practice in his or her personal life, that they are likely to carry that value system with them in their conduct of themselves in a business capacity.

Mr. GONZALEZ. I would agree with you.

Mr. Walker, does the risk just outweigh traditional products out there, the availability?

Mr. WALKER. I am afraid that it does, Congressman. And I can tell you from my own family's experience that if we had bad weather on what's called Black Friday, the day after Thanksgiving, on that one day, that meant that our business did not make a profit, no matter what else we did.

The small firms just don't have the ability to go to the market for funds. And, of course, even though the law says that no bank is too big to fail and the implication is that no firm is too big to fail, the footnote in those laws says unless it would have a negative impact on the whole economy. And so I think it probably is too much.

Mr. GONZALEZ. I guess my point is that it seems to me that everything mitigates against the lender really making a concerted effort to have traditional types of loan products out there for businesses.

And let me just start by the fact that the interest rates can be charged are drastically different, my understanding, in a credit card setting, as opposed to the traditional loan. The fees, the penalties, all of that is extraordinary as far as the exposure to the business person.

And I think, Mr. Walker, you are exactly right, the old thing about too big to fail. When it comes to small business, it's probably too little to matter. And I think that is what we are trying to get at here with the small business with the Committee and trying to figure out why the over-reliance on credit card type of financing or access to capital.

I think one reason is because it is so profitable. And so I am going to ask both Mr. Spearman and—I'm sorry. I can't make out—how do you pronounce this? I can't make it out.

Mr. ROSACKER. Rosacker.

Mr. GONZALEZ. And I don't know what it is for the community or independent bankers I have such great respect for, so different from my big banks. And, of course, my credit unions have more credit union members in my district than probably anywhere else in Texas.

The question is—and I'm trying to see how diplomatically I can put this—do you all expend the same amount of money and effort in extending to the small business man and woman loan products, access to capital as you do in promoting credit cards?

Mr. SPEARMAN. We do spend more time in providing input into business loans. In our situation, the credit cards become more—they are certain a credit value for our credit cards in the credit union operations and our—they end up being more of a transaction to them.

The credit card is used mostly in most cases of managing the operation. In many small businesses, the office for the small business is the vehicle. I have seen it up PC set-ups, cell phones. And they conduct their business from their vehicle.

So the credit card, while it provides a credit limit, our maximum credit limit in our portfolio is something like 30 or 40 thousand dollars. It's very small. So the credit portion of that vehicle is really a small piece of what they are using the card for. They are using it for transactions.

And I think, as the Committee's information research showed, about 60 or 70 percent of the small business credit cards get paid off every cycle. And so it becomes a vehicle for them.

We do sit down. And in our situation, we do provide term loans, vehicle loans, lines of credit of 100,000. And many of the clients that we have start with the credit card. And then we develop relationships with them for these lower-cost capital situations. And I would assume the community bank situation would be the same, but I will let Mr. Rosacker.

So we do do the traditional financing for our small businesses. The credit card becomes a small important piece, but it is part of the whole puzzle for the process.

Mr. ROSACKER. I will address the same question, maybe coming at it from a little bit different angle. But I do agree that on the credit card side, 80 percent of our portfolio pays off every month. So it is an interest-free loan.

On the other side, on the traditional products, one problem arises out of the fact of how the regulatory agencies look at market segments. When one market segment goes bad, the entire country is bad.

So you get a knee-jerk reaction many times that the banker says, "Wait a minute. I am not going to go down that road anymore because of the regulatory issues that the entire world has gone sour in a certain market segment." And that's not true. It is far different in California than it is in Virginia and Minnesota as it is in Texas.

But also banks would like to use or have more access to the SBA. And the SBA, the Small Business Administration, does not make it real easy for banks to get access to capital and funding and guarantees of loans. The fees have gone up dramatically. So a lot of bankers can't sell that. And the red tape and the bureaucracy are terrible.

So if there were a better streamlined method to use the SBA, the community banks would certainly use that route, which is a traditional route to go. But that is one area that needs to be addressed because it is a real cumbersome thing to do.

There are many small community banks that will not even—there's nobody even in the bank that knows anything about SBA.

Mr. GONZALEZ. Thank you very much, Madam Chair, for giving me the additional time.

Chairwoman VELÁZQUEZ. Mr. Akin, do you have any question at this point?

Mr. AKIN. No, I don't have a question at the moment.

Chairwoman VELÁZQUEZ. Thank you. Thank you,

Mr. Johnson?

Mr. JOHNSON. Thank you, Madam Chair.

Mr. Spearman and Mr. Rosacker, what percentage of your small business customers using credit cards for business purposes pay their credit card balances in full each month ?

Mr. SPEARMAN. The percentage? About 70 percent.

Mr. JOHNSON. At your bank?

Mr. SPEARMAN. At my—

Mr. JOHNSON. At your credit union?

Mr. SPEARMAN. Yes.

Mr. JOHNSON. And how about you, Mr. Rosacker?

Mr. ROSACKER. As I said, about 80 percent.

Mr. JOHNSON. Eighty percent? In 2005, Congress passed a bill that made filing for bankruptcy more difficult and more expensive. The credit card companies strongly supported this legislation because they claimed that borrowers were being reckless with their credit and then filing bankruptcy to avoid paying their debts. These companies argued that credit card fees would decrease when bankruptcies decreased because individuals would not be able to avoid paying their debts by filing of Chapter 13. As a result, there would be less risk to the credit card companies in interest rates and fees would decline.

This has not happened, however. Bankruptcies have fallen precipitously by 62 percent between 2004 and 2006, but credit card rates have not.

Given this seeming disconnect, why is it necessarily the case that regulating this increasingly consolidated industry would increase

credit card fees? And this is for anyone on the panel that may want to respond.

Mr. ROSACKER. Well, I will take a stab at it from the standpoint of we are talking about small business here and individuals are significantly different. In the small business world, the use of the credit card, again because 80 percent of ours pay off, they don't pay any interest. And our fees are traditionally well below the market value.

Again, they are our neighbor. They are our friends, not that you are giving them anything preferential, but that is just the way the community bank is.

We operate on a one to two to two and a half percent margin, much smaller margin than the large credit card issuers. Again, it's a service that we offer, but it isn't our profit-making service.

Mr. SPEARMAN. Yes. I will try to answer that as well. We do I think recognize a number of studies that have been done on the credit card industry regarding credit card rates and the credit union industry as being one of, if not the, lowest. I think the average rate credit unions charge nationally is around 11 percent.

So we have always been, I guess, the low-cost provider. We are maybe underwriting the credit cards a little more carefully in the beginning. Yes, bankruptcies have subsided a little bit, but now with economic situations and pressures, we have seen the blip up. But we are very, very competitive with rates. We don't charge those fees, and we provide a very competitive product.

Now, to exhibit the result of this, our credit card portfolio has actually grown over the last five years, in spite of the competition that everyone receives in their mail every day. Our portfolio—and I think people have read our fine print and have not found any surprises in our fine print. And that is why our portfolio has grown.

So we offer, we think, a very, very competitive product and a fair product for our members.

Mr. JOHNSON. All right. Have any of you experienced or seen predatory credit card lending to small businesses? And if so, what form has it taken? And if not, can you explain why not and if you anticipate predatory lending becoming a problem for small businesses in the near future?

Mr. ROSACKER. I don't think on the small business side the community banks have—they're not into that. I mean, it would not be to their best interest to have any hidden things in their agreements and be in the piranha and predatory mode because of the other relationships that they want to build.

And I would think, Bill, you would be the same way.

Mr. SPEARMAN. Yes. We still actively engage in the credit card programs for small business. We offer a very competitive rate. I think right now the actual rate for a business account is 11 percent, which is I think an extremely fair rate.

Mr. JOHNSON. Well, neither one of you would argue that predatory lending in the credit card industry is nonexistent?

Mr. SPEARMAN. I would agree. There is predatory lending out there. We can only speak for the industries that we represent.

Mr. JOHNSON. How extensive is it, do you think?

Mr. SPEARMAN. I don't know if I could really answer that from our perspective. I don't have the data to be able to identify that,

but I have read and understand that there are some issues out there in that regard. But I can't speak to our industry in that regard.

Mr. JOHNSON. Dr. Lahm, do you want to jump in?

Dr. LAHM. Yes, sir. I don't know what we want to call predatory lending in terms of a definition, but if someone is late, they get a late fee. That is the least of their problems, whatever it may be, $35. They tend to be tiered based on account balances held. But when a revolver is late and when they incur a late fee, that is just the beginning. The next thing is 30-something plus interest.

I don't know what rate we are going to call legalized loan-sharking, but I think we are certainly pushing it when we get into 30-something plus interest. Maybe we'll just call it 40. When they get to 40, we'll call it official legalized loan-sharking.

But 35 percent, as I had read in my earlier testimony, quoting a government report, 35 percent of account holders were charged late fees in 2005. So there's a tremendous number of big banks, in particular, accounts that are suffering through these sorts of practices.

Mr. JOHNSON. Thank you.

Mr. GATEWOOD. Congressman, I think that, actually, the late fees have gone up dramatically, but the rates on the credit cards have come down a bit. If you compare, for instance, the rates on the credit cards have come down faster than the prime rate over the last couple of years. And I think what they are doing is making it up in fees.

Mr. JOHNSON. There has got to be a profit motive to it and a profit—

Chairwoman VELÁZQUEZ. Time has expired.

Mr. Ellsworth?

Mr. ELLSWORTH. Thank you, Madam Chair. A lot of the questions that I have been asked a couple of different ways already. I would like to ask—we just heard some testimony mentioned of the SBA and its effectiveness.

Do any of you have any suggestion on how we could make that in Congress more effective, one, the SBA, just your shoot-from-the-hip reaction? What can we do in this Committee to make that more effective for you all?

And, second, just the ones, twos, and threes of how do we make credit cards more effective for the small business owner? What is a good way? What can we do in this Committee and this Congress to make the use of credit cards more?

I was very interested in the interest rate. I think Dr. Lahm just answered my question about the interest rates because I get a lot of calls on that but how the SBA could be more effective.

And so you all just start wherever.

Mr. ROSACKER. Since I brought it up, I will take a shot at it. I think from the community bank standpoint, they are not big organizations. They don't have deep staff. Their lending people are ag or commercial-orientated.

Streamlining the process so they can get at the SBA and get the loan application in. Get rid of the red tape and some of the fees. Make it easier. Most community bankers now shy away from the

SBA. I don't know in our part of the country—and our bank covers about 11 states.

We have even seen a program put on by the SBA telling us about programs and things that they are doing. I mean, they are not out there. They are missing in action. And I think that would be a big help.

Streamline the process and then educate us on what you can do and can't do and won't do. Don't forget years ago the SBA was very active, but they have slowly drifted away. And now you have new young loan officers that have never seen the SBA and don't know what it's all about. That would be my response, a knee-jerk reaction.

Mr. ELLSWORTH. Thank you.

Mr. SPEARMAN. If I could comment? While I agree with Mr. Rosacker's comment on it, we have a couple of SBA loans. Our member business loan officer is familiar with them but, frankly, because of the tedious nature of the process sometimes shies away. I certainly would support an increase in SBA lending with a streamlined process.

And I guess I would suggest that we taken action on H.R. 1849 introduced by Chairwoman Velázquez and move on that issue. It is an important tool that we have. We received education years ago. Programs have changed. We don't see the SBA people. We don't have contact with them.

I think it is a valuable tool. I really do think that it is a valuable tool. I would like to see us use it more. And I would encourage the Committee to do whatever they could to push that along.

Certainly we are an approved lender. And we would certainly want to include that product in more and more opportunities with our member businesses.

Mr. GATEWOOD. Congressman, I sought a small business loan for my wife's partnership. And inquiring of banks in the Washington area, Washington, Maryland and Virginia, close in, I found that if the loan was going to be an SBA guaranteed loan, then the rate would be at least 50 basis points higher because of the cost of dealing with the SBA process. And I am quite sure that is not what the Committee intends and it is not what any of us as public policy interest would prefer, but I think that is the fact.

Mr. ELLSWORTH. Thank you.

I don't want to start a fight with the two gentlemen from the end, but I know Mr. Chabot brought up the curiae legislation. Does the Community Bankers Association have a position on curiae? I know that when I talk to bankers and credit unions back home, you know, it seems to be a little bit of a sticky point, to say the least.

[Laughter.]

Mr. ROSACKER. Can't we all just get along?

Mr. ELLSWORTH. I was going to say, if you want to switch chairs before you answer this, that is okay.

Mr. SPEARMAN. No. That is all right. He has no sharp objects.

[Laughter.]

Mr. ROSACKER. The community bankers have always taken the position that we oppose expansion of powers, et cetera. And that has been our history, and that is our position today.

So yes, we would be opposed to some expansion of that as we move forward.

Mr. ELLSWORTH. Don't turn the microphone off now.

[Laughter.]

Mr. SPEARMAN. We disagree. We would argue that the enhancements in the bill are very, very important. They include the risk-based lending process, which I think puts us on equal basis with all financial institutions, modest increase in the member business lending areas, and a number of other things that would actually help us serve under-served areas and things of that nature.

So we strongly obviously support the bill, respect the community bankers in what they do in their communities. And so that is the counterpoint on that.

Chairwoman VELÁZQUEZ. Time. The time expired.

Mr. ELLSWORTH. Thank you very much.

Chairwoman VELÁZQUEZ. Mr. Sestak?

Mr. SESTAK. Thanks, Madam Chairwoman.

Just a question. Mr. Gatewood, I am really taken by your written testimony. I wasn't here for your spoken testimony. It really speaks of kind of what America is all about. You know, here you are. You knew by your effort, you say, that you're going to make it. So you with prudence used probably an abnormal but, nevertheless, an accessible form of risk, so to speak, access to capital, and use that to have float time, as you describe it.

I guess my question is more—I mean, I really am taken that this is neither inherently good nor bad, credit cards using for business. I am more taken that oversight or transparency in education and preventing ill use of it, I am convinced of that.

But I guess my question would have to do maybe just a little different. I am more concerned about people being less, like Mr. Gatewood here, be more risk-averse.

Yes, a credit card use is going up, but SBA's access to capital is going down. Health premium has gone up 70 percent. You know, people not going to small companies are going to big companies because they still, by and large, give health security to some degree.

Do you see this risk-averse, independent almost, credit card usage? Because I think I got enough from that. Do you see any of this in people who are even coming? Is there an impact that you are seeing as the SBA comes down, as the economy comes down?

Yes, more go into credit cards maybe, but is there more of a sense of a difference of this entrepreneurialship you see and I think emblazoned in you?

And I guess that is really more of a question for the community bankers and credit unions.

Mr. GATEWOOD. Well, yes. As far as risk aversion is, let me just be quite honest here. I hear the congressmen talk about the predatory lending. No one is a victim unless they want to be a victim.

First of all, business people, entrepreneurs as such, have a responsibility to function responsibly. Good business people understand what they are getting into or they shouldn't be in business, first of all.

So I, for one, don't have a lot of feelings for people that recklessly use credit cards or any form of lending.

Mr. SESTAK. I guess mine was more of a strategic type of take, not so much on the credit cards, because I think I got enough out of the testimony and the great questions that are—

Mr. GATEWOOD. Right.

Mr. SESTAK. I am just wondering about what you see, particularly down at that end of the table, about small business people coming forward to invest with their time and a bit of risk as they reach for capital to do what you did. That's kind of what I am curious about, the state of the risk taking, so to speak, out there in the economy.

Mr. GATEWOOD. I think it is dependent upon the person and what they have and what they can afford to give up as collateral. I had absolutely no collateral, and the banks wouldn't talk to me. So I had to take the risks I had.

I will tell you right now coming from a minority business community at the same time, oftentimes we're just turned out flat basically from where we come from.

Mr. SESTAK. How about the institutions? Because they all come to you.

Mr. ROSACKER. I can respond to it this way. The entrepreneurial individual is a risk taker from the start. And I think that is what has built this great nation. We were all risk takers at one time.

And I think bankers, contrary to the popular belief, we are risk takers. Community bankers are the only people that bet their personal net worth that that entrepreneurial is going to succeed. And their personal net worth is in the value of that bank, their franchise value.

So they are risk takers, community bankers. But when you look at how that risk is assessed, when you are looking at a traditional bank business loan, the regulatory agencies look at it differently than they do a credit card loan.

They look at a credit card loan from the consumer side. Is the application filled out properly? Is the closure statement sent? And are they reminded of those terms annually?

Mr. SESTAK. If I might, what about the person who walks in the door? All your years you have been involved in this, for the two of you, have you seen less people willing to be like him? I am more interested in the trends right now.

Mr. ROSACKER. No.

Mr. SESTAK. You are saying you are still seeing the same type or the breadth, not just the individual but the breadth, willing to take?

Mr. ROSACKER. I would say so because we are all community bankers. And in that town of 500 people, 300 people, businesses are dying, but there is somebody else willing to take the hardware store business on or be it the gas station fellow or the auto body repair store, the implement dealer.

There are always people walking in. They want a certain lifestyle of living in a community, and that is their way of doing it: staying in the community and starting a business. No, I don't think it has dropped off at all.

Mr. SESTAK. If I could, if you don't mind, Mr. Spearman?

Mr. SPEARMAN. Thank you, Congressman.

Yes, I would agree with Bill on that. We are in the business of managing risk, not risk-averse. Because of the—

Mr. SESTAK. I am not worried about you. I am worried about the person coming in the door.

Mr. SPEARMAN. Yes. And we have no problems with people walking in the door. Simply because of the fact in our area that IBM went away a number of years ago, many of the folks stayed in our community and started small business.

So all the business in our community, to be frank with you, is small business. So we have a tremendous amount of demand for that type situation. And that's relevant, again, to the member business lending cap. We have no scarcity of people coming in with innovative ideas, some well-thought-out, and some very, very successful stories, just even based on our portfolio.

Mr. SESTAK. Thank you.

Chairwoman VELÁZQUEZ. Time has expired.

Mr. Cuellar?

Mr. CUELLAR. Thank you, Madam Chair.

I have been a small business. I was in the import/export business. And I never used credit cards for a way to finance. I went to a bank. But I know of friends of mine that it was so easy for them to go to a credit card and use the credit card for financing.

Part of the reason has been mentioned already, "Oh, you know, you've got to go to SBA, so much paperwork." They're going to say, "No" for whatever reasons have been mentioned. And it's just the process is so long. And it was a lot easier to just go ahead and get a loan. And, of course, when they have to pay the high interest rates and when they have to pay all the fees, the late fees and all of that, they regretted that.

But at the moment, they needed something to be done quickly. It's the moment because you are under all the pressure to get this done and get some money available, get some cash into the business.

So I guess what the Committee has been referring to is, how do we make this—you know, because there are a lot of steps. We know the SBA, the accessibility, and all of that, the paperwork. I mean, what is the easiest way to get this done?

By the way, credit cards are a heck of a job at marketing. I mean, I think they know how to market. They know how to make it easy. And it's on the moment when you need the money. And, like I said, I have been a small businessman. But, you know, I never used the credit cards for the business. I use it personal but not for the business. It is so easy to just go ahead and get something because on the moment you need the money.

So, I mean, how do we make this? How do we make government more or how do we work with you to become more responsive?

And I don't want to get into curiae. You guys have done very well sharing the same mike together, but how do we get this competition? How do we make this more flexible?

And keep in mind put yourself in the shoes of a small business person. They need this on the moment. They are not going to go and do all this paperwork unless if it's a longer-term type of situation. I mean, you have got to put yourself in the shoes of the small business person.

From anybody?

Mr. SPEARMAN. Well, part of the thing that we didn't talk about, we have identified our small businesses. And small businesses use business credit cards. What we haven't talked about are the folks that are using our personal credit cards for the same reason. We don't know that. So this is a lot of times—

Mr. CUELLAR. And they do that.

Mr. SPEARMAN. I know they do that.

Mr. CUELLAR. And they do that.

Mr. SPEARMAN. And the point of view of education is if they were to come into the organization, a bank, mini bank, credit union, discuss what their plans are, I think we could handle it a lot better.

But some of these decisions are made independently by the individual. And we have no idea. Perhaps even some home equity loans have been done in this regard. We have no idea because they have never come in to talk to us.

Mr. GATEWOOD. And if I might add, sir, when I started my business, I had, I would say, maybe 13-14 credit cards. Sometimes I just paid the interest because I needed that lead time to become successful. I knew I could make it happen.

And, in all due respects, you indicate you went to the banks. Well, many of us don't have the capacity to do that. I came out of the Marine Corps, 21 years. I never had a bank account. I was overseas for 15 years of my 21-year Marine Corps career. I never had a credit card. I was unknown.

Many of us who come from communities throughout the United States never had bank accounts. Our families never had money. I mean, I grew up on surplus food in the projects in upstate New York, you know? So nobody would look at me.

The only way, the only way possible I was able to take this idea I had and move forward with it was to use credit cards. But I used them responsibly.

I knew when my payables were coming in. And I knew that I would succeed over time. The banks would not let me in the door.

Mr. CUELLAR. Right.

Mr. GATEWOOD. They would not talk to me.

Mr. CUELLAR. And you are hitting the point that I want to emphasize. As a former small business person, the import/export business and having a lot of folks on the border, you know, going to the bank, you know, bank, credit union, whatever it might have been, it was a lot easier just on the moment to move it, to go with a credit card.

I didn't do that, but, again, you put yourself in their shoes. So what do we do? And I guess it is more to you all. I mean, is there anything that can be as flexible as a credit card and not be the credit card company out there, but—

Mr. ROSACKER. I suppose we could develop that at the SBA or something. I think, like I said earlier, it is the streamlining of the application process and the reams of paper that go along with it and al of the disclosures and everything else that have to be made, not that that is bad unto itself.

But, again, it is part of this whole regulatory burden. And if you could shift some of this, make it streamlined, and move forward with it, you know, make it a low-doc loan of some type, yes, more

banks would use it. But it is not an easy process to go through today.

And I can only say streamline. And I don't have any particular examples of how I would recommend doing it, but that is it.

Mr. WALKER. Congressman, I think that is why the home equity lines have become so popular, that essentially what you have is a line of credit. And when you want to use it, you write a check.

The disadvantage, of course, to the institution is that it is an off-balance sheet liability. And they really have no control. If I have a line of credit of $400,000 and I have drawn down nothing, tomorrow the bank could have a $400,000 loan outstanding to me without me even telling them they have it.

Mr. GATEWOOD. If I might before—because I don't know what time we are going to finish, Madam Chairwoman. So I am going to take this opportunity, Madam Chairwoman and Mr. Chabot, Ranking Member, to thank this Committee, particularly under your leadership, ma'am, for what you are doing for Service-disabled veterans and veteran-owned small businesses.

We need your help. We appreciate your help. And it is not only our veterans but our women in business and our minority-owned business. So I want to thank you for all of your initiative and leadership.

Chairwoman VELÁZQUEZ. Thank you.

Dr. Lahm, do you want to answer?

Dr. LAHM. Thank you. I would like to insert something. What I have to say will be a little bit fuzzy, but I think it should be a point that should be considered. Particularly the bootstrapper, particularly the students that I work with, one of the biggest problems is they don't have know-how.

You had an import/export business. I recently heard someone who has expertise in that area addressing some study that he had done, but basically 65 percent of all small businesses wouldn't know where to turn to. They wouldn't have a clue where to start should they begin pursuing an import/export opportunity, which, of course, is a huge opportunity.

The point that I want to raise is that know-how is so critical. I know the focus of today's meeting is capital itself, but if we have know-how, we don't necessarily need quite as much capital. And that is one of the biggest problems, one of the biggest roles that the SBA could perhaps play. And this goes to one of the earlier questions asked at the end.

Students don't have know-how. They have all of these grand schemes. But they don't know how to actually act upon it. So if you want to make the capital more efficient, make the people more efficient through their knowledge enhancement.

Mr. CUELLAR. Thank you. Thank you, Madam Chair.

Chairwoman VELÁZQUEZ. SBA has a network of small business development centers throughout the nation. And some of them partner with higher education institutions. The problem is that the funding for those has been cut in the last six years.

The same is true with the fact that the cost of guaranteed loans has increased in the last six years at a time when there is a credit crunch.

I understand, Mr. Gonzalez, you have more questions.

Mr. GONZALEZ. Yes, Madam Chair. Just a couple of things. I think it has been so enlightening. And I surely want to pick up on something quickly. I think there has been by both the credit unions and the independent community bankers—and I call independent community bankers—to me they are one and the same—which represent, really, the old way of doing business, which I so appreciate because you still maintain relationships with the customers.

But I think those remarks that maybe as great as 70 percent or some number of credit card holders actually pay their accounts on time or maybe in full. I know Mr. Gatewood—in full?—which then means that the other 30 percent have to be subsidizing that service, which then, in turn, means that you have to build in those penalties, those fees, and those interest rates. And I think it is undeniable.

And I am not casting blame on you two particular lenders on it because I think, actually, where the abuses truly are and taking advantage of the consumer lies elsewhere.

I think we set up ourselves a system where, yes, the prudent and the responsible, but even those that are prudent and responsible sometimes because of situations, circumstances beyond their control cannot make that payment, cannot pay it in full. And there are consequences.

The interest that they are paying on that balance far exceeds what probably would be paid in a conventional loan instrument. I think that is undeniable. And I think we have to face this.

If it is, in fact, free money for 30 days or whatever it is, like my American Express account, I have got to pay it at the end of the month. And it does really instill discipline in me, as opposed to, let's say, my Visa or whatever it is account, which I don't pay fully at the end of the month.

So I understand it, but the problem that we have—and now this leads me into the last question, which is going to be posed to Mr. Walker and Dr. Lahm. And maybe it is just something I have struggled with and I don't know if Mr. Chabot and the Chairwoman—I don't think that Congressman Cuellar was here.

But a couple of years ago or maybe more than a couple of years ago, we voted on a bill that made it impossible to discharge a consumer's credit card debt. We thought at that time that was a good and prudent thing to do. We weren't going to reward irresponsibility and so on.

I will tell you that part of that debate did entertain that the lenders, the issuers, were going to do something else in return. We were going to look at interest rates. We were going to look at penalties. We were going to look at the fees. We were going to look at how you score. We were going to look at how you score credit and so on.

We were also going to look at practices such as you may be paying your credit cards on time on two accounts, fall behind on another one, and it impacted those other two accounts. We were going to try to establish that you should set and ascertain one's creditworthiness based on that relationship one on one and not necessarily with a third party.

I will tell you now that never came to fruition. And I am going to ask Mr. Walker and Dr. Lahm, did Congress make a mistake to

make it so incredibly difficult for the consumer to discharge credit card debt, which impacts small businesses?

Mr. WALKER. I am not sure, Congressman. I have studied that history a bit, but I don't really feel like I can contribute to that discussion.

Mr. CHABOT. Would the gentleman yield?

Mr. GONZALEZ. Of course.

Mr. CHABOT. Thank you.

I just want to make sure I understand what you are talking about. Are you talking about the bankruptcy reform bill when you say it made it impossible to discharge debt on credit cards?

Mr. GONZALEZ. The way we set it up makes it nearly impossible to completely discharge.

Mr. CHABOT. Okay. I guess when you say, "nearly impossible," it depends on what you are really talking about because the bankruptcy reform, what it did is that you can discharge, just as you could before, except you have to go into Chapter 13. Most people qualify, you know, depending on the means test, how much your income levels are, et cetera. A whole lot of people can still fully discharge debt, including credit card debt.

Now, if you have a job and you have certain income levels, then you have to go into Chapter 13, which is like a wage-earner test. The idea is that, rather than discharging all of the debt, if you had the ability to pay off some of the debt, that made more sense to everybody. So that is why a lot of—

Mr. GONZALEZ. But, see, you know, reclaiming my time, it is unquestionable, indisputable that we made it so incredibly difficult for the average consumer, businessman, businesswoman, to take advantage of bankruptcy laws that were there, actually, to take care of these circumstances.

There is no doubt. And if you talk, even to your bankruptcy trustees, to the judges, and to the practitioners on both sides, the creditor side as well as the bankruptcy applicant, we have totally changed that whole universe. I think there is no doubt about that.

So, Dr. Lahm, do you have an opinion on where we are in that state of the law?

Dr. LAHM. Thank you. I yielded to my colleague to let him go first, but I do have plenty to say. I am not sure what the timer is.

Let me just start by saying I am in favor of responsible borrowing and lending. And I think across this table and probably in this room at large, we are all in favor of people doing the right thing.

The problem is that the bigger banks, in particular, are definitely plaything a game. I characterized their ″or we may change their terms for no reason″ as whimsical. I think that is a very fair statement.

A lot of the bankruptcies if they are frivolous, well, you know, maybe they shouldn't be, those who are filing should not be able to so easily discharge, but, on the other hand—and payback is kind of interesting.

I personally have had dealings with the likes of MBNA. And I remember very vividly a few years ago a discussion in which I said, "But we didn't do anything wrong. Go pick on someone who has done something wrong."

This was a discussion about an adverse decision that had been made with respect to my wife and myself personally when we had missed no payments. And the little quip, which I am happy to repeat here today, was I said "Why don't you go pick on someone who has done something wrong?"

The quip was "Oh, we pick on them, too!" Well, I hope that is entered into this record.

Furthermore, it doesn't take much cruising of the Internet to find credit card company horror stories. Someone was on an automated payment system. The bank failed to deliver on time, no fault of their own. They were late.

Years ago anyone reasonable would have taken a letter from the bank saying, "Sorry. We messed up this payment. Please know, credit card company, it was our fault. Let things go on as normal." And someone would have accepted that.

They don't do that now. They are waiting for someone to be late. They want someone to be late. And they will just cream someone if they are late—one hour late. I have got a cite tip for that, which is in a paper.

Chairwoman VELÁZQUEZ. The time has expired.

Mr. GONZALEZ. Thank you very much. And thank you for your indulgence.

Chairwoman VELÁZQUEZ. Mr. Chabot, do you have any questions?

Mr. CHABOT. Yes. I don't want to get into a huge discussion here about the bankruptcy law, but it was basically kicked around for seven or eight years in the Congress before it finally passed years ago.

But the whole idea of the changes that did pass with considerable support on both sides, although it was mostly Republicans, but there were a fair number of Democrats who supported the change as well, the idea was we had some folks that were literally filing for bankruptcy on a fairly regular basis, every seven years. There were just a lot of abuses in the system.

And that was causing the average household to have an extra cost of, I believe it was, 5-6 hundred dollars a year or something. Just stuff costs more because people weren't paying for what they bought. They were just filing bankruptcy. So we were trying to do away with the abuses.

And Henry Hyde was instrumental in this. He was the Chair of the Judiciary Committee, I believe, when this passed. And what Henry was trying to do was a lot of folks who clearly—it was a medical problem they had, loss of job. There were a lot of people who really needed bankruptcy. It was still there. They can still file and have all their debts discharged and get a fresh start.

But for those folks that do have a reasonable income—and this is written into the law—reasonable income and able to pay at least a portion of their debts, why not have them over a period of a number of years try to pay off some of that debt so that that debt isn't just hoisted on the rest of the consumer public? That was the idea of the bankruptcy reform.

So I just didn't want to leave unchallenged the fact that all debt, that credit card debt, is non-dischargeable now. That is just not the case. Some of the credit card debt is clearly dischargeable by those

folks at lower income levels. Folks that have income and can pay off, some of that will be paid off. So I just wanted to put that out there.

I yield back.

Chairwoman VELÁZQUEZ. Well, again I want to thank all the witnesses for participating today and for offering your insights on this, the issues at hand. And I ask unanimous consent that members will have five days to submit a statement and supporting materials for the record. Without objection, so ordered.

This hearing is now adjourned.

[Whereupon, at 11:46 a.m., the Committee was adjourned.]

NYDIA M. VELAZQUEZ, NEW YORK
CHAIRWOMAN

STEVE CHABOT, OHIO

Congress of the United States
U.S. House of Representatives
Committee on Small Business
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STATEMENT
of the
The Honorable Nydia Velazquez, Chairwoman
House Committee on Small Business
"The Role of Credit Cards in Small Business Financing"
Thursday, April 3, 2008

Today, the Committee will examine the increasing role played by credit cards in financing our nation's small businesses.

In the past year, 60 percent of small firms made use of private and federally guaranteed loans. In comparison, during that same period, 77 percent of entrepreneurs opted to buy new equipment and pay for other business expenses using a credit card. The reason is simple. Credit cards give small businesses access to capital they need to grow.

That fact is especially crucial given the current economic climate, in which small firms are finding it difficult to secure traditional forms of financing. Not surprisingly, the rate at which purchases are charged continues to rise—up 14 percent over the last five years.

Today, we will delve into what that means for small firms. Credit cards have always been a convenient means of payment. They expedite transactions while allowing for considerable ease and security. Just as importantly, since 70 percent of small business owners pay their balances in full each month—they are gaining the equivalent of a 30-day interest-free loan.

While credit card use is on the upswing, many federal programs specifically designed to offer small firms access to capital are falling short of this goal. That is holding small businesses back and denying the economy contributions from entrepreneurs precisely when they matter most.

In the past months, members of this Committee have heard testimony from the Federal Reserve, the Small Business Administration and a host of experts on small business lending programs. Their testimony points to the considerable gap that remains in financing.

The witnesses have also shed light on how the current economic downturn, rising foreclosure rates, and a plummeting housing market are compounding these capital challenges. In fact, just when our small businesses economy would benefit tremendously from an infusion of capital, financial institutions are pulling back on credit.

As the availability of capital diminishes, more small businesses are delaying important purchases, halting expansion, foregoing the creation of new jobs, or laying off current employees altogether. Ironically, this keeps small firms from doing what they do best—fueling the nation's economic growth.

In such an environment, it would make sense for the SBA's lending and investment programs to step in. Shockingly, the agency's largest lending initiative—the 7(a) program—is doing the exact opposite. The SBA is pushing to raise fees and erecting new barriers to small business loans. As a result, 7(a) lending volume is down 14 percent, and lending to minority owned businesses has decreased by nearly 9 percent. Clearly, this all runs counter to the program's mission.

Given these realities, examining the role of credit cards in the financing of small businesses just makes sense. With the nation facing the prospect of a recession, it is also important to remember that entrepreneurs have always led the way back to economic recovery. This Committee will continue to work to ensure they have the tools to do so again, and I know my colleagues will join me in strengthening what is working in the current system while correcting what is not.

I want to thank all the witnesses for being here today, and for offering their insights on these crucial issues.

U.S. House of Representatives
SMALL BUSINESS COMMITTEE
Representative Steve Chabot, Republican Leader

Thursday,
April 3, 2008

Opening Statement of Ranking Member Steve Chabot

The Role of Credit Cards in Small Business Financing

Good Morning. Thank you, Madam Chairwoman, for holding this hearing on small businesses and credit cards. I also want to thank our distinguished panel of witnesses. We look forward to hearing their testimonies.

The financial services market in the United States is the most competitive, innovative and robust in the world. This vibrant market has helped individuals, businesses, and small businesses to meet their daily needs and achieve their dreams.

Cash management is an absolutely critical matter for small companies. Careful management of cash and credit may mean the difference between whether a business expands or doesn't, and whether it succeeds or fails.

According to the Government Accountability Office, the prevalence and use of credit cards in the United States has grown dramatically over the past 25 years. In 2005, consumers held more than 691 million credit cards and the total value of transactions in which these cards were used exceeded $1.8 trillion.

Over fifty percent of small firms rely on credit cards to help fund their operations, according to a financial services trade association. Credit cards can allow a small company to finance a purchase over time that they would otherwise not be able to make. They can be a source of short term, interest-free loans to enable a business to operate. Credit cards can also help a company to manage cash flow, or track and manage employee purchases and expenses. In addition, credit cards allow small companies to earn airline, hotel, retail or cash back rewards to enhance the business.

Whether a small business is well established or just beginning, these tools can have a positive impact on business operations. They can enable a small business to weather minor disruptions to cash flow. For a newly established business, credit cards provide the opportunity to build business credit. Especially in a time of economic uncertainty, when credit can be even more difficult to access, credit cards can make available the capital needed to maintain a company's position or expand, create jobs and add significant value to our economy.

Like any borrower or credit card customer, small businesses must use credit responsibly and be vigilant about managing debt. Credit is extremely valuable, and is a tremendous asset when used wisely.

Again, I thank the Chairwoman for holding this hearing. I look forward to hearing the testimony of our witnesses. I yield back.

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Statement of Rep. Jason Altmire
Committee on Small Business Hearing
"The Role of Credit Cards in Providing
Small Businesses with Access to Capital"
April 3, 2008

Thank you, Madam Chairwoman, for holding today's hearing to examine the role of credit cards in providing small businesses with access to capital. Recently, the Federal Reserve released a survey of senior loan officers in which 65 percent of respondents reported tightening lending standards in the first quarter of 2008. As a result, small firms are looking elsewhere to meet their capital needs, including the use of credit cards. In the past five years, the use of credit cards by small businesses has increased by 14 percent.

Credit cards can provide small businesses with the flexibility they need to run their operations, including expedited transactions, which is important considering how dependent small businesses are on cash flow. Additionally, if a small business pays off their balance in full each month, they are provided with the equivalent of a 30-day interest free loan, making credit cards a practical tool for any small business owner.

Small businesses continue to be a driving force in our economy. It is imperative that they have access to capital to expand and strengthen their businesses.

Madam Chair, thank you again for holding this important hearing today. I yield back the balance of my time.

# # #

Testimony of

William Spearman

President/CEO of Mid-Hudson Valley Federal Credit Union

On behalf of

The National Association of Federal Credit Unions

"Credit Card Lending and Small Business Perspectives"

Before the

House Small Business Committee

United States House of Representatives

April 3, 2008

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Introduction

Good morning Chairwoman Velazquez, Ranking Member Chabot and Members of the Committee. My name is William (Bill) Spearman and I am here today to testify on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as President and CEO of Mid-Hudson Valley Federal Credit Union (MHVFCU), headquartered in Kingston, New York. MHVFCU was founded to serve IBM employees in Kingston, but converted to a multi-occupational charter when the IBM plant closed in 1995, and to a community charter in 2002. Today, MHVFCU has nearly 50,000 members and $590 million in assets.

I have worked at MHVFCU for 36 years, serving as President and CEO for the last 14 of them. I currently serve on NAFCU's Education Committee and as a board member for the New York State Credit Union League (NYSCUL). I have also served on NAFCU's Regulatory and Advisory Committees, and was named one of the NYCUL's Professionals of the Year in 2004.

NAFCU is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU is comprised of over 800 federal credit unions—member owned financial institutions across the nation—representing more than 27 million individual credit union members. NAFCU–member credit unions collectively account for approximately two-thirds of the assets of all federal credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in this hearing regarding credit cards and small business lending.

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the federal credit union system was created and has been recognized as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have no access to financial services. Congress established credit unions as an alternative to banks and to fill a precise public need—a niche that credit unions continue to fill today for over 90 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 USC 1752(1)). While nearly 75 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- Credit unions remain committed to providing their members with efficient, low cost personal service; and,
- Credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

Credit unions are not banks. The nation's 8,305 federally insured credit unions serve a different purpose and have a fundamentally different structure, existing solely for the purpose of providing financial services to their members. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal

say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. Unlike their counterparts at banks and thrifts, federal credit union directors generally serve without pay—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit unions have an unparalleled safety and soundness record. Unlike banks and thrifts, credit unions have never cost the American taxpayer a single dime. While the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loans Insurance Corporation (FSLIC) were both started with seed money from the United States Treasury, every dollar that has ever gone into the National Credit Union Share Insurance Fund (NCUSIF) has come from the credit unions it insures. Furthermore, unlike the thrift insurance fund that unfortunately cost hundreds of billions of dollars, credit unions have never needed a federal bailout.

Credit Unions and Small Business Lending

Small businesses often face more requirements to get a loan than an equally credit worthy, larger business because lenders view small businesses as riskier ventures. This is due in large part to the high failure rates of small businesses and the fact that proper valuation and credit worthiness of these businesses is hard to determine. As a result, financial institutions that have had ongoing relationships with small business members are in the best position to lend to them because of their experience working with a

particular small business in the past. The unique not-for-profit, cooperative member-owner structure of credit unions enhances the relationship credit unions have with small businesses. Their structure means that credit unions design services to meet the needs of their membership – who can be small business owners and even the businesses themselves. It also means that the lender-borrower relationship is often very strong at credit unions.

This relationship allows credit unions to have a unique working knowledge of the owners, the way the business is run and other information about the borrower that other lenders do not have access to. Moreover, this relationship can lead to better lending decisions and mitigate the risk for both the credit union and the small business. Credit unions maintain a multitude of these unique relationships with current and potential small business owners throughout America.

As the Committee is well aware, small businesses today employ over half of all private sector employees. Small businesses also pay more than 45 percent of total U.S. private payroll and have generated 60 to 80 percent of net new jobs annually over the last decade. In short, small businesses are not only crucial to the health of the economy but also to the financial security of American families. Small business lending helps drive the development and expansion of small businesses in America. Many small business owners are members of credit unions around the country and rely on the services provided by them to help make their small business a success.

I am also pleased to report to the Committee that credit union participation in SBA programs is at an all time high. As of 2007 credit unions have made 3,398 SBA loans totaling close to $289 million. This is up from 297 loans totaling just over $20 million in 2004. Proportionately, the growth is substantial and credit unions can and would like to do more for America's small businesses when it comes to small business lending. At Mid Hudson Valley FCU we are an approved SBA lender. However, some of the cumbersome aspects of the SBA process and the restrictive nature of credit union member business lending limits constrain our efforts to take a more active role in the SBA 7(a) and 504 lending programs.

Even though credit unions have been able to grow in their ability to help small businesses, many want to do more. Unfortunately, many federal credit unions face an impediment to helping their small business members due to the arbitrary member business lending (MBL) cap that was placed on them in 1998 as part of the *Credit Union Membership Access Act*. This arbitrary cap is set at the lesser of 1.75 times the net worth of a well-capitalized credit union or 12.25 percent of total assets. Legislation has been introduced in the House that would attempt to provide relief to credit unions from the arbitrary cap. A provision of the *Credit Union Regulatory Improvements Act*, H.R. 1537, would raise this limit to 20% of total assets and adjust the current de-minimus level of loans exempt from the cap (current set at $50,000) to $100,000. NAFCU supports this modification of the current arbitrary cap on member business loans at a credit union from the current formula to a flat rate of 20 percent of the total assets of a credit union. This

provision will facilitate member business lending without jeopardizing the safety and soundness of participating credit unions.

While the current cap was first arbitrarily imposed on credit unions in 1998, CUMAA also directed the Treasury Department to study the need for such a cap. In 2001, the Treasury Department released its study entitled "Credit Union Member Business Lending" in which it concluded that "credit unions' business lending currently has no effect on the viability and profitability of other insured depository institutions." That same study also found that over 50 percent of credit union loans were made to businesses with assets under $100,000, and 45 percent of credit union business loans go to individuals with household incomes of less than $50,000. Furthermore, a 20 percent cap for credit union member business lending would be less than or equal to the business lending caps for other institutions. NAFCU also supports revising the current definition of a member business loan by giving the NCUA authority to exclude small loans of $100,000 or less as de minimus, rather than preserving the current threshold of $50,000. This would adjust the threshold for inflation, from the $50,000 level set in 1998. These much needed updates to the limits on credit union member business loans would promote economic growth by providing additional sources of credit for small businesses.

The *Credit Union Small Business Lending Act*, introduced by Chairwoman Nydia Velazquez is another piece of legislation that would substantially promote credit union small business lending. H.R. 1849 would exempt the guaranteed and non-guaranteed portions of SBA 7(a) loans made by credit unions from the regulatory cap for business

lending, providing greater capacity to make business loans. Furthermore, NAFCU supports the establishment of a credit union outreach program within SBA to increase credit union participation, as the red-tape and rising fees at the SBA have discouraged more credit unions from doing more SBA loans. NAFCU also believes that an 85 percent guaranty on member business loans up to $250,000 for loans made to small businesses in underserved areas will encourage more credit unions to make SBA loans in these areas. H.R. 1849 is a pivotal step toward facilitating more SBA loans by credit unions and thus encouraging greater credit union business lending. These proposals would undoubtedly benefit the entrepreneur and small business credit union members.

Business lending to our members has been very important for Mid-Hudson Valley Federal Credit Union. During the early 1990's the town of Kingston, New York and the Mid-Hudson Valley was left reeling from the closure of the IBM Kingston plant in town that employed over 7,000 people. As the federal credit union for the IBM plant, we have helped many former IBM employees establish their own small business ventures through small business loans. Many of these former IBM employees had to start their careers over from scratch. Some of the bigger financial institutions in the area were unwilling to make capital available to these entrepreneurs. As a result, Mid-Hudson Valley FCU stepped in and filled this niche market, providing countless small business loans that helped turn what could have been an economically devastating event into a success story. Today Mid-Hudson Valley FCU continues to help fuel small business growth in our region.

Credit card lending plays an integral role in providing much needed capital for our small business members to grow their companies. Currently, 61 MHVFCU business members have business credit card accounts with our credit union. This represents a total credit limit available of $600,000, of which $200,000 is in carried balances. The largest credit limit among these 61 businesses is $30,000. These small business members pay their bills regularly and on time and often do not carry balances and thus do not generate large amounts of interest income for MHVFCU. Absent the capital provided through credit cards these businesses surely would not be as successful as they are today and unemployment would likely be higher.

Credit Union Credit Card Practices

Credit cards offer a convenient form of payment and an easy way to track expenses. Many smaller companies and new start up businesses who find capital for business investment utilize credit cards as their main source of credit despite paying higher interest rates on these short term loans. Federal credit unions are the only federal financial institution with a statutory usury ceiling (currently 18%). This usury ceiling combined with the unique relationship that credit unions have with their members, ensures that small businesses using credit cards from their credit union do not face predatory interest rates for this valuable credit.

Federal credit unions have traditionally always been responsible lenders and have not participated in some of the predatory and egregious practices that other lenders have when it comes to credit cards. Thankfully, double cycle billing, universal default and hair trigger repricing are not a part of everyday federal credit union vocabulary.

Credit unions are proud that we have a solid and strong record of creating a safe and sound credit card lending environment for their members. Some facts about federal credit unions and their credit card practices are below:

- As member-owned financial institutions, federal credit unions are unique in that the products they offer are solely for the benefit of the members of the credit union.
- An extensive regulatory framework is also in place to ensure the safety and soundness of all lending practices that federal credit unions perform, including open-end credit granted through credit cards.
- Currently, approximately 50 percent of all federal credit unions offer their members credit card services.
- The growth rate of credit card lending by credit unions has averaged just 4 percent for the last five years, representing just over 5 percent of the total loan portfolio of credit unions.
- The average interest rate of all federally insured credit unions offering credit cards today stands at 11.91 percent (as of March 7, 2008). According to bankrate.com, one major credit card issuer stated the rate for some customers will increase to as much as 28 percent in 2008 regardless of credit history.
- Interest rates for credit cards offered by credit unions are capped at 18 percent because of the statutory usury ceiling on credit unions.
- The rate of consumers falling behind on their credit card payments is substantially lower at credit unions than at non-credit union lending institutions.
- Consumer complaints reveal few problems with credit cards issued by federal credit unions. A formal complaint process for credit union members monitored by the National Credit Union Administration (NCUA) ensures that credit unions remain member-friendly when it comes to credit card lending.

- NCUA has procedures in place to help members resolve any issues they may have with their credit union's lending practices. When a consumer complaint brings a violation to the regulator's attention, NCUA takes steps to strictly enforce applicable laws and regulations.

- Consumer Reports conducted a survey that focused on 21 credit card issuers. It found that credit unions' ranked higher in customer satisfaction than the five major credit card companies. According to the survey, median credit card rates were as much as 8% lower at credit unions than at other financial institutions.

- Member satisfaction is a priority for credit unions. Forrester Research found that credit unions beat banks two to one when consumers were asked which institution "does what's best for me, not what's best for its bottom line."

How Credit Cards Help MHVFCU Members

As stated earlier, federal credit unions, such as MHVFCU, are in a great position to lend to small businesses due to the established and continuing relationship and familiarity with the principles of current and potential small business owners. At Mid-Hudson Valley FCU, many of the loans that we make to small business owners are to people that have been members of the credit union for years. Knowing the operations and personnel that is behind a small business is crucial and really makes a difference when it comes to providing the best possible customer service to small businesses.

At MHVFCU, we tend to hear the same reasons over and over again as to why our members who own small businesses prefer credit cards to assist them with their business. The ease of obtaining a credit card, the ability to monitor cash flow, efficiency, fair rates and overall convenience are among the main reasons why our small business

owners utilize credit cards to help fund business operations. Also knowing our members and their businesses helps us to put them in proper loan products for their business needs. For example, if they needed to purchase a copy machine for $5,000 then we would suggest a term loan as opposed to putting the purchase on the credit card. It would be a mistake for the business owners to put $5,000 on a credit card in order to purchase the machine as they will be billed mostly interest and the value of the machine will decrease rapidly while the loan amount would only decrease slightly.

With their permission, I have highlighted a few of MHVFCU's business members that use credit cards below. These are typical examples of small businesses across the country that benefit from their credit cards that they obtain from their credit union in the operation of their business on a daily basis.

- The Barn Raiser, LLC – This company has been a business member since December 2003. It was a start-up business that has been very successful. The Barn Raiser, LLC has a $20,000 limit on their credit card. This card has worked very well for them as their business has them on the road a lot with deliveries of their barns, also creating a need for remote services with working over the phone to continue to run their business while on the road. They appreciate the convenience of this type of credit as it assists them with their cash flow from month to month. Obtaining this type of credit is easier than other options as it is unsecured and therefore has no closing costs as a real estate loan or equipment loan would require.

  This member has a full relationship with MHVFCU. They have all of their business deposits with us, 4 accounts and 3 loans. They have a business line of credit in the amount of $100,000, an equipment loan and the credit card.

  Michelle Heitmann, the owner, said *"The credit card also allows us to monitor our monthly cash flow closely thereby allowing us to be more efficient."*

- Cutting Edge Landscaping of Orange County, Inc. – This company is a new business member to MHVFCU but the principals have had a long extensive relationship with MHVFCU as personal members. The company was started to meet the needs of their consumers and they use the card to order quickly over the phone and manage their cash flow on a monthly basis. Also, they are on the road extensively and this card allows them to either handle charges out of the office or handle charges over their cell phone from their truck as opposed to their office. Their total relationship is just over a million dollars and is a full business lending relationship with checking and savings accounts, merchant services, along with loans including a commercial mortgage, equipment loans, a line of credit and the credit card

  Mark Press, the owner said *"The credit card allows us to order supplies over the phone and we can manage our cash flow on a monthly basis. We work out of our truck on the road via a cell phone and the credit card allows us this flexibility and convenience."*

- Vinmar Homes, Inc. – This company has been a business member since January 2007 and they started with a $5,000 card limit and has grown to $15,000 currently. They have a construction company that builds and renovates houses. This credit card allows them the flexibility to order materials and handle their cash flow on a monthly basis. They currently have a business checking and savings account along with their credit card.

  Mark Jensen the owner stated *" This credit card allows us the flexibility to order materials and handle our cash flow on a monthly basis. Also, obtaining this type of credit was quick and inexpensive due to lack of closing costs."*

I discussed this hearing with these and other small business members of MHVFCU and the reasons that our business members gave as to why they prefer a credit card to assist with their business are:

1. Ease of obtaining – one page application, run a credit report then obtain approval. "It's simple and quick".

2. It forces them to review and monitor their cash flow monthly as that is when they are billed.

3. Allows them to be very efficient. They are constantly reminded of their limit and that they need to stay within the set parameters.

4. Fair rates with MHVFCU. When they compare our rates are considerably below the competition. We also offer Rewards if they so desire but basically they prefer the no frills credit card with a fair rate, fair monthly billing cycle, fair grace period and no annual fee.

5. Cards for employees are also available.

6. Convenience = many businesses can now order and work on-line via the internet and the business credit card allows them the speed of the internet.

7. Proper loan product for the proper business need. The typical small business usually requires a line of credit to handle their daily, weekly and monthly cash flows needs. In general, they order product and hopefully within 30 days have sold that product and can repay the credit card with the proceeds from that sale. If they have a need for a regular term loan then we would work with them on matching the proper loan product for their need. For example, if they needed to purchase a copy machine for $5,000 then we would suggest a term loan as opposed to a credit card. It would be a mistake to put the $5,000 for the copy machine on the credit card as they will be billed mostly interest only and the value of the machine will decrease rapidly while the loan amount will decrease slightly.

8. Inexpensive credit to obtain – no closing costs when compared to a traditional loan like an equipment loan or real estate backed loan.

9. Good place to begin building credit and building a business relationship with a financial institution.

Efforts to Legislate Certain Credit Card Practices

NAFCU recognizes that there is a need to reign in unscrupulous and predatory practices that some credit card issuers have used, although some well-intentioned efforts can have unintended negative consequences. There have been troubling legislative proposals introduced that would restrict credit card practices, regulate risk, and limit market driven interchange fees. We believe that any effort to rein in credit card practices

should be carefully crafted to ensure that smaller financial institutions, particularly credit unions that fund small businesses with their best interest in mind are not unduly burdened by unnecessary regulation or unintentionally harmed by these legislative efforts.

A promising framework of solutions exists within the Federal Reserve's proposal to amend Regulation Z. The Federal Reserve's plan is intended to improve the effectiveness of consumer disclosures in regards to credit card accounts and other revolving credit plans. The plan would ensure that information would reach consumers in a timely manner and would be easy to comprehend. The disclosure of possible fees and penalties if a borrower is delinquent on payments would be a cornerstone of the proposal. These disclosures would accompany credit card applications and solicitations, while also highlighting fees and the reasons penalty rates may be applied. Creditors would be required to summarize key terms at the opening of a new account and when any terms of the agreement are changed. Furthermore, the proposal would also expand the circumstances under which consumers receive written notice of changes in terms to their accounts, including requiring an advance notice before a penalty is invoked and would increase the amount of time these notices must be sent before the change becomes effective.

Many of the proposals before Congress call for the implementation of the amendments to Regulation Z that the Federal Reserve is considering. While NAFCU is supportive of, and many credit unions already comply with, many of these proposals, we are wary of inflexible and unnecessary additional regulatory burdens being placed upon

good actors such as credit unions. Credit unions are more heavily regulated than any other consumer financial services provider. Restrictions on the operations of credit unions limit not only who can avail themselves of credit union services, but also how credit unions can raise capital. Any time additional compliance burdens are placed upon federal credit unions the operations of these institutions are severely impacted and usually come at the expense of member services. We urge Committee members to keep this in mind when considering any proposals concerning credit cards and consider any detrimental impact it may have on smaller financial institutions such as federal credit unions, specifically in terms of impacting small business lending.

Many members of Congress have called for patience before enacting any legislation that would essentially mirror the Federal Reserve's proposals. NAFCU believes this to be a prudent course of action and encourage members of the Small Business Committee to consider all aspects of any proposal and the potential unintended consequences on smaller financial institutions.

Conclusion

In conclusion, federal credit union small business lending is strong and continues to grow. However, the current regulatory framework prevents federal credit unions from doing more for America's small businesses. Legislative proposals such as the *Credit Unions Small Business Lending Act* and provisions pertaining to member business

lending limits contained in the *Credit Union Regulatory Relief Act* would go a long way in helping credit unions to bolster small business growth across America.

Furthermore, credit card lending plays a pivotal role in helping federal credit union business members start and grow their small businesses. Any proposals that could increase the cost of credit card lending and limit access to capital would essentially hurt small business development in America. NAFCU urges caution and careful consideration of any proposals that could simultaneously hurt credit union lending and small business development. America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident and productive purposes." Credit card and small business lending are two ways in which federal credit unions carry this mission out. I thank you for your time and I am happy to field any questions that the Committee members may have. Thank you.

Testimony of

William C. Rosacker
President, United Bankers' Bank

On behalf of the
Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
Committee on Small Business

Hearing on

"The Role of Credit Cards in Small Business Financing"

April 3, 2008
Washington, D.C.

Chairwoman Velazquez, Ranking Member Chabot, Members of the Committee, my name is Bill Rosacker and I am President of United Bankers' Bank in Bloomington, Minnesota. I am pleased to be here today on behalf of the Independent Community Bankers of America (ICBA).

"Bankers' banks" are unique in the community banking sector, as our customers and shareholders are actually the community banks themselves. The 702 community banks served by United Bankers' Bank need correspondent banking services[1] because they lack the scale to provide these services themselves, yet need to compete with large multinational banks as well as other non-bank financial institutions. Through bankers' banks[2], community banks can obtain these critical services, allowing them to focus their resources on controlling costs, improving management services, and achieving a reasonable margin.

On behalf of ICBA's nearly 5,000 member banks, I want to express our appreciation for the opportunity to testify on the important role credit cards play in supporting America's small businesses and entrepreneurs. Access to credit is critical in today's economy. Small business is one of the key drivers for this country's economy and many entrepreneurs rely on credit cards to get their businesses up and running. In my testimony today, I would like to focus on three main points: first, how community banks are able to help local small businesses run and finance their operations successfully through the use of credit cards; second, how community banks – as small businesses themselves – benefit from the ability to

[1] Bankers' bank correspondent services include: merchant acquirer settlement, commercial payroll services, commercial underwriting, check clearing, international payments, domestic wires, compliance consulting, loan participations and syndications, and a variety of investment, trust and operational services.

[2] Bankers' banks were formed beginning in the early 1980's in reaction to the fact that traditional large commercial banks offering bank to bank correspondent services often competed with their community bank respondents. For example, community banks readily share loan participations with bankers' banks, knowing that the bankers' bank will not, indeed cannot, steal the non-bank customer from the community bank. This relationship of trust may not exist in traditional correspondent relationships.

offer credit card products to consumers and entrepreneurs; and finally, I would like to discuss the legislative and regulatory landscape facing community bankers and their small business customers.

Credit Cards Benefit Small Businesses

As consumers, we all recognize the convenience that credit cards afford us in our daily transactions, since they are accepted at over 24 million locations worldwide[3]. Credit cards are open-ended credit plans, as opposed to installment plans like a mortgage or car payment. As a result, credit cards are the only loan or credit product that, generally, allows the consumer to control how much he will owe, and whether he will pay any finance charge or just be a convenience user.

While many consumers may take this financial flexibility for granted, for small business owners, credit cards can prove to be the difference between getting an organization off the ground or becoming mired in paperwork and regulation. Community banks are incubators for small businesses, and play a vital role in providing the all-important access to capital that entrepreneurs need to succeed. While community banks only account for a small percentage of total domestic banking assets, we provide nearly a third (32.7%) of the total dollar amount of bank business loans under $100,000[4], many in the form of small business credit card products. When a small business has no track record, access to funding through a credit card can be the key resource that helps get the business going.

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[3] See http://www.electronicpaymentscoalition.org/value/business-economy.html
[4] U.S. Small Business Administration, Office of Advocacy. *Small Business and Micro Business Lending in the United States, for Data Years 2005-2006.* February, 2008.

The 2007 ICBA Community Bank Payments Survey[5] revealed that more than 60% of respondent banks offer small business credit cards, and data from a recent National Small Business Association survey showed that credit cards are a leading source of financing for fledgling businesses[6]. A community banker's ability to offer small business credit cards at competitive rates and terms to entrepreneurs in our local towns is critical to supporting the engine of small business that drives our economy.

The small business owner who chooses to bank with an ICBA member community bank immediately gains the advantage of local decision making. This might not seem important on its face, but when the person actually making the lending decision for a small business is hundreds of miles away and doesn't really know the circumstances of the person sitting in a bank branch asking for a line of credit or the characteristics of the local market, that small businessperson is at a disadvantage. Community bankers know their customers and live and work in their neighborhoods. The community banker often knows the capabilities and needs of the principals of a small business and the local community, and can help them where help is needed. And should the small business find itself in a tough financial situation, both the banker and the owner have much more of a vested interest in making sure the business succeeds.

When a community banker issues a small business credit card, the end user immediately adds the flexibility of a new source of capital that can help them meet their dynamic financial needs while establishing business credit. From an operational perspective, credit cards greatly simplify accounting records and cash flow management. For example, in

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[5] To view an executive summary, please visit http://www.icba.org/publications/2007paymentssurvey.cfm?ItemNumber=38445

[6] National Small Business Association. *2007 NSBA Survey of Small and Mid-Sized Businesses*. Accessed at http://www.nsba.biz/docs/surveynewfinal.pdf

businesses which require a high volume of daily purchases – whether fuel for a small fleet of trucks, daily orders to vendors for automotive repair parts, or supporting employees on travel – small businesses need a ready source of cash. By using a small business credit card to finance theses expenditures, the businessman can free up what liquid assets he has available to be reinvested into the business to help it grow, rather than tying it up in making trade credit payments. Small business credit cards allow the businessperson to more easily track itemized and categorized expenditures, greatly simplifying the bookkeeping process, and saving time and money. In addition, it has been my experience – and data from a Federal Reserve study on small business finances[7] supports this – the large majority of small business credit cardholders pay their statement balance in full each month, using it as a transaction account. This provides almost the same convenience as does a regular checking account.

If a small business is involved in retail sales, the benefits from card acceptance to its profitability and operation are very significant. For example, they and their customers are assured a consistent payment experience, are protected against many types of fraud, and do not have to keep as much cash on hand or accept checks. In addition, the business receives guaranteed funds in its account immediately while mitigating through the payments chain the credit risk and other compliance burdens, and does not have to extend credit directly. The evidence is clear[8] that consumers are likely to spend more when they shop with credit cards. These factors can greatly help small merchants with sales volume as well as earning repeat customers. After all, increasing customer transactions is arguably the best source of capital available.

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[7] Mach, Trace L. & John D. Wolken. "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances." Federal Reserve Board. October, 2006.
[8] See, for example: http://www.electronicpaymentscoalition.org/value/business-economy.html

Many community banks serve the vital role of linking small retailers into the electronic payment networks by serving as merchant acquiring banks -- i.e. a member of Visa or MasterCard that maintains the merchant relationship and receives the card transactions from the merchant. Just as consumers should always shop around for a financial institution that best meets their banking needs, a merchant who is setting up a credit card acceptance process has the ability to shop around for a level of service, customer support, and range of fees that best fits their business plan. If a merchant opts to sign with a community bank, at the end of the day, it is getting tremendous value because of the benefits of electronic payments and the sophisticated payments infrastructure that a community banker can utilize to complete a transaction quickly and securely. This acceptance is important to the viability of local merchants and the economic base of many communities.

Community Banks as Small Businesses

While community banks are often lumped into the broad category of "bankers," it is important to keep in mind that community banks are small businesses themselves. As small businesses, we face our own unique set of challenges in a very competitive marketplace. Contrary to popular belief, for many community banks, the consumer and business credit cards we offer are not always sources of tremendous profits. The real value often lies in our basic ability to offer these popular products to consumers and merchants. For many community bankers, the high level of personal service we can provide is what makes card products valuable, not gigantic revenues. Offering community bank-branded cards creates a stronger relationship with the customer, and encourages loyalty for the long run. In other words, many community bankers offer these products as a customer service, not a source of revenue. We offer these credit cards to help our customers.

Across the industry, credit cards are very small-margin products. This is especially true for community banks, which do not issue consumer and corporate credit cards at volumes near those of the larger issuers. Frankly, that is better for our business model and gives us a competitive advantage. For the consumer or small business owner, that means they have more choices: they can choose to do business with the megabank with call centers all over the globe, or they can get that same product with local customer service at competitive and often better rates. Community banks want to provide their small business customers with a range of services, not just reap profit off credit cards, hoping to build a positive relationship that will last. Community banks are conservative lenders who have no desire to trap their local customers in never-ending cycles of debt.

Community Banks and Regulatory Burden

One unique challenge facing both start-up and established community banks on a daily basis is the burden of government regulation. Regulatory and paperwork requirements impose a disproportionate burden on community banks, diminishing their profitability and their ability to attract capital, support the credit needs of their consumer and small business customers, serve their communities and contribute to their local economies. For example, compliance with Sarbanes Oxley Section 404 requirements alone cost my bank thousands of dollars last year.

There are a number of troubling legislative proposals currently before Congress that would increase or create new statutory requirements for credit card issuers by restricting certain practices, limiting our ability to control for risk, or regulating interchange rates. If enacted, these measures would greatly increase the cumulative regulatory burden for community banks that is often disproportionate to the risk they pose. The increased

regulatory risks, costs and burdens which may result from the enactment of these proposals could be the tipping point that causes some community banks to discontinue offering credit cards products. The consolidation in the credit card industry has been increasing rapidly and the unintended consequences that might result from any new requirement – be it legislative or regulatory – could involve higher rates and fees to absorb additional regulatory costs, and a diminution in options for consumers and small businesses.

That said, there is also opportunity for Congress to enact measures that would make it easier for small businesses and community banks to grow and succeed. ICBA would like to thank you, Chairwoman Velazquez, for introducing the "Communities First Act," H.R. 1869, which provides much needed regulatory burden and tax relief for community banks, their customers, and their communities.

Conclusion

Even in the best of economic times, small businesses can struggle in their search for capital. Community bankers are well-positioned to meet these needs, be it through traditional loans or highly competitive business credit card offerings. Local businesses are not always better served by a financial institution just because of its tremendous size. The support structure built on local decision-making and long-term relationships unique to the community bank business model is a proven formula to help entrepreneurs succeed.

Credit cards have assumed a prominent role in supporting the financial needs of small businesses across the country, for many of the positive reasons I've described. While traditional lending will remain a strong source of capital, the use of credit cards can allow, for example, a start-up firm to manage its operating capital needs as it works to establish its own credit. More generally, a small business that can diversify the types of credit it utilizes can

find it easier to meet the dynamic needs of the business, while at the same time simplifying its bookkeeping.

For community bankers, our ability to issue cards and act as merchant acquirers creates more competition, giving more options to small businesses and merchants. Our business model is based on the ability to attract and keep customers for the long-term, and the only way we can do that is through the highest levels of personal service and competitive product offerings. Small businesses are the backbone of the U.S. economy, and community banks – as small businesses ourselves – are proud of the role we play in their financial success.

As legislative measures impacting the dynamic and vibrant credit card marketplace continue to be addressed, ICBA urges Congress to act with caution – if at all – on any proposal that would increase the regulatory burden on community banks. As I described, community banks often run a credit card business at very narrow margins, often less than 1%, and place great value on the relationship that offering can build. In today's economic environment, every source of capital needs to be an option for a small business, and adding further regulatory costs will make it increasingly difficult for community bankers to remain a viable choice to meet the needs of small businesses in search of credit card products.

Again, on behalf of ICBA and our 5,000 community bank members, thank you for the invitation to testify on this important issue. I look forward to your questions.

Testimony Of

Wayne M. Gatewood, Jr. USMC (Ret)
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To

The House Committee on Small Business

April 3, 2008

Longworth House Office Building, Room 1539

"The Role of Credit Cards In Providing Small Business Financing"

Good morning Madame Chairwoman and members. It is a pleasure to come before you this morning to provide my personal Testimony regarding the use of credit cards by our Nation's small businesses. My testimony is very personal and will hopefully reveal to the members of this Committee the very important role credit cards can play in the establishment, support, and success of America's small businesses.

When I joined the Marine Corps in 1966, my taxable income was $551.00. My second year in the Marine Corps earned me $1,361. When I retired from the Corps in 1987, my taxable income was $20,811. While in the Corps for 21 years, I maintained a bank account with Banks on the military bases but really had no banking and lending needs. When I left the Marine in 1987, I opened a checking account but had no money for savings. I went to work for two years in support of local minority owned small businesses and in December of 1989, left my place of employment, and started Quality Support, Inc. My operations started out of my home. When Quality Support, was established Inc. in 1989, I had no lending history or a track record of working with banks.

I started Quality Support with about $600 of expendable cash on hand, and a small loan from my Father who himself had little need for banks over his life time. I had gotten an American Express Card in 1988, and I also opened up VISA and Master Charge credit card accounts through a number of other sources. I also opened up a Wells Fargo Account. In 1989, I applied for and was accepted for an American Express Corporate Card and I also opened up a Corporate Checking Account.

Throughout the early years of Quality Support I used credit cards to purchase office supplies, pay for reproduction costs, pay for my travel and fuel costs, and a number of other items that would otherwise require the outlay of cash. I was always aware of what I was spending and did not overcharge on any of my many credit card accounts. I knew what money I had coming in, and I used these cards with prudence. There were many, many times however, when I would only pay interest due; this approach allowed me to effectively utilize what cash I had in my checking account and gave me the assurance of extended operations. Given my hard work, zeal, enthusiasm, and gaining experience, I knew it was just a matter of time until success appeared…and what I needed most was time, and time could be assured only if I stayed on top of my payables and costs of living.

When I applied for the Small Business Administration's Section 8(a) program after my first two years in business, I was rejected because "there was no evidence that I had access to capital nor a bank Line of Credit. In reality, my bank turned me down flat when I asked for a Line of Credit, and in retrospect, I now know why. A year after my rejection by SBA, and three years after the start of Quality Support, I once again applied for SBA 8(a) status, and in this application included a letter from a local ""Factoring Company" that indicated I had a Line of Credit up to $500.000.00. This "letter" cost me $500.00 to obtain. Thus, given my experiences in the early years of my business, I quickly learned the realities of lending and realized that banks would not be available until I gained much more capital.

During the period up to 1996, Quality Support used the American Express Corporate card because this card offered huge advantages of which I will speak of later in this Testimony. In 1997, Quality Support's international conference and meeting support division really took off and this is the time when we began to need quick access to flexible amounts of cash. We had to book and reserve hundreds of hotel rooms, pay for international travel, and pay in advance for other direct costs associated with our support to agencies of the Federal Government. In 1998, we used our American Express card to support $32,000.00 worth of purchases.

In 1999, Quality Support was selected by the Department of State to support international conference and meeting support requirements at the highest levels of Government. Quality Support was required to open an office in London, provide international lodging and travel services, and overall administrative and logistical support. This particular contract would require no less than $1M in available lines of credit. Knowing we could not accept this particular task order until cash flow was available, we went to our Bank where we had a fairly substantial cash balance and an established track record, but this Bank turned us down. Here we were with a multi million dollar contract and a significant task order that we might lose because we would not have the cash flow to support operations. We then contacted American Express OPEN, and through dialogue with a customer service representative, supported with a copy of our contract, we were authorized credit up to $1M. In essence, this credit card company, American Express, gave us the capacity to go forward and perform this task order through to completion. At the end of this task, we had charged $1.1M to our American Express account. So successful was our performance that we remain a competitive and experienced contractor in support of international Department of State requirements. Once we realized we had operational capacity through our Line of Credit with American Express and the use of our Corporate Credit Cards, we "fired" our long standing Bank. Since the time of this contract in 1999, and subsequent to a number of years of success and financial growth, our former Bank has repeatedly approached us to offer their services and we have repeatedly declined such offers.

Although Quality Support does have Corporate VISA Cards through our existing Bank, we still prefer to use our American Express OPEN Cards (AmEx). From 1994 to the first quarter of calendar year 2008, Quality Support has charged more than some $8M in other direct costs and purchases through American Express in direct support of our various contract requirements. Given the requirements we have planned for calendar year 2008, we are on pace to charge $2.5 million through our American Express credit cards this year.

It is a fact that American Express OPEN provides Quality Support with superior service and customer friendly terms not found at the Banks we have previously dealt with.

History of Credit Card Use - As noted above, from 1997 to 1999, the use of the credit card became much more central to our overall operations. From 1999 to present, it has become crucial to our contract performance. In recent years, we could have used cash in the bank for most, but not all, of our heavy 'other direct costs," but using AmEx has given us float time so that the time cash is out, is minimized. Using the aforementioned scenario, Quality Support is able to take on extremely large "other direct charge (ODC) " contracts with minimal risk.

In addition to flexibility and availability, the other reason we use credit cards, instead of Bank Lines of Credit, is that Bank LOCs are very restrictive with terms that are harmful and costly. The following are specific reasons we see Banks as hostile to our corporate interests:

HOSTILE BANK LINE OF CREDIT (LOC) TERMS – Quality Support's relationship with Amex is a stark contrast to setting up and using bank LOCs. They are inconvenient, can be very expensive and handcuff the way a business operates.

A few years ago after breaking ties with our old Bank, we went to another major Bank to seek a LOC. This LOC was for an amount less than what AmEx has extended. The agreement we were asked to sign indicated we could not enter Teaming agreements without the Bank's permission, forced us to incur huge and intrusive costs, and stated the loan could be called at any time. The agreement basically ensured that the bank would generate good income, while their level of risk in practical terms was zero. Below are the aggressive and harmful terms that this Bank required us to accept:

- Quality Support would not be allowed to make any distributions while the agreement was in effect, making the owners' personal finances at the mercy of the Bank. This would be the case whether the LOC was used or not.

- Quality Support would not be allowed to enter into any teaming agreements without permission from the Bank, basically stunting opportunities for future growth and stability.

- In addition to Quality Support guaranteeing the loan with its assets, the Bank wanted me, Wayne Gatewood, to personally guarantee the loan with my personal assets, thus circumventing the main reason that a company incorporates.

- The Bank would require Quality Support to assign our contracts to them. Thus, the Bank would put a lien on our receivables so that the Bank would be paid directly from our clients, and not from Quality Support.

- The Bank required that we maintain a Net Worth of $1.5 million to secure a $500K credit line. Not only was this amount excessive in comparison to the LOC, if we dipped even slightly below that $1.5M mark for even a short period of time, the Bank could call in the loan immediately.

- Even if we were not in default of the loan terms, the Bank reserved the right to "call in" the loan at any time for any reason and we would have to immediately provide full payment. This "right: of the Bank effectively cancelled any benefit of the LOC, because we had to be ready to provide payment of any monies borrowed any time the Bank requested, and without future notice.

- The term of the LOC would be one year only. On the 366th day of the agreement, all outstanding balances were due and terms would only be extended at the full discretion of the Bank.

- The Bank could request a field audit of our finances and other records at any time they chose, and as many times as they chose, at Quality Support's expense.

- In addition to the cost of the field audits, Quality Support would be responsible for all out of pocket expenses incurred by the Bank (including attorneys' fees) in connection with preparation of the LOC and other Loan Documents or any transactions contemplated by the agreement. This was the case even if we never used the LOC, and was in addition to the $2500 per year fee required to maintain the LOC. Overall, the Bank had the discretion to create expenses for Quality Support.

- To pay for these expenses, Quality Support would have to agree to let the Bank debit any account maintained by Quality Support, without prior consent from us.

- Quality Support could only use the borrowed funds for current operating expenses, to carry receivables, or for other short term working capital. We could not use the funds for any long term capital investment, etc.

- The Bank demanded a copy of our contract backlog, with specific information regarding our clients, our contracts values, the types of contracts, current funding, etc. They wanted this information updated every three months even if we did not borrow any money. The following is a portion of the LOC application recently offered Quality Support:

"The Borrower shall deliver to the Bank (1) within 120 days after the close of each of its fiscal years, reviewed financial statements of the Borrower, prepared in accordance with GAAP, including a balance sheet, income statement, statements of stockholders' equity and of cash flows, prepared by an independent certified public accounting firm acceptable to the Bank ; (2) within 30 days after the end of each quarter of each of its fiscal years, unaudited financial statements of the Borrower, including a balance sheet and income statement, prepared in accordance with GAAP; (3) when borrowing under the Line, within 30 days after the end of each calendar month (i) an appropriately completed Borrowing Base Certificate setting forth a calculation of the Borrowing Base as of the end of the preceding calendar month, and (ii) an aging of billed accounts receivable of the Borrower, and (iii) a report listing and describing any unbilled charges for work performed under the Borrower's contracts; however, when not borrowing under the Line, these reports listed in item (3) shall be provided within 30 days after the end of each calendar quarter (4) within 30 days after the end of each quarter of each of its fiscal years, status and backlog reports relating to the Borrower's contracts, (5) within 120 days after the end of each fiscal year end, the personal financial statement of each Guarantor; (6) promptly after receipt, copies of any reports from auditors of Government Contracts; and (7) such other information concerning the Collateral or the financial condition of the Borrower or any Guarantor as the Bank from time to time may reasonably request. All financial statements and reports shall be in form and detail acceptable to the Bank and shall be certified to be accurate by a duly authorized officer of the Borrower.

WHY AMEX IS THE PREFERRED METHOD OF BORROWING - Because of up front purchase requirements, AmEx has been crucial to our international logistical, meetings and conference operations. Quality Support could not have bid on and performed on many of our large contracts without this immediately available and flexible purchasing power, and this aspect of our corporate capabilities has been instrumental to our continued corporate competitiveness and growth. Without the flexibility offered through Amex, we would have to always have and use large amounts of cash on hand to support large ODC-heavy requirements. We have discovered that Banks do not offer such flexibility on an on-going basis without requiring the business to give up a large degree of autonomy in its financial and operational activities.

In addition to their important role in our growth, an important reason that we use Amex is for convenience, savings on finance charges, and the ease in which we can get short term access to extended credit.

American Express Credit Card Benefits

- **Finance Charges -** If Quality Support were to set up and access a LOC from the bank for short term access to credit for operating expenses, we would have to pay large amounts of interest. If we used cash in the bank, we would lose the opportunity of not being able to invest that money elsewhere. By using AmEx, we have access to the credit we need, pay no interest as long as we pay within the terms of our agreement, and are able to invest our cash on hand in interest paying accounts. While AmEx is only used for short term access to credit, this is no different that the bank LOCs, because the agreements specifically state that they can not be used for long term capital improvements.

- **Convenience**- AmEx is much more convenient because of its simplicity. When we have a short term requirement, like paying a $750,000 hotel bill for example, we just need to make a phone call to Amex, explain the situation and sometimes provide basic financial information. This allows us in most cases to instantly increase our credit line for short term requirements. Even when we don't have these extreme requirements that require us to request short term increases, Amex gives us a healthy and flexible ongoing credit limit in relation to our company size.

- **Air Miles For Each Dollar Spent**. An added incentive for using AmEx Cards is that Quality Support earns mileage for dollars charged. These miles have been used to reward our best employees by giving them and their family's cost-free travel as a result of stellar performance. The air miles are incentive that a number of cards are now offering but I have never heard of a Bank offering any such incentives, let alone air miles.

CONCLUSION. Given the foregoing, along with the flexibility provided through the use of various credit cards (in Quality Support's case, especially AmEx OPEN) it is my intention to continue using such methods as much as possible to sustain our corporate operations in the most beneficial, cost effective, and prudent manner. Credit cards when used judiciously, provide the budding entrepreneur as well as the tenured small business owner flexible and expeditious access to cash flow that they otherwise would be denied. I have found Banks to be hostile and

inflexible in many ways and as was the case in 1999, turned us down flat when we needed them the most.

I sincerely believe that Quality Support's growth and success over the past (almost) 19 years, would not have been possible if cash flow and access to capital had not been available to us. For this, I thank the Credit Card companies that gave me the added capacity to form and grow the Company, support our first small contracts, and now, our much larger and diverse contracts. I especially give thanks to AmEx OPEN for its innovative approaches to supporting small business entities, and for its sense of team work with those small businesses they support. I routinely suggest to newly-established small businesses, that they take a serious look into the use of credit cards in support of various contract operations.

Respectfully Submitted,

Wayne M. Gatewood, Jr.

SMALL BUSINESS FINANCING

Credit Card Financing, Consumer Credit, and Mortgage Credit

Testimony
in the front of the
House Committee on Small Business

April 3, 2008

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GREETING

Madam Chairwoman, Velázquez, Ranking Member, Chabot, and Committee members, thank you for the opportunity to testify in front of the House Committee on Small Business. I am David A. Walker, the John A. Largay Professor in the McDonough School of Business at Georgetown University. My bio is attached to this testimony as an appendix.

CONCLUSIONS

I would like to urge the Committee to do whatever you can to increase the supply of credit to small business. These firms are the growth engines of our economy, responsible for the creation of virtually all of the new jobs in the U.S. economy.

Technically we are not in a recession, because GDP growth has not been negative for two consecutive quarters. The GDP growth in the fourth quarter of 2007 was a minuscule, positive 0.6 percent. No matter what label we use, the U.S. economy is weak. Small business and poor and middle class individuals are incurring the greatest consequences, facing losses of business and personal proprieties and business and personal bankruptcies. In March, the U.S. economy lost 80,000 jobs, the largest decline in the past five years, and the unemployment rate has risen to 5.1 percent. Three small airlines, and many other small firms, have ceased operations in the past seven days. Moreover, when the U.S. economy does begin to improve, small business will be one of the last segments to experience the gains.

Figure 1 of my testimony shows the contrast between the credit card interest rate, the rate at which or similar to the rate that many small businesses borrow, and the prime interest rate, at which many large businesses are able to borrow. That figure shows the similarity between the current U.S. economic situation and the previous recession as identified by the prestigious National Bureau of Economic Research.

In my opinion, the stimulus package you have already enacted, plus the legislation that you and your colleagues are currently working to deal with the housing and economic crisis, plus the recent Federal Reserve actions will probably enable us to avoid what we technically define as a recession.

INTRODUCTION

Background

My interest in small business originated with the experience from my family owning and operating a retail store in York, PA for 93 years; working with the U.S. Small Business Administration, which this Committee overseas; and extensive small business research and policy analysis since beginning my Ph.d. dissertation in 1966. Appendix A for this

testimony lists my small business experience. My summary bio is provided in Appendix C.

As noted on my bio, until 2005 I chaired the governing board of the Credit Research Center (CRC) at Georgetown. I did not receive any compensation for this service and that experience has no influence on my testimony.
The CRC is funded by research grants from a variety of sources as well as contributions from the credit card industry. This Center moved from Georgetown two years ago.

Assistance
I would like to acknowledge the assistance I have received with this testimony from three experts: my friend and co-author Dr. Thomas Durkin, formerly senior economist with the Board of Governors of the Federal Reserve for 22 years; my son, Dr. Matthew Thayer Billett, the Henry B. Tippie Research Fellow and tenured associate professor in the Tippie College of Business at the University of Iowa; and my former student and Georgetown alum, Mr. Jay Tuli, vice president of commercial lending for Leader Bank, N.A., a $212 million commercial bank established in 2002 in Arlington, MA. Dr. Durkin's specialty is consumer credit. We have co-authored a paper on consumer and mortgage credit, and he is the lead author of a forthcoming book on *Consumer Credit and the American Economy*, being published by the Oxford University Press later this year. Dr. Billett has authored numerous publications in the most highly respected scholarly finance journals on financial services and corporate finance topics. Mr. Tuli is a specialist in lending to small firms.

SMALL BUSINESS AND CONSUMER CREDIT IN THE U.S. ECONOMY

Consumer Credit and Business Borrowing
Small business and consumer credit are often indistinguishable in the U.S. economy. Much of the credit available to small firms is based on the entrepreneurs' personal resources; credit card loans and lines of credit; and mortgage loans and potential home equity loans and lines. Therefore, costs and the supply of consumer credit and mortgage debt are clearly relevant to these hearings on small business credit.

In our study on "Long Run Growth in Consumer and Mortgage Credit," which I am submitting with this testimony, Dr. Durkin and I show that aggregate real consumer credit (adjusted for price changes and excluding mortgage credit) has increased at virtually the same rate as real disposable income in the U.S. over the past 60 years. The level of consumer credit is inversely related to interest rates. A one percent increase in the corporate AA bond rate, for example, has reduced the level of consumer credit outstanding by 10 percent over the past 60 years.

Much consumer credit is revolving credit, without a fixed payment schedule, that is often in the form of credit card loans from financial service firms to small business. In the next section you will see the magnitude of credit card lending to the business sector.

Table 1 delineates the trends in various components of American consumers' assets, debt, and income over the past 60 years, using the Federal Reserve's Flow of Funds Accounts. These accounts clearly show that the consumer sector of the U.S. economy is a net lender in financial markets (usually through financial intermediaries); moreover, households borrow substantial amounts for housing, durable goods, education, and other purposes. Continuing a long term trend toward higher nominal debt levels, borrowing by households grew sharply in the cyclical expansions of the past few decades. For example, total non mortgage consumer credit outstanding, which is an important component of household liabilities and small business credit, increased more than ten fold over the period 1975-2006 and approximately tripled in real terms (see Table 1), thereby providing financing for a significant portion of major consumer outlays and small business credit during those years.

Subprime Lending

Much of today's credit crunch has been caused by what I consider to be irresponsible mortgage lending and the unreasonable assumption that there would be no finite limit to which housing prices would rise during the current decade? Perhaps, the best treatise on the subject has been written by the late Federal Reserve Governor Edward M. Gramlich (see Gramlich, (2007), Subprime Mortgages: America's Latest Boom and Bust, Washington, The Urban Institute). Governor Gramlich spoke about the danger of subprime lending for approximately five years before public policymakers took the issue seriously.

Consider, for example, a 2/28 subprime mortgage where the initial loan equaled virtually 100 percent of the 2006 property appraisal. When the mortgage resets at new rates for years 3 through 30 in 2008, they may reset at an interest rate that is generally above the market rate that a new buyer might find on an adjustable rate mortgage, if the buyer qualified. For example, the rate in 2006 might have been 5 percent for two years and the reset rate might be 7 percent for 2008-2035 even though the market adjustable rate mortgages in 2008 might be 5.5 percent. If the borrower has negative equity in 2008, the borrower will not be able to refinance at the 5.5 percent market adjustable rate.

Adjustable rate mortgages have allowed many legitimate borrowers to purchase a home they might otherwise not have been able to purchase. These mortgages are not the blame for the current credit crisis, as has sometimes been claimed. The problem is the high reset rate, often above market rates, when the reset is required and the borrower has no equity in the property and no alternative, except to accept a high reset rate.

FUNDING THE SMALL FIRM IN AMERICA

Cost of Small Business Credit

Costs of credit to small business are usually very high compared to rates available to other sectors, and this is especially true during a credit crunch. 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. When the supply of credit deteriorates, large firms

usually receive preferential credit treatment over small firms by many lenders and credit markets.

The following national data for April 3, 2008 are typical, except that many small firms already have too much debt to qualify for this "low" credit card rate.

30 yr. fixed mortgage rate	prime rate	credit card rate
5.75%	5.25%	13.42%

Financing the Small Firm

Between 2005 to 2006, total business borrowing increased 34 percent, from $562 billion to $753 billion, (*The Small Business Economy,* December 2007, U.S. Small Business Administration, page 29), while U.S. GDP grew by 6 percent and total employment increased by 2 percent (*Economic Report of the President, 2008).* Over the same period, consumer credit outstanding increased by 4.6 percent, mortgage credit outstanding increased 8.9 percent, and revolving credit outstanding increased 6.6 percent. Obviously, the large increase in business borrowing far exceeded the other increments.

The Office of Advocacy of the U. S. Small Business Administration reports that small businesses employ 51 percent of the domestic work force; small firms produce 51 percent of the non farm private gross product; and small firms created "all of the net new jobs" in 2004 (*The Small Business Economy,* December 2007, U.S. Small Business Administration, page 9). Any disruption in credit card markets or any other source of small business credit has important consequences for small firms and for the economy as a whole.

The most recent period for which employment growth is available by firm size is 2004. Between 2003 and 2004, employment by firms with more than 500 employees decreased by 2.7 percent; employment at firms with fewer than 500 employees increased by 27.1 percent; and employment at firms with fewer than 20 employees increased by 59.8 percent. (*The Small Business Economy,* page 311). Small business in the United States is critical to employ the growing population.

To support continued employment and economic growth, small firms must have access to credit and external resources, and the funds must be available at costs that allow small firms to earn a fair rate of return. Data for 2003 from the Federal Reserve small business finance survey show that 47 percent of small business owners used a personal credit card to pay business expenses in 2003, and 48 percent used a business credit card to pay business expenses in that year. Combining these statistics, shows that more than 77 percent of small businesses used credit cards in 2003, an increase from 68 percent determined from a similar survey five years before (*The Small Business Economy,* December 2007, U.S. Small Business Administration, Table 2.5). Using the 2003 percentage and multiplying it by the 26.8 million small businesses in the United States in 2006, according to SBA statistics, implies that more than 20 million small businesses were credit card users in 2006.

Alpha Omega Jewelers

The unfortunate experience of Alpha Omega Jewelers in Boston exemplifies the credit circumstances that many small firms have faced during the past decade. In order to maintain the firm, the owner, Mr. Raman Handa, remortgaged and refinanced his home approximately a dozen times between 1997 and 2007.

Finally Mr. Handa reached the point where he had negative equity in his $2 million home and was adding to his principal balance each month. Alpha Omega Jewelers went bankrupt in January of this year, after operating for more than 20 years, and Mr. Handa felt such shame that he left the United States. He could not continue to serve his customers, which included President Clinton, Boston Celtics star Paul Pierce, and film star Ben Affleck. Much of the experience for Alpha Omega Jewelers is described in articles from the *Boston Globe,* some of which are provided in Appendix B of this testimony. Unfortunately the Alpha Omega experience is not unique for small businesses in the United States in 2008.

Costs of Credit for Large and Small Firms

The difference between the costs of credit for large and small American firms is illustrated by the difference between the prime interest rate and the rate of interest on credit card balances (available from the Federal Reserve, www.federalreserve.gov). The interest rate on outstanding balances on credit cards is not a perfect measure of the cost of credit for the small firm because the small firm is financed by many means besides credit card loans, but some of these means are more expensive than credit card interest rates. The prime rate is not a perfect measure of the cost of funds for large firms because these firms are financed by various forms of debt, equity, and retained earnings.
However, since credit cards are used so often for some of the financing for small firms and borrowing at the prime rate is possible for many large firms, the difference between the credit card rate and the prime rate surely reflects much of the difference of costs of debt for small and large firms.

Figure 1 shows the substantial difference in the credit card rate and the prime rate between 1995 and 2007. According to the National Bureau of Economic Research (http://www.nber.org.cycles.html), only March 2001 to November 2001 should be considered a recession period between 1995 and 2006. Some economists are suggesting that the United States economy is either in or entering a recession at the current time.

According to Figure 1, these are the only two times (2001 and currently) when the differences between the credit card rate and the prime rate have declined between 1995 and 2007. The recent months and 2001 (discussed below) are the two recent periods when the Fed was lowering its target interest rates. Yet throughout the period 1995 - 2007, the difference between the credit card borrowing rate and the prime rate is substantial. Thus, it can be argued that small firms have incurred a much higher cost for external resources than large firms over the past 13 years.

FEDERAL RESERVE ACTIONS

The Federal Reserve, under the leadership of.Chairman Bernanke, has implemented numerous policy actions to attempt to reduce the economic consequences that businesses and individuals are facing. Since the third quarter of 2007, the Fed has dramatically reduced the discount rate, at which banks may borrow from the 12 Federal Reserve Banks. Over the same time The Fed has reduced its target Federal funds rate, at which insured depository institutions borrow from one another. To attempt to deal with the liquidity crisis facing Bear Stearns, the Fed played an active role in arranging for investment banks to borrow from the discount window for the first time in almost 80 years and to assist in the negotiations for JP Morgan to purchase Bear Stearns over the weekend of March 28-30. Figure 2 shows the discount rate and the Fed funds rate since 1995.

POSSIBLE IMPACTS FROM REGULATORY REFORM

The U.S. Treasury has recently issued a "Blueprint for a New Regulatory Order" for American financial service firms. The Blueprint includes short-term recommendations, intermediate recommendations, and a Long Term Goal for a New Regulatory Structure. The short-term recommendations and intermediate recommendations would not appear, on the surface, to have much effect on the supply or the cost of credit for small business. The Long Term Goal for a New Regulatory Structure could affect the supply of credit because it calls for greater attention to "disclosures, business practices, and licensing of certain types of financial firms." The House Committee on Small Business will surely play an integral role in implementing the aspects of the Blueprint that could influence the economic and regulatory climate for small business.

THANK YOU

Thank you for this opportunity to meet and speak with you. I would be pleased to attempt to answer any of your questions and to provide further information to the Committee. As my students can tell you, I am a strong believer in answering "I don't know" too many of the complex economic questions we are facing in our current volatile, uncertain economic environment.

Table 1. Selected Measures of Assets, Debts, and Income of American Consumers, Selected Years, 1945-2006

	1945	1955	1965	1975	1985	1995	2005	2006
	Current Dollars (billions)							
Disposable Personal Income[1]	161	283	498	1187	3199	5408	9036	9523
Total Assets	742	1569	2868	5902	16,572	32,612	64,014	68,920
Financial assets	560	1015	1954	3665	9938	21,386	38,886	42,116
Deposits	104	172	373	968	2596	3332	6049	6870
Other financial	456	843	1581	2757	7432	18,054	32,837	35,446
Total Liabilities	30	144	352	761	2360	5052	12,220	13,293
Home mortgages	19	88	219	459	1442	3325	8883	9676
Consumer credit	7	43	98	207	611	1169	2327	2438
Other liabilities	4	13	35	95	307	558	1011	1179
Net Worth	711	1425	2516	5112	14,211	27,560	51,795	53,626
	2006 Dollars (billions)							
Disposable Personal Income[1]	1803	2129	3187	4448	5825	7153	9327	9523
Total Assets	8310	11,803	18,355	22,116	31,049	43,140	66,079	68,920
Financial assets	6272	7635	12,506	13,734	18,619	28,290	40,140	42,116
Deposits	1165	1294	2387	3402	4695	4408	6244	6870
Other financial	5107	6341	10,118	10,331	13,925	23,882	33,896	35,446
Total Liabilities	336	1083	2253	2852	4422	6683	12,614	13,293
Home mortgages	213	662	1402	1720	2701	4398	9170	9676
Consumer credit	78	323	627	776	1145	1546	2402	2438
Other liabilities	45	98	218	356	575	738	1044	1179
Net Worth	7963	10,719	16,302	19,268	26,626	36,457	53,465	53,626

Source: Federal Reserve Statistical Release Z1, "Flow of Funds Accounts of the United States," various issues. Figures shown are year end, not seasonally adjusted. Some lines include assets and debts of nonprofit organizations.
[1]Measured as annual rate, figure in 1945 column is for 1946.

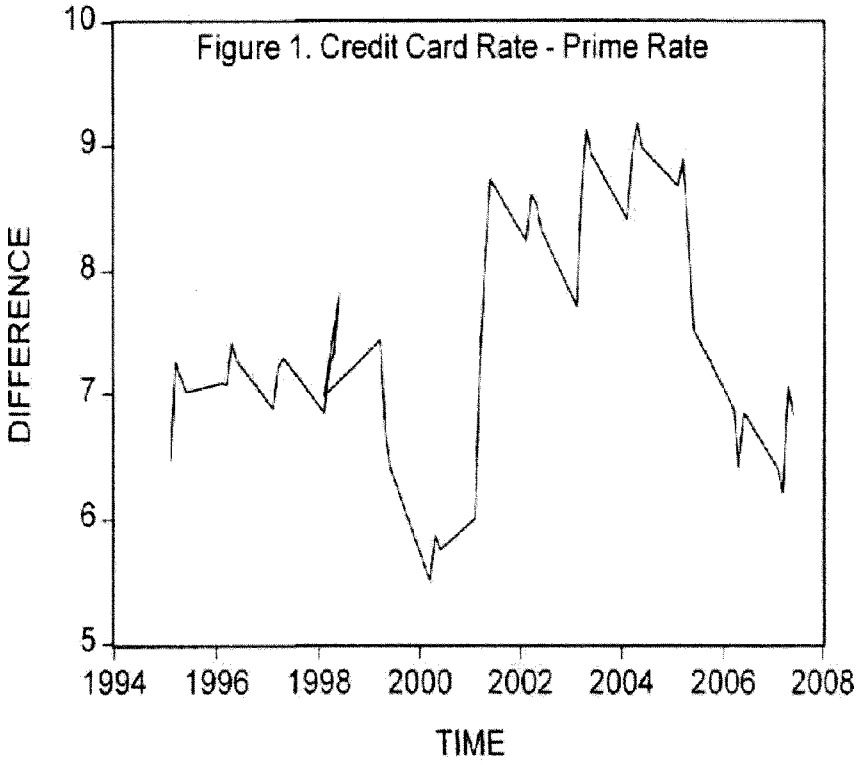
Figure 1. Credit Card Rate - Prime Rate
DIFFERENCE
10
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2008
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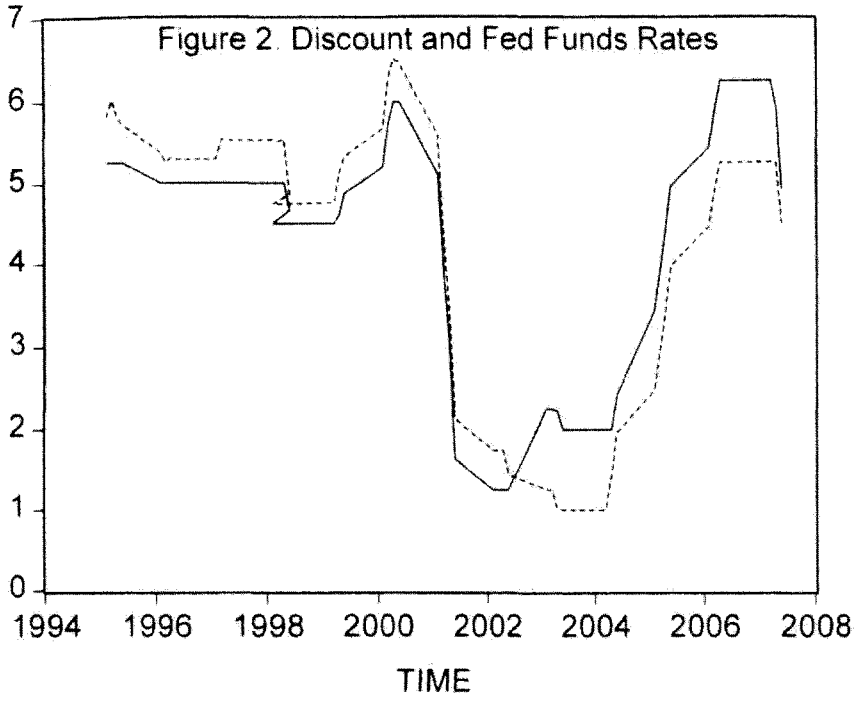
Figure 2. Discount and Fed Funds Rates
7
6
5
4
3
2
1
0
1994
1996
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2000
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2004
2006
2008
TIME

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APPENDIX A

David A. Walker
SMALL BUSINESS CREDENTIALS

director emeritus of the Georgetown University Capital Markets Research Center, 1988 – 2005.

chaired the Governing Board for the Credit Research Center, 1997 - 2005

chaired Board of Trustees and past president of Financial Management Association International, representing 4700 finance academicians and practitioners

Executive Editor: *Journal of Financial Research;* Co-editor: *Journal of Small Business Finance;* editorial board member for seven finance journals.

Director of Research for the Office of the Comptroller of the Currency and Financial Economist for the Federal Deposit Insurance Corporation (total of 10 years)

teaches courses on global financial markets and institutions, business economics, and applied macro-economics

advising a chain of several hundred medium sized retail stores and economic analysis for Dunkin' Donuts

U.S. Small Business Administration: visiting scholar, analyzed trade credit availability and demand; advised in creating the SBA proposal for a small business loan guarantee program with a secondary capital market.

topics for scholar publications include financing small firms, trade credit demand and supply, financial institutions decisions and performance; consumer and mortgage credit

APPENDIX B

ALPHA OMEGA'S EXPERIENCE

Alpha Omega files for bankruptcy protection The Boston Globe

By Nicole C. Wong, Globe Staff | January 3, 2008

Alpha Omega Jewelry filed for Chapter 11 bankruptcy late last night while the Cambridge-based retail chain's owners, who hastily left the country for their native India in a shroud of mystery days before Christmas, remained abroad, according to a company lawyer.

Richard E. Mikels, a partner at the Boston law firm Mintz Levin Conn Ferris Glovsky and Popeo, said his firm filed the paperwork at around 10:40 p.m. with the US Bankruptcy Court for the Eastern District of Massachusetts after the luxury store's owners and sole directors, Raman and Nilda Handa, unanimously voted to do so.

The bankruptcy filing kicks off an auction for Alpha Omega's assets, with the first bid placed by Tiger Capital and Gordon & Co at 70.25 percent of the cost value of the inventory Mikels did not know the dollar value of the jewelry store's inventory nor how much debt Alpha Omega had accrued

But the company's unpaid bills had been mounting for at least six months. Representatives of the LaSalle Business Credit arm of Bank of America Corp. took possession of Alpha Omega's inventory on Dec. 22, a few days after the Handas and their two grown children who work for the family business disappeared without notifying relatives or business associates.

The company is asking the court to auction off the assets around Jan 22, and until then employees and customers can expect "business as usual" at the four Greater Boston shops. Mikels said consumer programs and employee benefits will continue as before under a loan by LaSalle

Alpha Omega jewelry stores have attracted high profile customers over the years, including film star Ben Affleck, former Red Sox pitcher Pedro Martinez, and former President Clinton In addition to the flagship store in Harvard Square, there are Alpha Omega stores in Boston's Prudential Center, in the Burlington Mall, and in the Natick Collection mall.

Raman Handa's business problems led him to rely on his personal assets to bolster his jewelry stores. In November, he pledged his $2 million home in Lexington as collateral for business financing that the Alpha Omega parent company, Lexington Jewelers Exchange, had signed with LaSalle Business Credit, according to the South Middlesex Registry of Deeds.

Middlesex County records show Handa remortgaged his house and a second piece of property he owned about a dozen times in the last 11 years, often for million-dollar-plus sums. Some refinancings were for lines of credit, including a $350,000 line from National City Bank.

Leader Bank of Arlington was another frequent supplier of the loans to the Handas. Handa also used his home in a $2.4 million business financing that Alpha Omega negotiated with Middlesex Savings Bank in 2002. Many of the loans were repaid or refinanced.

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Alpha Omega's bad timing

The Boston Globe

Tempted by higher profits, watch seller switched to high-end jewelry, but with lots of inventory and too few customers he was soon on road to bankruptcy

By Nicole C. Wong, Globe Staff

January 4, 2008 Raman Handa's was an immigrant success story.

After leaving India and opening a store in Harvard Square almost three decades ago, he built his Alpha Omega Jewelers into a well-known chain by showcasing luxury watches from Rolex, TAG Heuer, and Movado and enticing actors, politicians, and other celebrities to shop in his stores.

But he was tempted by the bigger profit margins the purveyors of fine jewelry enjoyed.

He shifted to selling products from the likes of Bulgari and Lazare Diamond over the past five years, but his ambitions outpaced his ability to lure new customers. Handa wound up stuck with unsold stock, according to documents filed in US Bankruptcy Court this week that lay out details of the jeweler's rise and fall.

The value of the inventory soared almost 80 percent, from about $15.1 million at the end of 2002 to about $27 million in the fall of 2007 - due to what now looks like an overly ambitious expansion into a new market

Sales plummeted from $35.8 million in 2006 to an anticipated $25 million in 2007,

And unpaid bills began piling up last spring Print publications began denying Handa advertising space over the summer. As their livelihood began to unravel, the Handa family mortgaged their two-acre Lexington estate for $1.5 million last fall, in an effort to restructure Alpha Omega while seeking a buyer or investor.

"The process, while necessary, was personally distressing to Mr Handa," according to a statement in Wednesday night's bankruptcy filing given by Michael O'Hara, who was named as the company's chief restructuring officer two weeks ago.

Handa admitted himself to a hospital around Dec. 12, and a few days later left the country with his family - a step that prompted his banker, which Alpha Omega owes about $18 million, to seize the company's assets.

According to the bankruptcy filing, the company owes more than $12.7 million to suppliers; other creditors, including The Boston Globe, are owed more than $1 million more.

The company is asking the court to approve an auction of its assets, with the initial bid entered by a joint venture between Tiger Capital and Gordon & Co. for 70.25 percent of the value of the inventory.

The inventory was estimated to be worth $18.7 million on Dec. 31, which would mean the joint venture's bid is worth about $13.1 million. The actual value of the inventory is expected to change as items are sold while the auction proceeds.

Alpha Omega expects its stores to be open for business through the end of the auction, which is tentatively slated for late January.

According to Alpha Omega, the top three creditors are Rolex Watch USA Inc., with a $1,46 million claim, The Boston Globe, $1.15 million; and Swatch Group U.S., $665,985.

Alpha Omega burnished its brand name over seven years by advertising aggressively, buying up multiple pages in magazines r?nr! newspapers and splashing its image on billboards. It drew in high-profile customers like former President Clinton, Boston Celtics star Paul Pierce, and film star Ben Affleck.

The chain advertised 'more than any other jeweler I've ever seen," said Richard Caso, a manager at De Scenza Diamonds and a member of its advertising board. "We were dumbfounded with the amount of advertising and understanding the costs. We do about one-tenth as much" - though Caso said he would spend more if he could afford it.

In 2006, Alpha Omega spent about $1.9 million on ads, but mounting debt prevented it from maintaining "any consistent advertising presence in the marketplace" during the second half of 2007, according to its bankruptcy filing.

Lawyers handling Alpha Omega cases said they have been in touch with Handa via phone or e-mail since his departure, but since Christmas they have not received updates on his whereabouts or his timetable for returning.

Neil Sherring, one of the lawyers who is a longtime family friend, said Handa had been convalescing in India with the help of the country's traditional Ayurvedic treatments, including meditation, yoga, and herbal remedies.

Amit and Nidhi Handa, the son and daughter who hold senior positions in the family business, had traveled to England to meet with advisers about restructuring the company, according to the bankruptcy filing. Neither responded to interview requests left on their cellphones and sent online over the past week.

The family's abrupt departure jolted Alpha Omega's lender, the LaSalle Business Credit arm of Bank of America Corp., in part because the patriarch held the company's sole check-signing authority, the bankruptcy documents stated.

LaSalle obtained an order to seize inventory on Dec. 20. Alpha Omega's stores in Harvard Square and at the Prudential Center, the Natick Collection, and the Burlington Mall were closed for the next two days, angering customers who had planned to pick up watches and jewelry in time for Christmas.

On Dec. 21, Handa and his wife - the company's sole directors - gave their consent via e-mail to appoint O'Hara as chief restructuring officer and to file for bankruptcy protection. They also agreed to bring in an inventory liquidation specialist, Tiger Capital Group LLC, to sell the chain's assets.

The new management reopened the stores over the next two days and rehired the 100 employees, who days earlier were told they were being laid off.

O'Hara celebrated Christmas morning with his family but was back to work that night, working on the negotiations with banks, vendors, and potential buyers. Gordon Lewis, brought in with O'Hara as chief financial officer, rang in the new year sorting through budgets and preparing bankruptcy papers.

They weren't the only ones hustling to deliver court documents. On Christmas Eve, The Boston Globe - the jeweler's largest unsecured creditor, with $1.58 million in bills for advertisements through Nov. 1 (more than Alpha Omega said it owes) - filed for a restraining order and permanent injunction against Alpha Omega. Boston Magazine, the 20th-largest creditor, with $176,654 in bills, did the same.

On Wednesday afternoon, several Middlesex County deputies showed up at the Burlington Mall store, with a court order to seize the money in the cash register if the Globe could not reach an agreement with the jeweler, said Michael Hartigan, the sheriffs public information officer. The parties were able to settle the situation without the deputies intervening, he added.

The two publications' litigation underscored the jeweler's need to file for bankruptcy "in order to pursue an orderly sale or other divestiture of its assets," according to the company's filing.

Boston Magazine's president did not return a call for comment yesterday. The Globe's chief advertising officer Sam Martin, said through a spokesman that he could not answer questions about Alpha Omega due to a company policy not to comment on business agreements "We are obviously disappointed by the recent development surrounding Alpha Omega Jewelers," he said in a statement. "They have been a steady advertiser in good standing with us for the past 20 years."

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$6. 6m of goods unaccounted for at Alpha Omega The Boston Globe

By Nicole C. Wong, Globe Staff | January 8, 2008

First. Alpha Omega Jewelers' owners went missing. Now, about $6.6 million worth of its inventory can't be found.

According to a complaint filed in Suffolk Superior Court by the high-end retail chain's chief creditor, the unaccounted for luxury goods had "either been taken from Alpha Omega, or such inventory never existed."

A consultant retained by the Cambridge-based watch and jewelry chain told officials at LaSalle Business Credit, a retail lending arm of Bank of America Corp., about the inventory discrepancy on Dec. 19. The next day, LaSalle filed a complaint with the court and obtained a temporary restraining order stopping Alpha Omega from selling or otherwise moving any more merchandise. The court also reinforced the creditor's right to seize the inventory, something LaSalle decided to do earlier that week because Raman Handa, his wife, and their son and daughter - all of whom are executives of the nearly 30-year-old company - abruptly left the country without alerting relatives or business associates.

The consultant was not named in the complaint but was identified as Altman and Co. LLC by Adrienne Walker, a lawyer with Mintz Levin Cohn Ferris Glovsky and Popeo who is representing Alpha Omega in its bankruptcy.

Walker referred questions about the inventory discrepancy to Altman's Gordon Lewis, who has been serving as Alpha Omega's chief financial officer since Dec. 21 and could not be reached yesterday evening.

Michael O'Hara, whom Alpha Omega and LaSalle hired alongside Lewis as the retailer's chief restructuring officer after the Handas disappeared, declined to comment yesterday. "I have focused on stabilizing the business, and we are now working hard to prepare it for sale," O'Hara said in an e-mail. "We intend to investigate the matters noted in the LaSalle complaint following the sale of the business."

Lawyers representing two vendors that sold luxury watches or fine jewelry to Alpha Omega and that are each owed hundreds of thousands of dollars were surprised yesterday to learn about the missing merchandise.

It is unclear whether the discrepancy is due to bookkeeping errors, pilferage, or some other reason. But an official at another jeweler said it's hard to lose track of merchandise in a well-run jewelry store - especially if the store uses a good computer system - because every item that comes through the door is tracked through its final sale with a unique identification number.

Jewelers commonly photograph each item for sale, tag it, and account for it during weekly inventory "case counts," according to the official, who spoke on condition of anonymity because he didn't want his company to be associated with the Alpha Omega case. Independent auditors also account for the merchandise annually or more often.

The stress from trying to cope with Alpha Omega's $30 million debt prompted Handa to check himself into a Boston-area hospital around Dec. 12. A few days later he flew to India, according to the company's bankruptcy filing.

A lawyer and family friend who talked with Handa on Dec. 27 said he has been convalescing in India with the help of the country's traditional Ayurvedic treatments, including meditation, yoga, and herbal remedies. However, neither he nor another Alpha Omega lawyer have

received updates since then about the Handas' whereabouts or when the family might return to the United States.

LaSalle's litigation was put on hold after about two weeks because Alpha Omega filed for bankruptcy Dennis MrKenna, an attorney for Riemer & Braunstein who filed the temporary restraining order, declined to comment.

On Friday the Movado Group - which is owed more than $606,278 for stocking Alpha Omega with watch brands such as Concord, ESQ. Swiss, Movado, and Ebel - filed a complaint asking Middlesex Superior Court to place a lien against Raman Handa's Lexington home and any other real estate he owns.

Alpha Omega's assets will be auctioned off Jan. 22. A joint venture between Tiger Capital Group LLC and Gordon & Co. entered the first bid at 70.25 percent of the cost value of the inventory.

the inventory was estimated to be worth $18.7 million on Dec 31 but could end up being worth less by the auction date, since a bankruptcy judge has allowed Alpha Omega to continue selling its merchandise in the interim.

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APPENDIX C
SUMMARY BIO

David A. Walker
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Background

Dr. David A. Walker is the John A. Largay Professor and director emeritus of the Capital Markets Research Center, which he directed for 17 years at Georgetown University. The Israel Council on Higher Education has appointed him to their business school quality assessment team for the Israel Council on Higher Education. Dr. Walker is currently a board member for the George Town Club and the Georgetown University Student Credit Union. He chaired the Governing Board for the Credit Research Center for eight years. His biography appears in recent and many previous editions of *Who's Who in America, Who's Who in the East,* and *Who's Who in Finance and Industry.*

Dr. Walker recently completed two terms as chair of the Board of Trustees and is past president of Financial Management Association International, representing 4700 academics and practitioners. He has served as Executive Editor of the *Journal of Financial Research*, Co-editor of the *Journal of Small Business Finance*, and an editorial board member for seven finance journals.

Dr. Walker joined the Georgetown faculty in 1980, after serving as Director of Research for the Office of the Comptroller of the Currency and Financial Economist for the Federal Deposit Insurance Corporation. He served as Associate Dean for the Georgetown Graduate MBA and MS Tax Programs during their initial accreditation, and he has chaired many search committees and academic committees during his 28 years at Georgetown. Previously he taught at Northwestern University, the Pennsylvania State University, the George Washington University, and Iowa State University, where he earned his Ph.D. and Master's degrees in quantitative economics. Dr. Walker's special expertise is developing quantitative analyses to represent financial and economic situations using sample and population data.

Research

Dr. Walker has published seven books and monographs, 55 scholarly, peer-reviewed articles, and presented many research and policy studies at professional meetings. The topics include financing and operations of global and domestic financial service firms, financing small companies, mutual fund performance, trade credit demand and supply, and monetary and fiscal policies for emerging markets. His recent published papers are: "Impacts of Bank Acquisitions on Shareholder Returns," in *Bank Accounting & Finance,* "Predicting Presidential Election Results" in *Applied Economics,* "Performance Persistence in Fixed Income Mutual Funds," in the *Journal of Economics and Finance*,

and "Emerging Markets' Deficits, Privatization, and Interest Rates," *Economia Internazionale*.

Teaching and Lectures

Professor Walker teaches a variety of courses on global financial markets and institutions, applied macro-economics, and managerial economics. At various times he has taught courses in management science, micro-economics, mathematical economics, and statistics. He has also lectured and conducted courses in Australia, China, Estonia, Hungary, India, Japan, Poland, Singapore, and Thailand and was previously selected for a Fulbright Award in India.

Consulting

Dr. Walker is currently a consultant to the Promontory Financial Group and Nathan Associates. He has served as consultant to the World Bank, the U.S. Department of the Treasury, the U.S. Small Business Administration, and numerous companies. For the World Bank, Dr. Walker and several colleagues developed models to identify factors that would lead to successful ventures for new firms in emerging markets. Dr. Walker was a member of a blue ribbon commission to review the Treasury's efforts to implement of electronic processing and payments options for Treasury Bill accounting and to reduce paper processing and bookkeeping.

Dr. Walker has analyzed trade credit availability and demand for the U.S. Small Business Administration (SBA). He also developed cases for state and local governments' delineating their experiences contracting services with the private sector. Dr. Walker created the SBA proposal for a small business loan guarantee program with a secondary capital market. He has published studies on financing small firms through venture capital, informal investment, trade credit, and bank credit.

Dr. Walker's consulting work with Nathan Associates has involved price fixing cases, studies of long-term debt and equity levels and their impacts on Federal revenues and expenditures, and review of numerous other projects. He serves on the academic Advisory Board for the firm, with which he has had an affiliation for 25 years.

Case Experience

Dr. Walker has been qualified as an expert economist by seven Federal, state and local courts and for the Federal Energy Regulatory Commission. He has never been rejected by a court as an expert. Dr. Walker has completed legal, case-oriented economic analyses for a variety of clients. His clients have included: prestigious and smaller law firms, the U. S. House of Representatives, Nathan Associates, Memphis Gas & Light Company, the District of Columbia, and Dunkin' Donuts, Inc. The issues on which he has qualified or been retained to provide expert reports include: lost income, valuation of financial assets, bank management and financial practices, financial institutions' asset portfolio management, costs of capital, bank share valuations, profit projections for privately held firms and franchises, business profits and sales and personal income projections, and valuation of professional medical, legal, and business services.

Robert J. Lahm, Jr., Ph.D.

April 3, 2008

Nydia M. Velázquez, Chairwoman
1539 Longworth House Office Building
Washington, DC

Testimony for a hearing of the U.S. House of Representatives, Committee on Small Business entitled, "The Role of Credit Cards in Small Business Financing"

Thank you to the U.S. House of Representatives, Committee on Small Business for providing this opportunity to submit some of my research and observations for its consideration.

As you will note from my Bio, I am not a lifelong academic. I have been an entrepreneur. I have also been an entrepreneurial bootstrapper, i.e., one who has started a business from scratch with little or no capital. I know exactly how it feels to float with my head bobbing sometimes beneath and sometimes above the surface of treacherous entrepreneurial waters.

The credit card industry has in recent years been aggressively targeting the small-business market. My research shows that credit cards, whether labeled or classified as personal accounts or as business cards, have become a surrogate for traditional sources of capital by bootstrappers.

In one of my earlier papers entitled "Just Say 'Charge It': The Use Of Credit Cards In Entrepreneurial Startups," I attempted to extrapolate data from a variety of sources such as the Census Bureau, SBA, the Federal Reserve, and NFIB (many of us who conduct research recognize that data sets often overlap). While today's numbers would differ, 2001 census data showed 5.7 million firms with employees and 17 million without employees (for a total of 23.7 million businesses); 2002 census data showed 17,646,062 million non-employers. SBA data from 1998 showed that 48.2 percent of very small firms used personal credit cards as a source of capital. Obviously, it would have been ideal if the years matched up. However, by multiplying the credit card usage rate by the number of small firms, I estimated that somewhere in the vicinity of 8.5 million businesses with zero employees across all industry sectors were using personal credit cards as a source of capital in 2002. Usage rates as well as the total number of businesses have both increased since that time.

The subject of entrepreneurial bootstrapping has thus far not been vigorously researched. Bootstrapping is therefore evolving as a subject of study and discussion. For instance, while the term was originally used in reference to financing, I recently introduced a paper examining the construct of "bootstrap marketing." Some entrepreneurs use bootstrapping techniques because they have no choice, but my research suggests that others employ bootstrapping techniques deliberately.

Bootstrapping can be viewed as a philosophy, a way of life among certain individuals who start and operate businesses. Bootstrappers commonly select from a range of resources or methods such as

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bartering, sharing, negotiating, drop shipping, locating in low-cost facilities, and do-it-yourself (DIY) methods. They may tap financial resources such as credit cards, home equity lines, retirement funds, severance packages, negotiated supplier repayment terms, internally generated cash flow, and money from friends, relatives, or personal savings.

Boostrappers do not, or cannot access traditional lenders, business angels who buy ownership in their firm, or venture capital. There are many reasons for this behavior. They may not want other owners to meddle in their business, they may want to prototype their business concept before jumping into selling ownership for capital, or they may fear the loss of control by having other owners. Even when one accepts money from family members on an informal basis, there are expectations and emotional strings attached. Some researchers, including myself, note that the constraints of having little or no capital produce innovation. When one is forced to make-do, the likelihood of a creative solution is increased.

To a bootstrapper, a business credit card is a fast, easy, virtually instantaneous, means of acquiring capital for their business. Credit card applications are easy to fill out as compared to preparing financial statements and perhaps incurring accounting fees in the process of submitting an application for a traditional loan. There are, however, many dangers for the would-be business (or consumer) credit card holder. Most of us are aware of the game that is played given that credit card companies incorporate regular change in terms provisions in their application/contracts. Indeed, language such as "we may change our terms at any time, or for any reason," foreshadow that they can and will do so regularly. The biggest problem with respect to credit card companies is that they can be whimsical in their treatment of credit card holders. I believe my use of the word "whimsical" above is appropriate given that some issuers have added "or for no reason" to their change in terms disclosures.

Another danger is that so-called "business cards," are no different from ordinary credit cards relative to personal liability (whereas many small business owners think that once they form a business, they are protected – they have typically never heard of veil piercing). What I fear is that less sophisticated bootstrappers may be drawn into this scheme, believing that there is a difference in personal liability between an advertised "business card" and a "personal credit card." There isn't.

Credit card companies may slap the unwary borrower with higher interest rates when payments are late, in addition to late fees. According to a United States Government Accountability Office (GOA) report entitled, CREDIT CARDS: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers, "35 percent of their [credit card issuers'] active U.S. accounts were assessed late fees and 13 percent were assessed over-limit fees in 2005." Even the IRS uses a postmark to signify compliance with the spirit of a taxpayer's filing deadline. Credit card companies will impose a late fee even if someone is "one hour late," and they are racking up huge profit margins on these fees. I also remain concerned about differences among women and minorities with respect to access to capital or the treatment they receive as borrowers in any context.

Knowing that entrepreneurship is vital to the economy, we must find ways to study and support bootstrappers, since they comprise the vast majority of all start-ups. These businesses may finally reach the cover of *Inc.*, *Fast Company*, or *Entrepreneur*, but they are started on kitchen tables. In terms of entrepreneurs as research subjects, scholars have tended to focus upon larger more

noticeable firms, those with public visibility, and greater chances for immediately or eventually obtaining capital from traditional sources. However, there are millions of very small businesses – bootstrappers – whose activities, operations, and aspirations are barely visible on the scholarly researcher's radar screen. These small businesses are visible to credit card companies, as they represent a promising new target market.

As policymakers, I would invite you to consider novel approaches to disseminating formal education and training for nescient entrepreneurs. I urge your consideration of the following:

1) We need better disclosure requirements. When other industries have produced products that may be hazardous to consumers' well being, they have been forced to educate consumers. I believe that so-called business cards should contain a bolded warning: "Though this card may be issued in your name and the name of your business, you are making a personal loan when you use this credit card. You are fully liable for paying on any debt created by the use of this card." The reverse mortgage industry produced a video.

2) Unfortunately, "personal finance" has been greatly underserved as a subject for contemporary students in high schools and universities. While this may fall under the purview of the U.S. Department of Education, I suggest that this Committee could pass along its recommendations for increased attention in addressing a societal need for financial literacy.

3) I fear that a proposal to require that the terms of credit be frozen at the time the credit was taken would actually raise the cost of credit to all. On the other hand, lenders who are utilizing predatory lending practices, trickery, and an obviously disingenuous strategy to trap borrowers in a classic game of "bait and switch" with change in terms agreements must be stopped, given that entrepreneurs are the life-blood of the economy.

There is one thing that Congress should avoid doing: please do not add to the complexity of regulation as it applies to individual entrepreneurs and small businesses.

We are all looking for a model to advance entrepreneurial growth and development, one with which we can prosper as a nation. As is the case in biological systems, it is a sad fact of life that some young will not survive. Nevertheless, we must thwart the predators and conditions that threaten new businesses. I appreciate this opportunity to share my observations. I would also like to thank the Committee Members for their service to our country and for their thoughtful deliberation of the challenges and role of entrepreneurial bootstrappers. I wish you well on your quest to create policies that can nurture those businesses that deserve an opportunity to succeed. If I may be of further service in the future, I hope you will call upon me again.

Respectfully submitted,

Robert J. Lahm, Jr., Ph.D.

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JUST SAY "CHARGE IT": THE USE OF CREDIT CARDS IN ENTREPRENEURIAL STARTUPS

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Abstract

This paper reviews the use of credit cards in small business startups and for everyday use by entrepreneurs. Credit cards, especially those classified as personal accounts, have become a surrogate for traditional sources of capital by bootstrappers. Indeed, the use of credit cards is among several methods entrepreneurs have adopted to launch businesses. The use of credit cards can be hazardous. On the other hand, some entrepreneurs have leveraged credit cards to create multimillion dollar businesses. Entrepreneurship educators and scholarly researchers should therefore acknowledge both bootstrapping and credit cards as the means by which most businesses are actually started and grown. Students must be trained to critically and creatively analyze every possible method by which they can possibly start, finance and operate a business.

JUST SAY "CHARGE IT": THE USE OF CREDIT CARDS IN ENTREPRENEURIAL STARTUPS

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Abstract

This paper reviews the use of credit cards in small business startups and for everyday use by entrepreneurs. Credit cards, especially those classified as personal accounts, have become a surrogate for traditional sources of capital by bootstrappers. Indeed, the use of credit cards is among several methods entrepreneurs have adopted to launch businesses. The use of credit cards can be hazardous. On the other hand, some entrepreneurs have leveraged credit cards to create multimillion dollar businesses. Entrepreneurship educators and scholarly researchers should therefore acknowledge both bootstrapping and credit cards as the means by which most businesses are actually started and grown. Students must be trained to critically and creatively analyze every possible method by which they can possibly start, finance and operate a business.

Introduction

Contemporary entrepreneurship courses, relying on popular textbooks, tend to emphasize (or at least include) writing a business plan. Indeed, Katz, Harshman and Dean (2000) observed that writing a business plan is "the sine qua non of modern entrepreneurship education" (p. 235). So far, so good—this paper raises no argument about the value of business planning, or with writing. The use of spell-check, correct grammar, and coherent thinking is also encouraged. However, the plot thickens. This paper does suggest that neither courses, nor authors who are involved in the development and writing of business plans should proceed under an assumption that "bankers, investors, and lawyers" (p. 235) are necessarily the target audience of that writing. A reality check would strongly suggest that most business startups rely on sources of startup capital besides that which arises from the coffers of bankers, investors, and lawyers.

Business plans have an internal function, and an external function (Hormozi, Sutton, McMinn and Lucio, 2002). According to guidelines from the U.S. Small Business Administration, SBA, in its publication (1993), *How to Write a Business Plan*, and despite any emphasis that courses may inculcate in the minds of students about traditional sources of capital through bankers and investors

> There are two main purposes for writing a business plan. The first, and most important, is to serve as a guide during the life of your business. It is the blueprint of your business and will serve to keep you on the right track. To be of value, your plan must be kept current. If you spend the time to plan ahead, many pitfalls will be avoided and needless frustrations will be eliminated. Second, the business plan is a requirement if you are planning to seek loan funds. It will provide potential lenders with detailed information on all aspects of the company's past and current operations and provide future projections. (pp. 2-3).

A textbook emphasis on- and business plans written for an audience of bankers and investors may be popular and appropriate for students at affluent institutions (Maddy, M. 2000). Venture

capitalists and angels do exist (Wirtz, 2001; Fried and Hisrich, 1995; Freear, Sohl and Wetzel, 1994), they just don't make themselves visible to the average undergraduate student by regularly frequenting classes at the average institution. In reality, even experienced business professionals, much less recently minted undergraduate students would probably better served by focusing their personal and business development efforts on learning more about bootstrapping (Van Auken, 2005; Van Auken, 2004; Roberts, 2003; Arora, 2002; Worrell, 2002; Winborg and Landstrom, 2001; McCune, 1999; Hyatt and Mamis, 1997; Van Auken and Neely, 1996; Mamis, 1995; Bhide, 1992; Mamis, 1992).

Overwhelmingly, startup entrepreneurs who do succeed in launching businesses do so by using other non-traditional methods for creating and launching businesses. Startups typically report a lack of access to venture capital and bank financing (Cole, Lahm, Little, and Seipel 2005; Van Auken and Neely, 2000). In keeping with this line of reasoning, this paper also argues in favor of increasing classroom emphasis on bootstrapping, and providing students with the skills to make progress with their ideas and create unique advantages (Brush, et al, 2001), despite a lack of traditional capital. Ingredients include picking the right type of business (one that is susceptible to low start-up costs), and understanding off-the-beaten track strategies such as, how to negotiate six months' free rent; how to enlist suppliers and customers as "champions" of the business; how others "do it," and the like.

The Widespread Use of Bootstrapping

Entrepreneurs typically rely on a variety of non-traditional methods to raise capital, or to otherwise mitigate some of their startup capital needs. In other words, the vast majority of all businesses are founded by individuals who employ bootstrapping as a means to launch their respective enterprises. Bootstrappers typically utilize methods such as bartering, sharing, negotiating, drop shipping, locating in low-cost facilities such as a home-based business (Pliagas, 2000), guerilla marketing (Levinson, 2005), and do-it-yourself (DIY). Relative to cash resources, business founders have leveraged credit cards (Detamore-Rodman, 2002; Anonymous, 2002; Deceglie, 1998), mortgaged homes, dipped into retirement funds, and used just about any other way to get their hands on operating funds including severance packages, negotiated supplier repayment terms, internally generated cash flow, and money from friends, relatives, or personal savings (Pliagas, 2005; Williams, 2005; Roberts, 2003; Mamis, 1992).

Bootstrapping is essentially a creative process (Mieszkowski, 2003; Arora, 2002; Freear, Sohl and Wetzel, 1995; Bhide, 1992). While it has been characterized as a creative financing method, which is true, that description doesn't necessarily convey the richness of the term. At an observable level, bootstrappers are saving money and building business revenues, sometimes starting from scratch or very modest beginnings (Fenn, 1999).

However, there is also a mindset (Lahm, 2005) on the part of these entrepreneurs who use "ingenuity and a lot of gumption" (Fenn, 1999, p. 43) to start their businesses. These individuals are sometimes characterized as driven (Longenecker, Moore and Petty, 2002), passionately committed zealots who take on their startup challenges as a personal quest. As a consequence, the businesses they create often exhibit remnants of earlier days (reflected in their organizational cultures), as illustrated by the following passage, which describes the beginnings and meteoric---internally financed--growth of The Pampered Chef:

> Today "The Kitchen Store That Comes to Your Door" occupies a modern 220,000-square-foot brick warehouse and office in an industrial park outside Chicago, employs more than 400 full-time workers, and fills orders for a sales force of 20,000 part-timers. Behind an everyday desk in an unassuming second-floor office--cost-constraint remnants from her bootstrapping years--chief executive Christopher remains TPC's master chef. And, never having financed growth beyond the company's $3,000 beginnings, she (together with her husband) owns every spoonful of the still-rising soufflé. (Mamis, 1995, p. 40).

The number of businesses that are founded through the use of bootstrapping is difficult to determine definitively. This is because small businesses may use both traditional sources of capital (particularly bank financing) in a mix, along with non-traditional sources (Shermach, 2004; Parchois, 2000). Further, some traditionally capitalized businesses no doubt have owners who may practice an observed behavior such as credit card use on behalf of his or her business, but that could be a matter of shopping convenience (Swain-King, 2004) as compared to the opposite end of the spectrum, wherein the credit card usage may represent a significant source of financing to the business. In addition, as mentioned above, besides tapping sources of capital, bootstrappers also employ specific methods. One thing is obvious, bootstrapping is the method most entrepreneurs to start the vast majority of businesses (Worrell, 2002). One estimate suggested that approximately 75 to 85 percent of startup businesses use some form of bootstrapping (McCune, 1999, p. 1).

Small Business Financing Patterns

Overview

Except as cited otherwise, data and statements in the following section are taken directly, or developed from the SBA (Office of Advocacy) report, *Financing Patterns of Small Firms: Findings from the 1998 Survey of Small Business Finance;* Office of Advocacy Web site FAQ's (updated June, 2004); the Board of Governors of the Federal Reserve System (*Report to the Congress*, 2002); the National Federation of Independent Business (NFIB) *National Business Poll: Business Structure* (Dennis, 2004); and the U.S. Census Bureau (2002).

- Over 80 percent of the small businesses surveyed used some kind of credit and had outstanding debt on their books at the end of 1998.
- Fifty-five percent of small firms had some kind of traditional loan, while 71 percent obtained credit from non-traditional sources, mainly owners' loans and credit cards.
- The most frequently used kinds of credit were personal and business credit cards, lines of credit, and vehicle loans.
- Forty-six percent of small firms used personal credit cards, 34 percent used business credit cards, and 28 percent used lines of credit.

- A large percent of the smallest firms were forced to use personal credit cards because of limited availability of loans and of business credit cards.

- Very small firms tend to use alternative sources because other sources of financing, which are usually cheaper, may be unavailable; these firms also appear to rely heavily on costly personal credit cards and owners' loans.

- The use of home equity lines for business purposes in an important source (although not be quantified by the SBA study).

- The use of owners' loans and personal credit cards leveled off or diminished as firm size increased.

- Owner loans are a very convenient source of financing and may be preferred for their simplicity.

Small Women-Owned Firms
Credit cards were the most often used kind of credit, with 48 percent and 29 percent of firms using personal and business credit cards, respectively.

1.3 million women-owned small businesses had $110.3 billion in debt comprised of:

$99.6 billion from the six traditional types of credit.
$9.5 billion from owners.
$1.2 billion in credit card debt.

The most important form of borrowing was mortgage loans, which accounted for 45 percent, and credit lines, which accounted for 22 percent.

As compared to men, many women entrepreneurs avoid the sale of equity in their businesses and "are more likely to rely on credit cards and personal loans" (Thomas, 2001, p. B.2). "Women are not only more likely to start their businesses on a shoestring but also more likely to operate on a shoestring" (Brush, et al, 2004, p. 59).

Small Minority-Owned and Hispanic-Origin Firms
Personal credit cards, business credit cards, and lines of credit were the most frequently used types of credit, with 46 percent, 29 percent, and 20 percent respectively.

773,000 minority-owned small businesses had $59 billion in debt comprised of:

$51.5 billion in the six traditional loan categories.
$6.6 billion in loans from owners of partnerships and corporations.
$990 million in credit card debt.

Minority- and Hispanic-owned firms' reliance on high-cost personal credit cards and owners' loans was heavier than that of all firms. This was especially the case for very small minority

firms. This seems to confirm the anecdotal complaints expressed by very small firms regarding the shortage of credit and the inefficient operation of the credit markets for these firms. Overall, the means to acquire capital through traditionally accepted sources is more limited for minority and women entrepreneurs (Brush, et al, 2004).

Very Small Firms

In its *National Business Poll: Business Structure*, the National Federation of Independent Business (NFIB) reported that approximately one-third of small businesses "employing nine or fewer people are located in the home" (Dennis, 2004, p. 5). The same report indicated that "59 percent of small (employing) businesses are owned by one individual (including his/her spouse if applicable)" and "twenty-seven (27) percent or over one in four have two owners" (p. 4). Hence, the NFIB's data shows that 86 percent of small (employing) businesses have only one or two owners.

While the NFIB's data set and that of the SBA are not formally related, it is important to note that most businesses are very small enterprises. The SBA's data set distinguished very small businesses with no employees, and its report emphasized that these businesses are an important source of new business startups. According to the U.S. Census Bureau (Economic Census, 2002) most nonemployers "are self-employed individuals operating very small unincorporated businesses, which may or may not be the owner's principal source of income."

The Census Bureau uses Internal Revenue Service (IRS) data obtained from the annual business tax forms that are filed to identify nonemployer businesses. The Bureau's 2002 nonemployer data (latest available) indicated that there are a total of 17,646,062 million nonemployers across all industry sectors, with $770,032,328,000 in receipts. To place the number of nonemployer firms in perspective, 2001 Census data showed 5.7 million firms with employees and 17 million without employees (for a total of 23.7 million businesses). With or without employees, small businesses with less than 500 employees account for 99.7 percent of all businesses.

In Table 1, the SBA's data shows that among all very small firms, which it also defined as those with zero employees (as did the Census Bureau), the number one type of credit used was personal credit cards (48.2 percent). If we multiply the two figures (number of nonemploying businesses times the percentage that use credit cards) together, we can estimate that approximately 8,505,402 million businesses, with zero employees across all industry sectors are using personal credit cards as a source of business capital.

TABLE 1
Very Small Firms with Zero Employees and Their Credit Sources

Credit Type or Supplier	All Small Firms	Minority-Owned Firms	Women-Owned Firms
Any Depository Institution	32.8	16.8	15.1
Commercial Bank	17.3	8.9	12.4
Finance Company	11.5	11.2	5.4
Leasing Company	2.5	1.7	1.9
Family and Friends	3.6	6.9	4.2
Owner Loans	0.2	1.1	0.5

Personal Credit Card	48.2	43.3	47.7
Business Credit Card	17.4	18.8	14.1
Line Credit	12.8	5.5	8.0
Mortgage	6.5	9.7	7.2
Vehicle	12.3	13.9	11.0

Very small firms, defined as those with zero employees.
Data Source: SBA, *Financing Patterns of Small Firms: Findings from the 1998 Survey of Small Business Finance*, p. 19.

It is well known among disgruntled business founders that banks can be difficult to deal with (if not impossible) when it comes to any discussions about startup capital for a new business (Van Auken and Neely, 1999; Van Auken and Carter, 1989). Most banks require an already established positive cash flow, three or more years in business, and good business as well as personal credit (Parchois, 2000). Thus, it is interesting to note that despite a reputation for being uncooperative with startups, the underlying source of capital that is being used by many businesses is still banks, except that they are lending, via plastic (Nixon, 1997).

Just Say "Charge It"

Credit Card Usage is Becoming More Popular

While 1998 SBA data above is already provocative, de Paula (2003), writing in *U.S. Banker*, cited more recent industry sponsored research. According to that later research, credit cards are becoming increasingly popular:

> Of the 64 percent of small business owners who use plastic for business expenses, 57 percent use personal cards, with 33 percent using those personal cards exclusively and 24 percent using them in addition to small-business cards, according to research recently commissioned by MasterCard. The research also indicates that of those who use credit cards for business expenses, 42 percent use only small-business cards. Credit cards of all kinds are quickly gaining in popularity as a method of financing for small business owners, says Charles Ou, senior economist in the Small Business Administration's Office of Advocacy. The SBA estimates increased credit card use may account for nearly all of the growth in its smallest loan category--micro-business loans--which are those under $100,000. While other forms of micro-business loans haven't risen much, micro-business lending through credit cards is up by 34.5 percent from $7.9 billion in 2000 to $10.7 billion in 2001. This far outpaces overall growth in micro-business loans, up only 4.4 percent from 2000 to 2001, for a total of $126.8 billion. (p. 54).

According to Rosenfeld (1999), commercial loans enjoy a "hallowed reputation for respectability" (p. 1), however, "more and more small business owners are turning to credit cards for funding…because they are easy to come by and the credit limits are high" (Scully, 2002, p.1). De Paula further observed that banking industry executives see the market for small business credit cards "as a growth area, mainly because the personal credit card market is saturated and because business owners tend to spend more per month and carry higher annual balances than

the average consumer, promising higher fees and interest revenue" (p. 54). Another reason that banks have become more aggressive is that "statistical models prompted a major leap forward. They demonstrated a strong correlation between company principals' repayment of personal debt, and the likelihood that a small business loan would be repaid, and made it easier to handle the risk." (Kitchenman, 1999, p.37).

Upon opening the floodgates to market expansion, some banks found similarities between small business credit card users and regular consumers, as compared to large corporations (Cocheo, 1997). However, they also found that they were sometimes competing with themselves (i.e., internally) due to competing offers that are presented to the same consumer, for business and personal credit cards. Cocheo (1997) quoted Cynthia Gadberry, director of marketing, BancBoston, Small-Business Banking, who (in recognizing the problem for banks) asked, "Why would anyone pay a higher rate for a commercial product?" (p. 7). (As a sidebar, but one that is related, bootstrappers have long recognized that in many instances the same product or service, once it is identified as a commercial product as compared to a personal product, comes with a significantly higher price tag; accordingly, they use the "personal" version of whatever that product or service may be.)

Some evidence suggests that certain potential applicants for traditional business credit do not even bother to apply (Buttner and Rosen, 1992). Kon and Storey (2003) identified a subject group that they called discouraged borrowers, described as "good borrowers who do not apply for a bank loan because they feel they will be rejected" (p. 37). Other research pertaining to discriminatory lending practices has similarly identified individuals who did not apply, "because they believed their applications would have been turned down" (Cavalluzzo, K.S, Cavalluzzo, L.S. and Wolken, 2002, 641). Hence, it is obvious by now, disenfranchised applicants for traditional business credit may adopt the view that they should, "Just Say "Charge It."

Multiple Credit Cards

Business founders have used multiple cards for startup funding. However, Selz (1994) reported that entrepreneurs were using credit cards both for startup capital, and to finance operating expenses. *Entrepreneur, Inc., The Wall Street Journal*, and others in the business press regularly feature stories about card-carrying, bootstrapping entrepreneurs. Often, the imagery surrounding the individuals who are highlighted portrays a heroic (if not swashbuckling) persona. An article featured in *Inc.* magazine concluded that despite the horror stories that result from the use of credit cards to finance new businesses, personal credit cards remain a fast, cheap, and easy way to obtain much needed start-up capital (Hise, 1998).

The *Wall Street Journal* reported that it was not unusual for individuals who were starting businesses to amass "myriad of credit cards for this purpose—possibly 14 or 15!" (McCue, 1999, p. 6). Increasingly, credit cards are becoming a financing tool of choice (Loftus, 2004). As Prince (2003), writing for *Entrepreneur* magazine, observed: "Good, old-fashioned plastic" is a source of capital that remains "plentiful even in tough times" (p. 1). The result has been twofold: some fallout in the banking industry, but also numerous success stories.

"Many people use multiple credit cards to finance fledgling or marginal business ventures, which can result in hefty card balances. Personal bankruptcies are soaring to record levels right now"

(Streeter, 1996, 15). Relative to success stories, they are both abundant and compelling. An entrepreneur may leverage multiple cards for a while, and then grow a multimillion dollar business (Scully, 2001). *Entrepreneur* magazine's November 2004 cover story article titled, *Young millionaires*, profiled one business founder who initially amassed $50,000 in credit card debt; his company now has 55 stores with "sales topping $30 million" (Kooser, Pennington, Riggs, Torres and Wilson, pg. 82).

Plastic: The Entrepreneur's New "Venture Capital Card"

In many ways, the banking industry has painted itself into a proverbial corner. On the one hand, it would like to service good-paying small business customers, and it sees the potential in those customers as they represent a new marketing opportunity (Vincent, 2000). Credit cards, after all, are in a sense a commodity. It was not all that long ago that the banking industry new virtually nothing about marketing or customer service. Consultants could teach basic skills such as, greet the customer as he or she enters the lobby, and their advice was considered cutting-edge. On the other hand, bankers, as debt based and not equity-based lenders thrive on security, literally. As a consequence of these conditions, some entrepreneurs have created a de facto "venture capital card" (Nixon, B.(1997, p. 33):

> Another option for entrepreneurs seeking financing for a start-up venture is credit cards. Although difficult to measure, bankers concede that it is happening….Many entrepreneurs perceive that the process of obtaining a commercial loan from a bank is too difficult, or that it would ultimately be a vain effort. In some respects, this perception is not far off the mark. "In a typical small business banking environment, you start to measure capacity to repay and other factors relating to the five C's of credit….A credit card, or multiple credit cards, can be obtained over the telephone or through the mail, although the interest rate likely is higher. The bottom line for the entrepreneur is that this source of credit is easier to tap. "Some [credit card issuers] just give you the mirror test"…."They hold a mirror up to your face and if you're breathing, you get a card." In such instances, credit cards are serving as a substitute for venture capital. The possible problem for the banking industry, and credit card issuers in particular, is that when a consumer credit card becomes a business credit card, or when a home equity loan is used to establish a business venture, the risk profile of the credit product changes. Another issue: Credit card issuers and home equity lenders typically don't ask what the proceeds of these loan products will be used for and how they will be repaid. (p. 33).

In the final analysis, it is standard practice for thousands of entrepreneurs to use their personal credit cards to provide initial capitalization (Hise, 1998). They serve as a possible, if not highly likely substitute for traditional capital.

Conclusion

This paper has reviewed the use of credit cards in small business startups and for everyday use by entrepreneurs. Credit cards, especially those classified as personal accounts, have become a surrogate for traditional sources of capital by bootstrappers. Indeed, the use of credit cards is

among several methods entrepreneurs have adopted to launch businesses. While the banking industry and the federal government (Board of Governors of the Federal Reserve, Report to the Congress, 2002) have both expressed concern, banking industry executives recognize, and are actively pursuing credit card marketing efforts to small businesses. The process for acquiring traditional capital does perform a screening function by identifying business startups that do not have sufficient assets to guarantee debt repayment. However, many startups, having no tangible assets to report, cannot meet this test; all they have is the strength of an idea and whatever other skills, knowledge, and abilities they may bring to the table. As observed by Nixon (1997), even Bill Gates would have been told "sorry" (p. 31).

The use of credit cards can be hazardous, and bankruptcies have been on the rise in recent years. On the other hand, some entrepreneurs, having been thwarted in their efforts to obtain traditional capital, have leveraged credit cards to create multimillion dollar businesses. Entrepreneurship educators and scholarly researchers should therefore acknowledge both bootstrapping and credit cards as the means by which most businesses are actually started and grown. To insist that students write business plans under the assumption that investors, bankers, and angels will necessarily comprise the audience for their writing (and converge to offer salvation) suggests a teaching strategy that is totally out of step with the realities of launching a business that the vast majority of students will ultimately face. Students must be trained to critically and creatively analyze every possible method by which they can possibly start, finance and operate a business.

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BOOTSTRAPPING: METHODS ENTREPRENEURS REALLY USE TO START A BUSINESS; A HOLISTIC VIEW

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Abstract

This article examines the use of bootstrapping as a means to launch startup businesses as well as to manage ongoing operations. Although bootstrapping methods are widely used and discussed frequently in the business press, scholars have not addressed these practices holistically; nor have they vigorously pursued bootstrapping as a topic that is sorely in need of additional research. Existing research has primarily emphasized specific bootstrapping methods and identified typologies, often characterizing bootstrapping as a response in light of constrained resources. This article argues that bootstrapping may be a forced choice, or an elective choice. Once one does engage in bootstrapping, additional decisions as to specific methods must be made relative to options that are available or created.

Introduction

An examination of several leading entrepreneurship textbooks showed that "bootstrapping," which in the context of business startups refers to the use of creative techniques (Bhide, 1992; Arora, 2002) to launch and operate a business, is barely acknowledged. Entrepreneurship courses, as they are often taught may (accordingly) be flavored by this lack of coverage. In writing about the entrepreneurship classroom, Katz, Harshman and Dean (2000) referred to writing a business plan as "the sine qua non of modern entrepreneurship education" (p. 235). This present paper does not dispute the value of a business plan; however, it does argue against the notion that the target audience of that writing is necessarily "bankers, investors, and lawyers" (p. 235).

On the one hand, some bootstrappers may not be considered worthy of traditional sources of capital by the gatekeepers who control that capital (Wirtz, 2001; Buttner and Rosen 1992). On the other hand, other bootstrappers may be rejecting traditional sources of capital; avoiding those sources; unaware of those sources (Van Auken, 2000); or "have limited business skills" (Van Auken, 2005, p. 94). Of the four alternatives suggested above, the important point being made here is that bootstrapping may occur as a result of an entrepreneur having no other choice (lacking knowledge, skills, or opportunities), or it may be that a business founder is not interested in dealing with bankers, lawyers, and investors. Bootstrappers commonly select from a range of resources or methods such as bartering, sharing, negotiating, drop shipping, locating in low-cost facilities, do-it-yourself (DIY); they may tap financial resources such as credit cards, home equity lines, retirement funds, severance packages, negotiated supplier repayment terms, internally generated cash flow, and money from friends, relatives, or personal savings (Pliagas, 2005; Roberts, 2003; Mamis, 1992). Hence, the issue for educators is to recognize that bootstrapping is far more prevalent than

teaching approaches (relative to the logical inference that bankers, lawyers, and investors are the sine qua non of business plans) and textbooks might suggest. Bootstrapping is the method most entrepreneurs really use to start the vast majority of businesses (Worrell, 2002). One estimate suggested that "between 75 and 85 percent of startups use some form of bootstrapping" (McCune, 1999, p. 1).

Existing Research on Bootstrapping

The lack of formal acknowledgement in textbooks is mirrored by the research efforts of scholarly authors, to date. To further exacerbate this problem, it could also be the case that existing scholarship may be focused on more noticeable firms, those with public visibility, and greater chances for immediately or eventually obtaining capital from traditional sources in the first place. High-tech, Silicon Valley-type businesses (no derision intended to researchers or subjects under study—one must start somewhere) seem to have gained a lot more attention than small home-based businesses, for example. A comparative lack of glamour on the part of numerous small businesses is suggested by the imagery of a lawn care service or a similar business, where most of the assets of the business ride in the back of a pickup truck with a trailer in tow. Alternatively, very small, less visible businesses may be more difficult to recruit as participants in research on bootstrapping.

Nevertheless, the National Federation of Independent Business (NFIB) reported in its *National Business Poll* [on] *Business Structure* that "almost one-third (32 percent) of those [small businesses] employing nine or fewer people are located in the home" (Dennis, 2004, p. 5). The same report indicated that "59 percent of small (employing) businesses are owned by one individual (including his/her spouse if applicable)" and "twenty-seven (27) percent or over one in four have two owners" (p. 4). Adding these two figures together indicates that eight and one-half out of ten (86 percent) small (employing) businesses have only one or two owners. Thus, the population of bootstrappers which perhaps should be under study by future researchers may be associated with more quaint beginnings than those of businesses that are living "life in the fast lane."

Van Auken, working alone and with co-authors, has produced several studies and is one of the more prolific researchers investigating bootstrapping (such as, Van Auken, 2005; Van Auken 2004; Van Auken and Neely, 1996 and 2000; Van Auken and Carter, 1989). However, earlier this year Van Auken, (2005) observed:

> Although bootstrap financing commonly is used and is an important source of capital, few studies have investigated its use by small firms. Previous studies have focused on specific types of bootstrap financing techniques, such as accounts receivable, factoring, and leasing. However, few studies comprehensively have examined the role of bootstrap financing in small firm financing (p. 94).

In other words, "bootstrapping is a phenomenon which deserves more attention in future research on small business finance" (Winborg and Landstrom, 2001, p. 235).

Bootstrapping as a Philosophy

At first glance, one might conclude that large, established firms, may be beyond the stage of development where they might turn to bootstrapping methods, as compared to small, early stage firms. However, an alternative view of bootstrapping, which could be described as a way of life among certain individuals who start and operate businesses, is another possible framework for future researchers to explore. Some individuals may thrive on a "grow from within," type of strategy, based on cultural notions of independence and self-sufficiency, values that are strongly associated with entrepreneurialism. Bootstrappers may use know-how, imagination, and effort as a substitute for capital (Mamis, 1992; Levinson, 2005). As Lahm (2005) observed:

> Bootstrapping is not necessarily a tool used only by business community "have-nots." Some bootstrappers are awfully proud of the money they save (and the money they make)....It's not simply an issue of having plenty of spending money, or not. Rather, there is a mindset that says, "I want fair value for my dollar, and I hate feeling ripped off by paying 'way more' than something is worth." In many ways, bootstrappers develop their knowledge and personal skill-sets and use their abilities as a substitute for cash. There's also a certain satisfaction that comes from becoming more self-sufficient. (p. 2).

Hence, this paper, which is necessarily exploratory in nature, suggests that in addition to research focusing on specific types or methods of bootstrapping (as mentioned above), bootstrapping should be studied as a holistic approach on the part of entrepreneurs. That is, bootstrapping could be characterized as a philosophy, or a way of entrepreneurial life.

Bootstrapping by Choice

It is certainly the case that in some instances business founders resort to the use of bootstrapping methods when they have no other choice (Cole, Lahm, Little & Seipel 2005; Roberts, 2003). These bootstrapping methods can help to either augment traditional sources of capital (Winborg and Landstrom; 2001) or be the sole source of financing for a business. The most common theme associated with bootstrapping is that it is an alternative action taken by entrepreneurial founders in light of constrained resources. Van Auken (2005) suggested that bootstrapping by small firms "may be especially important due to their lack of access to capital markets" (p. 95). There are several reasons that explain why entrepreneurs may elect to engage in bootstrapping by choice.

"Discouraged Borrowers"

Ken and Storey (2003) have proposed a type of borrower that they identified as discouraged borrowers: "good borrowers who do not apply for a bank loan because they feel they will be rejected" (p. 37); their findings relate to other research by Cavalluzzo, K.S, Cavalluzzo, L.S. & Wolken (2002) who studied discriminatory lending practices and identified business owners who did not apply for credit "because they believed their applications would have been turned down" (p. 641). Individuals have made a choice to *not even try* to

access capital from traditional sources; these individuals may or may not have been successful, if they had tried.

Desire for Autonomy and Privacy

Bootstrappers may avoid outside investors because "the venture capitalist plays a role in the management of companies receiving investment" (Fried and Hisrich, 1995, p. 101); besides venture capitalists, any other type of lender or investor usually becomes entitled to exercise some type of oversight. Further, any individual who has applied for business or personal credit cannot help but become immediately aware of the extremely intrusive nature of lending processes: complete credit, debt, tax, personal and other information is typically required. Even when one has "nothing to hide," he or she may not want to endure such probing on the part of would-be traditional lenders (or other investors).

Self-sufficiency as a Personal Value

When one accepts capital, he or she must legally and ethically accept that there are certain strings attached. Even in the case of an outright gift from a benefactor, typically a close friend or family member (Detamore-Redman, 2003), there are at least social strings attached. Some individuals may prefer self-sufficiency so as to avoid those social, legal, or ethical obligations. While this may impose a constraint on a business, "strings attached" are a cost and do imply some risk.

Challenge of the Entrepreneurial Game

Serial entrepreneurs and ex-franchise owners come to mind as possible entrepreneurial "types" who may feel compelled by their own vision, and confident in their ability to create a business from the ground up. These individuals may enjoy bootstrapping and attain gratification from activities such as bartering, negotiating favorable terms, or otherwise exercising their creative financing skills.

Emergent Nature of Entrepreneurship

Entrepreneurship classes and business plans attempt to liken themselves to entrepreneurial reality, but they are not reality. Business startups, ideas, and new products all tend to lead tumultuous lives, filled with "bumps and turns" (Brush, Greene, Hart and Haller, 2001, p. 64). "The odds of any one idea becoming an economic success are so very low that many ideas are needed" (Stevens and Burley, 1997, p. 16). In real life, founding and nurturing businesses is an emergent, creative, problem-solving process. Bootstrapping is, at its core, a creative process (Bhide, 1992; Freear, Sohl & Wetzel, 1994); and it, too, can also be characterized in context as an emergent, problem-solving process. Entrepreneurs are necessarily adaptable, and they ordinarily must creatively meet not just financing challenges, but technological, human resources, operational, organizational, marketing, and virtually any other kind of challenge one might care to name. Entrepreneurs tend to use all of their wherewithal, including a lifetime of accumulated knowledge, skills, and personal resources (Longnecker, Moore & Petty, 2002) to create their businesses and manage them through "multiple iterations" (Brush, Greene and Hart, 2001, p. 64).

Luck and Momentum

On occasion, an entrepreneur may found a business that seemingly takes on a life of its own. A mere mention by celebrities such as Oprah can create a bestselling book or propel a business to success. As observed by Cohen (2005):

> Lori Karmel's business. We Take the Cake, got the ultimate celebrity endorsement: Its Key lime bundt cake was featured on the "Favorite Things" episode of The Oprah Winfrey Show. Then Karmel had to deal with the aftermath. The Fort Lauderdale cake maker's server collapsed after its Web site recorded 800 orders in four hours. The voicemail reached capacity every four minutes. Karmel had to spend $10,000 to hire an answering service. Orders poured in from far and near. "People were coming in, picking up 60 cakes, 80 cakes," Karmel said. (pg. 1).

Speed and Convenience

As suggested by numerous articles in *Entrepreneur* (Worrell, 2002; Prince, 2003), *Inc.* (Hise, 1998), and *The Wall Street Journal* (Seiz, 1994), bootstrapping in its various forms such as leveraging credit cards (Cole, Lahm, Little & Scipel 2005; Loftus, 2004; Report to the Congress, 2002) is faster and easier than suffering through a "chilly reception" from bankers (Rosenfeld, 1999, p.1). After all, startup entrepreneurs often conclude that tapping other resources (discussed above) is faster, easier, almost instantaneous and more certain relative to acquiring capital for a business (with less or no oversight). For example, by leveraging multiple credit cards (Deceglie, 1998; McCune 1999) business founders can gain access to relatively large amounts of capital in comparison to the size of a business startup loan (if that loan was even attainable). As Scully (2002) observed, credit cards "are easy to come by and the credit limits are high" (p.1).

Conclusions

As discussed in this paper, the existing scholarly literature on bootstrapping is limited. As an exploratory analysis, bootstrapping has been presented from several alternative vantage points. Implications for teaching, scholarship, and service to the entrepreneurial and small business community have also been indicated. If future small business and entrepreneurship researchers wish to connect with reality, they must go beyond a review of the sparse scholarly literature and include additional articles from the business press and more data from a plethora of bootstrappers as research subjects and informants. The overarching argument presented here is: bootstrapping is the way entrepreneurs really start and operate businesses; as such, it deserves far more respect, attention, research and analysis.

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Objectives

- Reward bootstrappers.
- Promote entrepreneurial bootstrapping.
- Connect bootstrappers with one another, ideas, and resources to enhance the bootstrapping experience and improve its outcomes.
- Provide individuals with the power of entrepreneurial choice.
- Motivate those who have started, would like to start, or who are afraid to start a business.
- Change the world through supporting entrepreneurialism.
- Capture the wisdom embedded in Bootstrapping Stories (whether those stories have positive or negative outcomes).
- Publish and disseminate bootstrapping information.
- Entertain, provoke, enliven, and inspire vigorous discourse about entrepreneurial bootstrapping.
- Recognize those among us who are striving to create a better future.

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Statement for the Record

By the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Small Business

United States House of Representatives

April 3, 2008

Statement for the Record

American **Bankers** Association

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Madam Chairwoman and members of the Committee, the American Bankers Association (ABA) is pleased to submit this statement for the record regarding the use of credit cards by small businesses. The ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $12.7 trillion in assets and employ over 2 million men and women.

ABA appreciates the opportunity to submit this statement for the record regarding the use of credit cards by small businesses and we would like to thank Chairwoman Velázquez for exploring this issue. Given that credit cards are responsible for more than $2 trillion in transactions each year in the United States and are accepted at millions of merchant locations and ATMs, there can be little doubt of the significant role they play in our national economy. It is important for this Committee to consider how useful credit cards are to small businesses, particularly start-ups that may have limited access to other sources of funding.

As Congress contemplates intervening in the credit card marketplace, it should consider the potential that such intervention will have substantial negative, unintentional consequences for both

consumers and our nation's small businesses. These are likely to come in the form of higher prices and less access to credit and – with respect to small businesses – will come at a very inopportune time in our economic cycle.

Credit cards are used by small businesses every day. They serve as a source of funding, as a means for handling short-term fluctuations in cash flow, as a tool for tracking purchases and controlling employee spending, and as an instrument for simplifying tax preparation. These benefits are significant and legislation that reduces them will be harmful to small businesses.

The ABA would like to make two points with regard to this issue:

- Small businesses are significant participants in the credit card market.
- Policymakers should exercise caution as legislative intervention into the credit card market may have unintended consequences that will harm small businesses.

I. Small Businesses Play a Significant Role in the Credit Card Market

Credit cards are used with such ease and ubiquity today that it is easy to take them for granted. Industry participants spend vast amounts of time, money and resources each year to maintain and improve upon the complex electronic payment system that makes using credit cards so easy and convenient. Thanks to continual innovation and market forces, credit cards have evolved from a simple perk for the wealthy into an everyday financial tool that everyday people can use to make purchases and manage their personal finances.

But credit cards are more than just a convenient purchasing device for consumers; they are also an indispensable source of funding for small businesses.

One of the greatest reasons why small businesses fail is because they lack sufficient capital. Traditional sources of capital generally require that collateral be pledged as a guarantee of repayment. In many cases, funds borrowed may only be used for a pre-approved purpose, such as the purchase of heavy equipment or industrial machinery. Absent sufficient collateral, the risks are too great for banks to loan money based solely on the notion that a business idea is a good one.

Credit cards do not carry the same limitations as traditional loans. Use of a credit card constitutes a loan, but the only security that a card issuer has for the loan is the customer's promise to repay. Moreover, credit cards can be used to purchase goods or services from any vendor that accepts the card. Because of their flexibility and near-universal acceptance, small businesses rely on credit cards to finance many of their operations and manage their monthly expenses.

According to the most recent Survey of Small Business Finances conducted by the Federal Reserve, 77 percent of small businesses used either a business credit card or personal credit card for business expenses in 2003.[1] A more recent survey by SurePayroll, an online payroll service provider, puts the figure at 90 percent.[2] Significantly, Federal Reserve data indicates that almost 30 percent of small business card users carried a balance from month to month in 2003 – that is, they used credit cards as a funding mechanism to keep their businesses running. Based on 2006 statistics from the Small Business Administration (SBA) indicating that there are nearly 27 million small businesses in the U.S., this means that more than ***20 million*** small businesses use credit cards in their business operations and that more than ***8 million*** use credit cards as a source of funding. This figure is likely much higher considering that the Federal Reserve statistics are five years old. Data from the 2007

[1] Traci L. Mach and John D. Wolken, "Financial Services Used by Small Businesses: Evidence from the 2003 Survey of Small Business Finances," *Federal Reserve Bulletin*, October 2006, p. A167.

[2] News Release, SurePayroll, SurePayroll Insights Survey: Business Owners Share Opinions on Perks and Pitfalls of Business Credit Cards, April 16, 2007, *available* at http://www.surepayroll.com/spsite/press/releases/2007/release041607.asp

SurePayroll survey suggests that nearly 40 percent of small business card users carry a balance, meaning that upwards of ***10 million small businesses*** use credit cards as a funding mechanism.

The role credit cards play as a financing tool for small businesses is enhanced with commercial cards. Commercial credit cards operate in much the same way as personal credit cards with the main difference being that they are issued to a business or its proprietors rather than to individual consumers. Business credit cards used to be plain vanilla with few perks, but today there is a wide variety of rewards programs that small business owners can choose from. Another difference is that while some business cards carry preset spending limits like personal cards, others do not, although these usually carry annual fees. It is estimated that commercial cards were responsible for nearly $500 billion in volume from cards issued in the U.S. in 2006.[3] These cards are a significant tool for managing cash flow concerns as well as a convenient source of funding when necessary.

Credit cards serve not only as a valuable source of funding for small businesses, they also improve the ability of small business owners to closely monitor and control expenses and they aid in tax preparation. Monthly credit card statements make it easy for small businesses to keep track of capital outlays and they significantly reduce the costs associated with wading through piles of paper receipts and invoices. Commercial credit cards also allow small business owners to avoid commingling their personal finances with those of their business and some commercial cards can be set up to limit how much money employees can charge or where they can use them. This improves efficiency and gives proprietors greater control over their business. Small business owners are also increasingly using their credit cards to pay their quarterly tax bills. According to a recent study by Visa USA, credit card spending on tax payments and preparation by small businesses increased 80

[3] "Commercial Cards' Share of B2B Payments Grows," *Cards and Payments*, March 2008, p. 20.

percent between February 2006 and February 2007.[4] Using a credit card for this purpose helps small businesses avoid tax liens and small business owners get the extra benefit of adding points to their rewards programs.

Finally, it is important to recognize that credit cards also generally carry a zero-liability policy. If unauthorized use of a card occurs or a business entity does not receive an expected shipment of goods, the charges can be contested and are usually reversed almost immediately pending resolution of the dispute. This benefit is extremely significant for small businesses, particularly those for which cash flow is a big concern. The ability to avoid an unexpected outflow of funds helps keep afloat those small firms that often have to wait 90 or 120 days to get paid for their goods or services.

II. Intervention in the Credit Card Market Will Negatively Impact Small Businesses

Given the fact that millions of small businesses regularly use credit cards for both funding and day-to-day business management purposes, significant harm could result from legislative intervention that reduces access to credit cards or increases the cost of their use. If legislation contains price control provisions (or the functional equivalent thereof), the cost of borrowing will increase. A recent study by noted economist Jonathan Orszag bears this out.[5] According to Orszag, price controls that were placed on interchange fees in Australia in 2003 have resulted in an increase in fixed prices for cards. Annual cardholder fees have increased by more than 30 percent and the value of rewards to cardholders has decreased by nearly 20 percent. Similarly, the Office of Fair

[4] "Small Businesses Pay Taxes With Credit," *Washington Post*, June 12, 2007.

[5] Orszag, Jonathan, "An Economic Assessment of Regulating Credit Card Fees and Interest Rates," Commissioned by the *American Bankers Association*, September 2007.

Trading in the United Kingdom set maximum limits on credit card penalty fees in 2006. According to Orszag, recent reports indicate that several companies have reintroduced annual fees and raised fees in other areas.

Price controls not only run the risk of increasing costs for borrowers, they also threaten to reduce access to credit. If card issuers are limited in their ability to accurately price their products to reflect the risks involved, they will be less likely to extend credit to riskier borrowers.

Higher prices and less access will have a detrimental effect on small businesses – particularly on start-ups. Many entrepreneurs rely solely on their personal savings and credit cards as a source of start-up capital for their fledgling businesses. Consider the case of Home Artisan Authority, a remodeling business in Dallas, Texas. The proprietors of the firm contributed $5,000 apiece to start the business and the rest was funded with various credit cards. In 2007, sales were just under $2 million and the Home Builders Association of Greater Dallas named the company the 2007 Remodeler of the Year.

The story of Home Artisan Authority is not unique. Many start-ups rely on credit cards to get their business off the ground. Moreover, the vast majority of small businesses use credit cards. If the cost of doing so increased as an unintended consequence of legislative intervention, or if bootstrapping entrepreneurs could no longer get access to credit cards, the deleterious effect on small businesses and the national economy could be significant. According to the SBA, small businesses accounted for 50.9 percent of the domestic work force and all the net new jobs in 2004.[6] Arguably, many small businesses and the many people they employ might not exist today if they were not able to rely on credit cards to help them get started.

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[6] Small Business Administration, Office of Advocacy, *The Small Business Economy: A Report to the President 2007*, p. 9.

Finally, it is worth noting that many small businesses continue to use personal credit cards for business expenses. This is particularly true for smaller firms. According to the Federal Reserve, 46.7 percent of small business owners used a personal credit card to pay business expenses in 2003.[7] Thus, the unintended effect of higher costs and reduced access will be felt not just by consumers who use credit cards for personal expenses, but by many consumers who are also small business proprietors that use credit cards for business reasons.

Conclusion

Small businesses play a significant role in the national credit card market and they receive considerable benefits from using credit cards to manage everyday company affairs. Small businesses are also the backbone of our nation's workforce and a vital part of the economy.

The desire to protect consumers from practices that are deemed harmful is laudable, but policymakers must be wary of the unintended consequences that may result from intervention into the marketplace. If legislative proposals have the unintended consequences of higher credit card costs and reduced credit card access, a significant negative impact on American small businesses could result. Hence, policymakers should exercise caution and carefully consider the full extent of their actions before proceeding.

[7] *See* Mach and Wolken, *supra* note 1.