TESTIMONY OF
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ON BEHALF OF THE
NATIONAL SMALL BUSINESS ASSOCIATION
AT A HEARING BEFORE THE
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
U.S. HOUSE OF REPRESENTATIVES
ENTITLED
"IMPROVING CREDIT CARD CONSUMER PROTECTION: RECENT INDUSTRY AND REGULATORY INITIATIVES"
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Good morning. Chairwoman Maloney and Ranking Member Gillmor, thank you inviting me here today to discuss the impact that various credit-card practices are having on America's small-business community. My name is Marilyn Landis and I am representing the National Small Business Association. I am proud to serve as NSBA's first vice chair as we celebrate our 70th year of small-business advocacy, and continue our long-standing tradition of working in a nonpartisan manner to promote pro-small-business policies. In addition to my leadership role within NSBA, I am the owner of Basic Business Concepts, a consulting and financial management company serving small businesses primarily in Pennsylvania and Ohio.

Prior to starting Basic Business Concepts, I spent 30 years working for and with commercial lenders, banks and small businesses throughout western Pennsylvania. I worked for three of the largest U.S. Small Business Administration (SBA) lenders in the country and have continued working with my clients on securing SBA loans and myriad other sources of capital. After 36 years of working with small businesses, the one thing I can tell you without hesitation is that it is not easy to start or develop a business in America. Entrepreneurs must overcome a host of obstacles to create and expand their businesses—and the practices of the credit card industry are not the least among them.

Small-Business Challenges in Financing

Access to capital is one of the largest obstacles facing America's small businesses, hindering both aspiring and thriving entrepreneurs. In fact, the small-business members of the National Small

Business Association recently identified access to capital as one of the top-10 issues impacting their companies. Many small and startup businesses lack the assets necessary for traditional bank loans. Smaller loans are generally less-profitable for banks, and typically have a higher default rate. The increased usage of personal credit ratings for business owners has further exacerbated the problem. Additionally, ongoing bank consolidation has resulted in fewer community banks and fewer character-based loans.

One of the biggest barriers to small-business financing is debt secured by equity in fixed assets. Many small-business owners do not have the kind of equity required by banks to acquire a sizeable loan. This gap in debt-equity financing primarily hinders both startup businesses and growing businesses. An entrepreneur wishing to open any business would face significant barriers to financing, as home ownership (if the entrepreneur owns a home) rarely meets the equity requirements for receiving a larger commercial loan. The small-business owner seeking to expand his or her business or hire additional employees faces the same challenges.

Small-Business Reliance on Credit-Card Financing

Into this access to capital vacuum, a new capital issue has sprung to the forefront: an increased reliance on credit cards. Starting in the early years of this decade—when a multitude of banks tightened their lending standards—many small-business owners have been forced to turn to credit cards as their primary source of working capital. Bank regulators require business borrowers to have either equity in hard assets or historic cash flow to support their loan requests. Rapidly growing businesses that are not traditional brick and mortar, like mine, have neither. We are forced to use bank credit lines which, if not secured with equity in a home, are increasingly credit card accounts. As such, these loans are subject to credit card regulations, which permit significantly higher and more volatile rates and payment structures. I can personally attest to this phenomenon, as not long ago I applied for a "line of credit" with Wells Fargo and instead received a new credit card.

Rapidly-growing service and technology companies do not want to rely on credit card debt—they are forced to. According to a nationwide survey of small- and mid- sized small business owners, recently commissioned by the National Small Business Association, credit cards are a primary source of financing for America's small businesses. In fact, 44 percent of small-business owners identified credit cards as a source of financing that their company had used in the previous 12 months—more than any other source of financing, including business earnings. In 1993, only 16 percent of small businesses owners identified credit cards as a source of funding they had used in the preceding 12 months. This dramatic increase does not only represent emergency or short-term usage. Of the small-business owners who use credit cards as a source of funding, 71 percent report carrying a balance month-to-month. This is up from 64 percent in 2000. Thirteen percent of small-business owners are carrying a balance of more than $25,000, and 36 percent are carrying a balance more than $10,000.

It is important to note that small-business owners are not turning to credit cards to finance their businesses because they think they are getting a good deal. In fact, among those using credit cards, 53 percent say that the terms of their cards have gotten worse over the last five years.

Why should the small-business community's increased reliance on credit cards and their sense of worsening credit-card terms be of interest to this subcommittee? Put simply, small businesses are the engine of the U.S. economy and the backbone of the communities you represent. Small businesses comprise 99.7 percent of all U.S. employer firms and more than half of all private-sector employees. Over the last decade, they have generated 60 to 80 percent of all net, new jobs in the country. They are responsible for more than 50 percent of nonfarm private gross domestic product. In short, what harms America's small businesses harms America's economy.

The billions of dollars generated from outlandish retroactive interest rates hikes, the escalating imposition of undisclosed fees, and unilateral and unforeseen interest-rate increases is money diverted from economic development. For small businesses, it means less money to advertise or invest in new equipment or hire new employees. A third of small- and mid-sized businesses say that they would hire additional employees if more capital were available to them. More capital might be available if so much of it was not being siphoned off by the unacceptable business practices of the credit-card industry. In order to address the practices that are making running a small business increasingly difficult and hindering the economic development of the nation's small businesses, NSBA supports credit-card reform.

Recommendations

NSBA supports the enactment of the new credit card regulations recently proposed by the Federal Reserve Board. Improved disclosure—which must not be construed as simply *more* disclosure—

is of paramount importance to the small-business community. We are businesspeople, more than capable of playing by the rules—but the rules must be made known, and they must be consistent and predictable.

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

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

There is one predictable aspect of my Bank of America card: the due dates are never the same, fluctuating by five days in the last seven months, from 12/19/06 to 1/20/07 to 2/20/07 to 3/23/07 to 4/20/07 to 5/21/07 to 6/19/07. The statement cut-off has remained the same during this time. The same can be said of my MBNA card, since it was sold to Bank of America. Previously, the due date was the 27th of the month. Between December 2006 and April 2007, the due dates for this card fluctuated greatly, from 12/28/06 to 1/27/07 to 2/24/07 to 3/22/07 to 4/22/07. Again, the statement cut-off has remained the same during this time. While I will stop short of calling this willful inconsistency, however it is characterized it makes running a business more challenging and perilous.

As welcome and necessary as the improved disclosure practices at the heart of the Fed's proposal are, they are not enough. Adding more pages to the typical encyclopedic credit card contract (which, on average, is now longer than 30 pages, according to the *Wall Street Journal*) will do little to assist most small business. America's entrepreneurs are not naïve or uniformed consumers. They are accustomed to dealing with myriad complex financial and regulatory frameworks. The current rules—such as they are—governing the credit-card industry are simply stacked against them.

Eliminate Universal Default

Starting in 2000, credit card issuers began increasing a credit card holder's interest rate if the cardholder was late on an unrelated payment to a different credit card, a utility company, or a mortgage lender, to name a few. This practice, known as "universal default," is particularly injurious to small-business owners, who have intermingled personal and professional finances as they increasingly rely on personal credit cards to finance their businesses. In practice, universal default meant small-business owners that were a day late paying their power bill might see the interest rate on their business credit card soar to nearly 30 percent.

In 2004, the Office of the Comptroller of the Currency issued a guidance to banks urging them to disclose this practice in promotional materials. This guidance, which included language warning of the risks of using a universal default policy, was fairly successful in motivating U.S. credit-card issuers to cease the practice. According to a September 2006 report by the Government Accountability Office (GAO), however, three of the 28 most popular cards still employ a universal default policy. This GAO report also found that four other of the most-popular 28 cards are seeking to reinstate universal default, but are trying to do so under the auspices of a "change-in-terms," which unlike the automatic increase previously done with universal default can require prior notification.

While Regulation Z of the *Truth in Lending Act* requires that affected cardholders be notified in writing of any proposed changes in rate terms at least 15 days before such change becomes effective—and the Federal Reserve proposed increasing this notification period to 45 days—this "opt-out" option does little to help small businesses who are carrying large month-to-month balances. Most small-business owners forced to turn to credit cards to finance a capital expenditure or an expansion of their business would be hard pressed to immediately pay off their balance with a 15, or even a 45, day notice. NSBA urges Congress to codify language preventing banks and credit-card issuers from using universal default increases on credit cards unrelated to a particular late payment.

Eliminate Double-Cycle Billing

The aforementioned GAO report found that two of the six largest credit-card issuers employ a billing technique known as double-cycle billing, wherein the issuers consider two billing cycles when assessing interest on custumers that move from non-revolving to revolving status. In other words, a consumer who begins with no balance and pays off some but not all of his or her new expenditures is forced to pay interest on the entirety of the original bill, even that which previously had been subject to an interest-free period.

Eliminate Retroactive Application of Interest Rate Increases

As exorbitant as the penalty rates most credit-card issues charge may appear, the small-business members of NSBA are not advocating a cap—although America's small-business community certainly would welcome a voluntary reduction in penalty rates or an enlarged threshold for their application. Jumping to the average default rate of 27.3 percent because of one late payment or slightly exceeding one's credit limit seems an awfully stiff penalty. Having said this, NSBA does support eliminating the retroactive application of penalty rates. This effectively increases the purchase price of products and services for which consumers are already committed. This *ex post facto* application is contrary to basic market principles and undermines business plans. As Travis Plunkett, legislative director of the Consumer Federation of America, recently testified before this committee, "There is no other industry in the country that is allowed to increase the price of a product once it is purchased."

Conclusion

America's small-business owners are not in the habit of advocating the passage of increased federal regulations, preferring free enterprise and market solutions, but there is no functionally-free credit-card market. One of the basic tenets of the free-market capitalism is the sanctity and insolubility of contracts, but somehow the credit-card industry has managed to insulate itself from adherence to this basic principle, retaining the right to unilaterally change the conditions of their contracts.

Free market competition also is based on informed consumers, but the business practices of the credit card industry appear geared more towards obfuscation than illumination. The aforementioned GAO report found that credit-card disclosure statements were written at too-high a level, displayed poor organization and formatting, and were filled with extraneous, non-pertinent information. As Professor Elizabeth Warren recently testified before the full committee, "In a perfectly competitive market, both firms and consumers have the information they need to make sound economic decisions. Because these tricks and traps are effectively hidden from customers—invisible until they bite, that is—credit card issuers face no economic penalty in the marketplace for including them in card agreements."

The free-market system also relies on actual competition, but there is no longer real competition in the credit card industry. By 2006, the top three card issuers controlled more than 61.8 percent of the market (understood as their proportion of outstanding credit card debt) and the top 10 issuers controlled 88.1 percent in 2004, according to Professor Robert Manning.

The small-business community is not opposed to the credit-card industry nor does it begrudge it the $109 billion in revenue it made in 2005. In fact, as I previously outlined, the small-business community is increasing reliant on credit cards for its very existence. This is why Congress must act to protect the interests of America's small businesses, while still allowing the credit-card industry ample opportunity to turn a profit. NSBA strongly encourages both the administration and Congress to fully support small businesses as the true centers of growth in the U.S. economy and take the lead in ensuring that egregious credit-card practices are not restricting small-business growth.

I thank you for your time and welcome any questions.