Small Businesses and Credit Cards: New Rules for Plastic in an Economic Recession

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A lack of capital through traditional forms of lending to small businesses has long led many entrepreneurs to rely on credit cards. However, firms relying on credit cards have recently been subjected to numerous "any time or any reason" change in terms notices, and banks have cut credit lines, and increased rates, minimum payment amounts, and fees. The challenges encountered by small businesses in an already difficult business environment could well increase the time it takes for the economy to recover, because these are the very firms that would otherwise be driving job creation and growth.

INTRODUCTION

Small businesses in the United Sates have been subjected to significant stresses during the recession that began at the end of 2007 and has continued through 2010, with only a few signs of improvement (some of which have destabilized during the summer months of 2010). This paper reviews current issues related to small businesses and credit cards, with a particular focus on stresses experienced during the 2007-2010 recession, ongoing. A lack of capital through traditional forms of lending to small businesses has long led many entrepreneurs to rely on "plastic" in the form of more and more credit card debt, but banks have cut credit lines, increased rates, minimum payment amounts, and fees, or otherwise imposed more and more onerous terms.

One of the problems associated with this shift is the exposure that the firms relying on credit cards have begun to experience with increasing regularity, namely changes in the basic terms and conditions of the cards "at any time or for any reason," at the sole discretion of the lending institution, with little or no recourse for the borrower. Consumer angst reached a crescendo which served as the impetus for Congress to enact the passage of the C.A.R.D. Act, but so-called "business" cards were excluded. Further, many start-ups rely on "personal" credit card account-types. Indeed, Federal Reserve Board data shows that as firms mature, they tend to more frequently adopt and use business credit cards. The challenges encountered by small business start-ups in an already difficult business environment could well increase the time it takes for the economy to recover fully, because these are the very firms that would otherwise be driving job creation and growth.

As of July 2010, the unemployment rate was 9.5%. According to the U.S. Bureau of Labor Statistics:

> Total nonfarm payroll employment declined by 131,000 in July, and the unemployment rate was unchanged at 9.5 percent, the U.S. Bureau of Labor Statistics reported. Federal government employment fell, as 143,000 temporary workers hired for the decennial census completed their work. Private-sector payroll employment edged up by 71,000. Both the number of unemployed persons, at 14.6 million, and the unemployment rate, at 9.5 percent, were unchanged in July. Among the major worker groups, the unemployment rate for adult men (9.7 percent), adult women (7.9 percent), teenagers (26.1 percent), whites (8.6 percent), blacks (15.6 percent), and Hispanics (12.1 percent) showed little or no change in July. The jobless rate for Asians was 8.2 percent, not seasonally adjusted. ("United States Unemployment Rate ", 2010)

With the release of the July 2010 unemployment figures, the Federal Reserve Board announced on August 11, 2010, that it would continue to pursue stimulus policies to avoid what spokespersons fear is a "double dip" recession. The *Financial Times* notes that only months earlier the Fed was headed in the opposite direction: "The move signals a significant shift in thinking at the Fed, which only a few months ago was tilting towards tightening monetary policy to fend off inflation as the economic recovery gathered strength. Fed officials significantly downgraded their economic outlook, saying the "pace of recovery in output and employment has slowed in recent months" and was likely to be "more modest" than anticipated in the near term" (Politi, 2010).

The move to invest proceeds from the Fed's mortgage-bond portfolio in longer-term Treasury debt was met with criticism by the longest serving of the Fed's 12 district bank presidents. Mr. Hoenig, president of the Kansas City Fed since 1991 warned that: "Monetary policy is a useful tool, but it cannot solve every problem faced by the United States….In trying to use policy as a cure-all, we will repeat the cycle of severe recession and unemployment in a few short years by keeping rates too low for too long" (Chan, 2010).

The impact of the downturn on credit is highlighted in the March 6, 2009, Economic Letter (Udell, 2009) published by the Federal Reserve Bank of San Francisco (FRBSF), where it states:

> A key barometer of credit conditions, the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, showed a record level of tightening in October 2008 over the previous three months. For large firms, 84.4% of the largest surveyed banks and 82.6% of the smaller surveyed banks reported a tightening of credit standards. For smaller firms, 71.9% of the larger banks and 78.3% of the smaller banks reported tightening. None of the surveyed banks reported any easing of standards. The January 2009 survey also showed severe tightening—though not quite as dramatic as the October numbers. For large firms, 65.5% of large banks and 62.5% of smaller banks cut back credit over the three-month period. For small firms, the percentages were 67.8% and 70.9% respectively. Just as in October, no banks reported any easing over the period. (p. 1).

However, "credit cards have become a common form of new-business borrowing. With the recent contraction of credit markets, many new businesses will face difficulties in accessing traditional forms of credit, which likely will create greater demand for credit cards" (Scott III, 2009). The FRBSF letter goes on to state that the credit crunch may hit small businesses particularly hard since they do not have direct access to public markets like the larger firms have. It is because commercial banks are the primary source of external finance for small businesses that the credit crunch associated with the recession is of concern.

The H.8 report of the Board of Governors of the Federal Reserve System ("Federal Reserve Statistical Release: H8 Report--Assets and Liabilities of Commercial Banks in the United States," 2009) shows the continuing decline in commercial and industrial loans from $1,572.9 billion in August of 2008 to $1,452.2 billion in August of 2009. As of September 16th, 2009, the loans had shrunk further to $1,415.4 billion.

With the above as a backdrop, the authors of this present paper review the use of credit cards by small businesses (Lahm, 2005). The continued recession and the consequences of a “severe tightening” of credit standards (as they have impacted entrepreneurs and consumers) has reduced small business expansion and consequently has reduced the potential contribution of small business to an economic recovery.

BUSINESS CREDIT CARDS – A RELATIVELY NEW DEVELOPMENT

Small business cards are a relatively new product. Staff members of the Federal Reserve System in preparation for submitting their report pursuant to section 506 of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (C.A.R.D. Act) interviewed a number of small business card issuers - “Some of the issuers did not enter the business until the mid-to-late 1990s” ("Report to the Congress on the Use of Credit Cards by Small Businesses and the Credit Card Market for Small Businesses," 2010). This observation was also noted by the National Small Business Association report that credit card usage among small business owners hit 44 percent in 2007, compared to just 16 percent in the 1990s (O'Connell, 2008). The National Small Business Association estimates 59% of small business owners use personal or company credit cards to finance their businesses. And most of them have had the interest rates on those cards increased or credit limits reduced, according to a new survey by the organization (Kass, 2009).

Two major reasons may account for why small business owners are resorting to the use of both personal and business credit cards. Macro-economic developments had a major role in discouraging lending by banks to small business. With the implosion of the housing bubble and the demise of capital due to the lack of liquidity of the market for collateralized housing derivatives, many large banks that normally lend money to smaller banks in the course of regular bank operations were unable to do so. The result was that smaller banks who normally lend to local, small businesses were unable to extend credit in order to comply with Federal Reserve risk-based capital requirements.

While the Federal Government did have TARP money to bolster the big banks, taking money from the Federal Government resulted in very harsh regulations and penalties for higher risk loans, which meant that bank officers were regulated into using the TARP funds to buy “riskless” securities - US Treasury bonds and notes. Most bankers had the sense to realize that borrowing at nearly zero percent interest allowed them to create profits by investing in 1.5% Treasuries. Business owners could see that the economy was heading into a recession and they trimmed their borrowing. The smaller businesses found that maintaining their conventional lines of credit was becoming more difficult as the smaller banks reduced their exposure to loans to small businesses due to anticipated higher risk from the declining economy (Ivashina, 2009).

Speaking before The Business and Industry Association of New Hampshire and the Greater Manchester Chamber of Commerce, the President of the Federal Reserve Bank in Boston on September 2008, noted that:

> The results of the July 2008 survey indicated that nearly 60 percent of banks had tightened their lending standards for large firms and 65 percent had tightened their lending standards for small firms. This was the largest percentage of banks tightening commercial and industrial loan standards for small firms in the survey’ history, which includes both the 2001 and 1990 recessions (and the number for large firms is right in the vicinity of the observations from those eras. (Rosengren, 2008).

A second advantage of using credit cards to finance a business is that creating such banking relationships increases access to capital. Some academic researchers have suggested that data from the early 1990's suggests that greater access translates to lower costs of capital (Peterson, 1994). The problem is that by 2008, the availability of credit shrank for small business so that comparisons are skewed by the impact of the recession.

Credit cards are appealing to small business due to more pragmatic reasons: They are easier to obtain than traditional bank loans or government business plans. In filling out a credit card application, business plans and other documentation followed by lengthy waiting times for traditional lines of credit or SBA loans are not required. The credit cards offer some flexibility in that "draw downs" are done through the Internet and most credit cards are accepted world-wide; further, the creditor does not have to give approval on how the credit cards are used (Scott III, 2009).

CREDIT CARD USAGE AMONG 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). 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.

According to the Federal Reserve Board, as of 2003, 77.3 percent of small businesses used either a personal or a business credit card ("Report to the Congress on the Availability of Credit to Small Businesses," 2007). We would explain that these reports are published at five year intervals: the 2007 report is based on 2003 data (and that which came before it); the previous report was dated 2002, and was based upon 1998 data (and 1993 data). Subsequently, the Federal Reserve Board reported that as of the end of 2009, the use of credit cards by small business had grown to 83 percent with 64 percent using small business cards and 41 percent using personal cards ("Report to the Congress on the Use of Credit Cards by Small Businesses and the Credit Card Market for Small Businesses," 2010). During 2009, and in the midst of the recession, 20 percent of small businesses attempted to obtain a new credit card (four out of five were applying for a "business" card). As compared with applications for small loans where only one third of applicants were successful, the success rate for credit cards was 50% ("Report to the Congress on the Use of Credit Cards by Small Businesses and the Credit Card Market for Small Businesses," 2010).

Relative to the type of credit card, either "personal" or "business," that may be used, based on 2003 data from the 2007 Report, 46.7 percent used personal cards while 48.1 percent used business credit cards. More recent data from the Fed's 2010 report showed that 80% of small businesses were using business as opposed to personal cards. The Federal Reserve Board's previous report ("Report to the Congress on the Availability of Credit to Small Businesses," 2002) found that 46 percent used personal cards, and 34.1 percent used business credit cards. Between 1998 and 2009, we observed a marked increase in the use of "business credit cards," which is presumably associated with stepped-up efforts on the part of the credit card industry to aggressively market business credit cards. And, since the C.A.R.D. Act excluded business credit cards, credit card issuers may be more inclined to aggressively market these over personal cards.

With respect to the use of personal credit cards, businesses that are organized as sole proprietorships (in terms of their legal form) have been identified as the heaviest users of personal credit cards, and among the lightest users, relatively speaking, of business cards. Thus, we can observe that generally, as a firm matures relative to its organizational form, it may gradually migrate away from personal credit cards to business credit cards.

According to the 2002 Federal Reserve report, "This difference may indicate that small firms have more difficulty than larger firms in obtaining business credit cards and therefore use personal cards as a substitute." We can also note that reliance on personal cards is heavier prior to incorporating, and incorporating usually comes as a natural evolutionary step when businesses mature and grow in size, complexity, number of employees, and the number of years that they have been in business. Hence, fledgling entrepreneurs tend to rely on personal credit cards, the most.

The Small Business Administration (SBA) defines small businesses as those that have less than 500 employees, and according to its most recent data ("SBA: Frequently Asked Questions," 2009), small firms represent 99.7 percent of all employer firms. In 2008 there were 29.6 million businesses in the United States. The SBA also reports that "Credit cards account for much of the growth in small business lending over the past few years" (2009 FAQs, p. 2). To add further perspective, it also reported that of the 29.6 million businesses, 21.7 million had no employees.

While the NFIB's data set and that of the SBA are not formally related, it is important to note (again) 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; the NFIB showed that many entrepreneurs work from home. The Fed's 2010 report notes that:

> The small business credit card market has grown considerably since the late 1990s. According to *Nilson Reports* (2003 through 2008), a payments industry newsletter, spending on small business Visa and MasterCard credit cards more than tripled between 2002 and 2007, to about $150 billion in 2007, and held steady at that level in 2008. Despite this rapid growth, the small business credit card market is still quite small in terms of annual spending compared with the consumer credit card market. Indeed, spending on Visa and MasterCard consumer credit cards exceeded $2 trillion in 2008 ("Report to the Congress on the Use of Credit Cards by Small Businesses and the Credit Card Market for Small Businesses," 2010).

VERY SMALL FIRMS' RATIONALE FOR CREDIT CARD USAGE

The 2002 FED Report to the Congress stated "survey evidence suggests that credit cards are used primarily for convenience and that, despite a large increase in the use of credit cards between 1993 and 1998, small businesses have not substantially increased their use of credit cards as an alternative to traditional forms of credit" (pg. 29), and the 2007 report made a similar observation. However, the 2007 report added, "Such behavior [that "they paid their credit card balance in full each month"] suggests that most firms used credit cards for convenience and not as a substitute for traditional credit products."

We might add that credit cards could, on the other hand, be used as a cash flow management tool from month to month, i.e., as a means to supplement cash flow, even if balances are paid in full. Further, "Smaller and younger firms, which are most likely to have difficulty obtaining traditional forms of credit, were more likely to carry balances on their credit cards" (2007 Report to the Congress).

It should be noted that it is not easy to distinguish the purpose or circumstances that may be associated with such usage of personal credit cards, regardless of such an assessment on the part of the FED Report's authors. To define and discern the true intentions and circumstances behind every purchase decision, therefore, would be a daunting task, even for credit card companies that obviously are in a position to track every single transaction relative to their dollar amounts and the parties who are involved. Despite such a robust capacity to track transactions themselves, knowing the actual rationale behind such transactions would require something akin to "mind reading."

For instance, some purchases might be for shopping convenience, whereas cash advances, balance transfers, and other transactions might be associated with a genuine need for funds to support ongoing operations, or start-up capital. Focusing on one small example, supposing that a small business owner purchased an Internet domain name for $10, and charged that to a personal credit card, the question becomes: "Was that because he or she found that it was convenient to charge an online purchase, or because the funds available on a personal credit card were actually needed to support start-up costs?"

Another interesting caveat is that functionally speaking, so-called “business” credit cards and “personal” credit cards may not differ at all relative to liability. In other words, many business credit card applications still hold a business owner or officer personally liable, even if the name on the card that is issued is associated with a business or profession (Lahm & Geho, 2007).

RECENT CREDIT CARD USE PROBLEMS FOR SMALL BUSINESSES AND CONSUMERS

According to the US PIRG’s TruthAboutCredit.org website, “Credit card terms keep changing. Read the fine print and find this disclosure: “We reserve the right to change the terms (including the APRs) at any time for any reason, including no reason. A fixed rate is fixed only until the bank provides at least 15 days notice that it isn’t” ("The Worst Credit Card Industry Practices: Deals That Are Too Good to Be True," 2008).

In its recent *National Business Poll*: *Credit Cards,* the National Federation of Independent Business (NFIB) reported that approximately one-third of small businesses “Small business owners, as credit card consumers, in the last 12 months often experienced abusive practices by the industry. For example, 14 percent did not receive credit for payments until well after the payment cleared and 11 percent were charged overdraft fees when the overdrafts were the exclusive result of bank holds” (Dennis, 2008).

Because small business owners often use personal credit cards, we feel it is relevant to observe that a significant tightening across the board in credit card markets has been problematic for all concerned. For example, as observed by O'Connell on the website, CreditCards.com:

> Bank of America’s small business line of credit program is essentially a Visa card, and it’s been that way for some time now. “Like most banks, Bank of America is raising interest rates based on owner’s credit scores, cutting credit lines, and lowering credit amounts even for business owners with stellar credit,” he says. “And they're doing so by design because they can cut risk and make money on the higher rates -- and because business owners don’t have many financing options right now” (O'Connell, 2008).

Beyond slashing credit lines and raising rates, Chase Card Services imposed a change in terms by sending account holders a notice that their monthly payments would increase from 2% of the balance to 5% of the balance (Grow & Berner, 2009); a.k.a., “payment-jacking” ("The Case Against Chase -- Issue Backgrounder," 2009). Credit card account holders at large are angered (Frye, 2009; Hook, 2009; Leatherdale, 2008) to the extent that they have revolted in unprecedented numbers, pushing for reforms such as the Credit Card Accountability Responsibility & Disclosure (C.A.R.D.) Act (Klein, 2009). Finally, because these markets are in a state of flux, as researchers we are concerned that no real mechanism appears available to fully understand the effects of tightening credit on small businesses; but, they are very likely to be harmful (Martin, 2009; Mindy, 2008; Tarquinio, 2008).

SO WHAT?

Given the often quoted observation that small business employs nearly half of the private sector works, and that each year since the mid-1990s, small business has been attributed with creating between 60 and 80 percent of new jobs, the implications of greater use of credit cards and the tightening of conventional bank financing are striking. The availability of credit for the job creation engine of the economy, small businesses, has devolved into a constrained and costly source of capital. Simultaneously the availability of private capital has been reduced. Entrepreneurs, those in the start-up phase as well as those trying to grow their businesses, have long indicated that one of the biggest problems they face is access to capital (Bernie, 2009; Gern & Jannsen, 2009; Martin, 2009; Tarquinio, 2008).

The Kaufman Firm Survey report dated March 2008 (Table 12) (Ballou et al., 2009) shows clearly the extent to which small firms rely on credit card financing. 48.1 percent of firms are financed with some form of personal debt; and 30.1 percent have personal credit card debt and 14.6 percent have business credit card debt. Direct bank loans are used by 18 percent. It is virtually impossible to overstate the importance of bank financing, either via credit cards or direct loans to small businesses.

Economic stimulus plans have largely been focused on financial institutions and the industries with large labor union representation. Those with the connections and resources to successfully lobby the federal government are at the front of a very long line of entities seeking to grow their way out of the worst recession in decades. In some cases those at the front of the line were the very ones who had a major hand in creating the toxic financial environment that small businesses face today. It is unconscionable to believe that the most important engine for growth – small businesses – would be left to try and scrape together the crumbs off the banquet table where executives in the financial services industry and others have recently dined at the collective expense of taxpayers.

Hopefully, established small business owners (and would-be entrepreneurs) will demonstrate a more conservative use of credit card debt than the general public and certainly more restraint than the financial engineers who constructed the mortgage backed securities that led to the housing bust. In the meantime, especially in light of radical "change in terms" notices (there is even an entire protest Website devoted to these, ChangeInTerms.com) affecting consumers and small businesses as have been issued over the past several months (e.g., payment-jacking, rate-jacking, slashing credit lines, and closing accounts), entrepreneurship researchers and educators, should find these issues, which are of dire concern in the practitioner world, to be extremely relevant as topics for discussion and further examination.

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