SMALL BUSINESS FINANCING

Roles of Consumer Credit, Credit Card Financing and Mortgage Credit

Testimony
in the front of the
House Committee on Small Business

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David A. Walker
John A. Largay Professor
McDonough School of Business
Georgetown University
Washington, DC 20057
walkerd@georgetown.edu
202-687-4582

INTRODUCTION

Madam Chairwoman, Committee members, fellow panel members, and guests. Thank you for the opportunity to testify in front of the House Committee on Small Business.

Background

My interest in small business originates from 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 that I believe is relevant to this hearing. My summary bio and complete resume are provided in Appendix C.

As you may have noticed from my bio, until 2005 I chaired the governing board of the Credit Research Center (CRC) at Georgetown. I did not receive any compensation whatsoever for this service and in no way will that experience influence my testimony.

The CRC is funded by a variety of research grants from many 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 my friend and co-author Dr. Thomas Durkin, formerly senior economist with the Board of Governors of the Federal Reserve for 22 years, and my former student, Mr. Jay Tuli, vice president of commercial lending for Leader Bank, a $212 million nationally chartered 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. 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. Costs and the supply of consumer credit and mortgage debt are within the subject of these hearings.

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 double A bond rate, for example, has reduced the level of consumer credit outstanding by 10 percent over the past 60 years.

In that same study, Dr. Durkin and I argue that much of 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 actually a net lender in financial markets (usually through financial intermediaries), households still 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, 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 during those years. Many other household economic factors have risen sharply over this period and generally in the years since World War II, however, including employment, income, assets, and wealth.

Despite the obvious cyclical contribution of credit availability to support the expansion of consumer spending (and economic growth), the increase of consumer debt levels in cyclical upswings inevitably leads to expressions of concern.[1] Because the periods of most rapid growth in consumer credit usually occur early in the business cycle, later cyclic stages are perennially subject to the contention that consumer debt has risen "too fast" or that the level has become "too high." Doomsayers assert that high and increasing debt levels lead inevitably to overindebtedness and are likely to cause delinquencies, a spending slowdown, recession, and rising unemployment. Some of this concern is directed towards housing-related debt, especially recently in the subprime area, but much concern aims also at consumer credit, in the recent past decades particularly at credit card debt. Certainly, communications media pronouncements about consumer credit growth have generally been dismal (see Durkin and Jonasson, 2002). It is difficult to estimate how influential such statements have been, if at all, but even the casual empiricism of asking one's neighbors for their views of the domestic credit picture reveals the widespread notion that consumers' credit use has grown too fast for too long.

One possible cause for credit growth among consumers is the hypothesis of consumer profligacy and some sort of inexorable desire to live beyond one's means. But there are other possible explanations for credit growth, ranging from statistical artifacts associated with how the data are collected to changing population demographics and greater macro-economic stability over time that have produced a greater willingness to take on the risks sometimes associated with increased leverage. There is also the possibility that leverage, or at least the asset accumulation that greater leverage permits, is a luxury good where an income elasticity greater than one might reasonably be expected. This paper does not explicitly attempt to model the behavioral foundations of such a possibility, but rather presents an empirical approach to exploring correlates of postwar credit growth and explaining empirically the trends it exhibits." (Durkin and Walker, 2008, pages 5-6).

Subprime Lending

[1]See, for example, front-page articles in the Wall Street Journal for June 17, 1964, January 29, 1970, March 26, 1973, June 28, 1977, December 2, 1985, and February 2, 1987, among others. [XXX STEPH: CAN YOU HELP DESIGNATE SOME NEWER FRONT PAGE ARTICLES?]

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.

Consider for example a 2/28 subprime mortgage where the loan equaled virtually 100 percent of the 2005 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 you would find on an adjustable rate mortgage. For example, the rate in 2006 might have been 5% for two years and the reset might be 7% for 2008-2035 even though the market adjustable rate mortgages in 2008 might be 5.5%. If the borrower has negative equity in 2008, the borrower will not be able to refinance at the 5.5% market adjustable rate. According to an experienced mortgage lender whom I contacted for this testimony, "the offered rate is not normally the same as the fully indexed rate, sometimes the one-year Libor rate plus a margin or spread."

Adjustable rate mortgages have allowed many legitimate borrowers to purchase a home. They 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 often 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.

The following national data for April 3, 2008 are typical, except that many small firms would 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%

In the Chairwoman's home district of Brooklyn, New York, if the borrower had a FICO score of 750 and could offer a down payment of 20 percent, the interest rate on a conforming mortgage (below $417,000 for a single family dwelling) would be approximately 6 percent and the same loan with a FICO score of 650 would be 25 basis points higher.
(Approximately 30 percent of the FICO scores are above 750 and 80 percent of the FICO scores are above 650.)

Financing the Small Firm

Total business borrowing in the US increased by 34 percent, from $562 billion in 2005 to $753 billion in 2006 (*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. The large increase in business borrowing far exceeded the other increments.

The Office of Advocacy of the 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 is not likely an inconsequential occurrence, either for these important businesses or 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, while employment at firms with fewer than 20 employees increased by 59.8 percent and employment at firms with fewer than 500 employees increased by 27.1 percent. (*The Small Business Economy*, page 311). Obviously, 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 on equity. 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. Looking at both of these groups together, over 77 percent of small businesses used credit cards in 2003, an increase from 68 percent determined from a similar survey in 1998 (*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 using credit card users in 2006.

Among small business credit card users, almost 30 percent used revolving business balances (without a fixed payment schedule) in 2003, indicating they were using the credit cards for business financing purposes, an increase of 6 percentage points from 1998. Employing the same multiplication approach, this would mean more than 8 million small business used this form of financing in 2006. The Office of Advocacy of the Small Business Administration has reported in its "frequently asked questions" that "Credit cards account for much of the growth in small business lending over the past few years."

Alpha Omega Jewelers

The unfortunate experience of Alpha Omega Jewelers in Boston exemplifies the 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 see 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. 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 1994 and 2007. According to the National Bureau of Economic Research (http://www.nber.org.cycles.html), between 1994 and 2006, only the period of March 2001 to November 2001 should be considered a recession period. 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 (2000-2001 and currently) when the differences between the credit card rate and the prime rate have declined between 1994 and 2007. Yet throughout the period 1994 -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.

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, the demand, or the cost of credit for small business. The Long Term Goal for a New Regulatory Structure could have an effect 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 improve 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 on matters that are of particular interest to you. As my students can tell you, I am a strong believer in answering "I don't know" to 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	3109	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	908	2506	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	5142	14,211	27,560	51,795	53,626
					2006 Dollars (billions)			
Disposable Personal Income[a]	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	16,102	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

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APPENDIX A

David A. Walker

SMALL BUSINESS CREDENTIALS

David A. Walker
Small Business Finance Credentials

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

chaired the Governing Board for the Credit Research Center(sponsored by the credit card industry), 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

Pages 14-19 are the Alpha Omega Story

APPENDIX C

David A. Walker

SUMMARY BIO

and

COMPLETE RESUME

David A. Walker
John A. Largay Professor
The McDonough School of Business
Georgetown University
Washington, DC 20057
Phone: 202-687-4582 Fax: 202-333-0835
walkerd@georgetown.edu

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. He has applied this expertise to a variety of consulting opportunities, legal issues, and research questions.

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.