The Impact of the Consumer Financial Protection Agency on Small Business

Center for Capital Markets Competitiveness

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I. Introduction

The U.S. Department of the Treasury submitted draft legislation for the Consumer Financial Protection Agency Act of 2009 in July,[1] shortly after the Department proposed this new agency as part of the Administration's overall plan to reform financial services regulation.[2] The Consumer Financial Protection Agency (CFPA) would have significant powers to issue new regulations and toughen existing regulations of consumer financial products. It would also take over the responsibilities of enforcing existing consumer protection laws from federal regulators, including the Federal Reserve Board and the Federal Trade Commission. Under the Act, the CFPA's rules and regulations would function as a floor for individual states that could impose more stringent consumer protection regulations.[3]

Although the CFPA Act of 2009 is focused on consumers, it would also affect millions of small businesses. Most of the 26.7 million businesses in the United States, including the self-employed, rely on credit cards, home equity loans, auto title loans, and other sources of consumer lending to finance their business.[4] They use these loans for everything from obtaining seed capital to start their business, to managing monthly cash flows, and providing working capital. Many of these businesses do not have access to a commercial line of credit, often because they are too small or too new. Many others use consumer loan products to supplement commercial credit.

Small businesses account for significant employment and job growth. According to the Small Business Administration, employer firms with fewer than 100 employees accounted for more than 35% of U.S. employment in 2006.[5] Small businesses include many new firms that tend to grow quickly. These new firms account for a disproportionate share of the net new jobs that

[1] See United States Department of the Treasury, *Consumer Financial Protection Agency Act of 2009* (2009), available at http://www.financialstability.gov/docs/CFPA-Act.pdf [hereinafter CFPA Act] (proposing 2009 Consumer Financial Protection Agency legislation for passage by Congress).

[2] U.S. Department of the Treasury, Financial Regulatory Reform: A New Foundation, June 2009, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. The proposal is detailed at 55-75.

[3] *Ibid*, at 14.

[4] This figure, which is based on 2006 data, includes 20.7 million firms without employees and 6 million firms with employees. For the number of firms *see* Office of Advocacy, U.S, Small Business Administration, Non-employer Firms and Receipts by Industry, 2002-2007, available at http://www.sba.gov/advo/research/ind97_07.pdf. For the numbers of firms with employees, see Office of Advocacy, U.S, Small Business Administration, Firm Size Data, available at http://www.sba.gov/advo/research/st_06.pdf.

[5] See Office of Advocacy, U.S, Small Business Administration, Firm Size Data, available at http://www.sba.gov/advo/research/st_06.pdf. This figure is an underestimate since it excludes most individuals who have no employees besides themselves. When the number of non-employer firms are included and one assumes that each non-employer firm accounts for one job position, the share increases to 43%.

are added to the economy. Indeed, a Census Bureau study finds that new firms, most of which are small, accounted for most of the net additions to jobs in the United States between 1987 and 2005.[6] Moreover, some of these startups grow into very large firms. Microsoft®, for example, operated as a small firm for several years before growing rapidly into one of the largest corporations in the world based on market capitalization.[7] The well-being of small businesses is critical for the long-term performance of the economy, and the ability of small businesses to obtain credit is essential for their health.

In this economic analysis of the likely effect of the CFPA Act on small businesses, it is probable that if the U.S. Department of the Treasury's CFPA Act of 2009 were enacted, it would have a significantly adverse effect on small businesses by restricting their access to credit. Some would lose access to credit altogether. The businesses that would be most adversely affected would be the new businesses for which consumer loan products are a principal source of funding. As a result, the CFPA Act would inflict the greatest harm on those small businesses that account for a significant portion of the economy's net job growth. Fewer entrepreneurs would be able to start and expand their business. It does not go too far to suggest that the CFPA Act of 2009 could deny the credit that garage-based entrepreneurs need to create the next Apple® or Hewlett Packard®.[8]

The following four specific conclusions have been reached:

1. The CFPA would likely reduce an important source of credit to small businesses. This induced credit squeeze comes at a time when it is likely that small business credit will be already highly restricted as the lending industry digs out of the current financial crisis.
2. The CFPA credit squeeze would likely result in business closures, fewer startups, and slower growth. Overall, this would cost a significant number of jobs that would either be lost or not created. It is not possible to give an exact accounting of the magnitude of this impact, since counterfactual conditions are never directly observable, but there certainly would be an effect similar to opportunity costs.

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[6] John Haltiwanger, Ron Jarmin, and Javier Miranda, "Business Formation and Dynamics by Business Age: Results from the New Business Dynamic Statistics," Working Paper, (May 2008), available at http://econweb.umd.edu/~haltiwan/bds_paper_CAED_may2008_may20.pdf.

[7] See Michael A. Cusumano and Richard W. Selby, *Microsoft Secrets, How the World's Most Powerful Software Company Creates Technology, Shapes Markets, and Manages People* (New York: The Free Press, 1995), at 2-7.

[8] Both Apple and HP started as small, garage-based firms. For Apple, see Jim Carlton, *Apple, The Inside Story of Intrigue, Egomania, and Business Blinders*, (Times Books, 1997) at 5, and for HP, see HP Company Information, "Rebuilding HP's Garage," available at http://www.hp.com/hpinfo/abouthp/histnfacts/garage/.

3. The CFPA adopts a "one-size-fits all" approach to consumer protection that ignores the fact that small businesses use consumer financial products in different ways than the average consumer. Rules that are designed to protect ordinary consumers are likely to impose collateral damages on informed and sophisticated small business owners who depend on consumer loan products.
4. Many suppliers of consumer financial services products are small firms such as community banks. The CFPA would harm these smaller suppliers because the new agency would impose fixed costs of compliance that weigh disproportionately on smaller firms, and because it would encourage product standardization that benefits larger firms. Also, only larger firms have the sophisticated legal staff to cope with waves of new regulations.

Section II of this paper describes the role of small businesses in the economy and, in particular, their role in generating new jobs. Sections III and IV summarize government data on how small businesses finance their operations and demonstrate their reliance on consumer loan products. Section V explains why the CFPA Act would likely reduce small business access to credit. Section VI presents conclusions.

II. The Role of Small Businesses in the Economy

U.S. Census Bureau data show that firms operating at a small scale of production and employment account in the aggregate for a substantial portion of U.S. jobs and output. Entrepreneurs, including those who are seeking to develop large, publicly traded firms, typically start small and grow over time. Many firms start with a self-employed, even part-time individual without any paid employees. Small firms play a significant role in economic innovation and growth, and often in driving American exports. Whether they are mature small firms or startups, small firms have tenuous access to capital, in part because they are too small to rely on the public debt and equity markets, and in part because they face moral hazards and asymmetric information problems that make lenders leery of providing credit to them.

A. Overview of Small Firms

There is a wide range of small firms in the U.S. economy. The smallest of these firms are individuals who work for themselves and who have no employees. There were 15 million self-employed individuals, most of whom did not have employees, in 2007 based on estimates from the U.S. Census Bureau.[9] These individuals include small contractors, home-based manufacturers, professionals working on their own, and a multitude of other small operations. About 75% of all firms with revenues in the United States did not have employees in 2000.[10]

Many businesses have a small number of employees. These include the local landscaper, retail shops ranging from the local jeweler to the neighborhood hardware store, franchises of big brands, restaurants, small manufacturers, and so on. Table 1 reports data on several employment size categories of these firms. Of businesses with employees, there were 5.4 million firms with fewer than 20 employees in 2006. They accounted for 18% of U.S. employment that year and 15% of payrolls. There were 5.9 million firms with fewer than 100 employees in 2006. They accounted for 35% of U.S. employment and 31% of payrolls.[11]

Table 1. Employment and annual payroll by firm size among firms with paid employees, 2006

Employment Size	*Firms*	*Percent of Total Employment*	*Percent of Total Annual Payroll ($1,000)*
<20	5,377,631	18.0%	15.2%
20-99	535,865	17.6%	15.5%
100-499	90,560	14.6%	13.8%
500+	18,071	49.8%	55.6%

Note: Employment is measured in March, thus some firms (startups after March, closures before March, and seasonal firms) will have zero employment and some annual payroll.

Source: Office of Advocacy, U.S, Small Business Administration, Firm Size Data, available at http://www.sba.gov/advo/research/st_06.pdf.

[9] Of those, 9.8 million are self-employed in their own unincorporated business, and 5.1 million in their own incorporated businesses. Some of the self-employees probably own more than one firm and that can explain why the number of firms with no employees is higher than the number of self-employed. See U.S. Census, American Community Survey 3-year Estimate, 2005-2007, available at http://factfinder.census.gov/servlet/DatasetMainPageServlet?_program=ACS.

[10] Although this figure is based on 2000 data, there is no reason to believe that the proportion has changed significantly since then. See Figure 6 in Steven Davis, John Haltiwanger, and Ron Jarmin, "Turmoil and Growth: Young Businesses, Economic Churning and Productivity Gains," Ewing Marion Kauffman Foundation (June 2008), available at http://www.kauffman.org/uploadedFiles/TurmoilandGrowth060208.pdf.

[11] These numbers are an understatement since they exclude self employed with no employees for which no payroll data are available. Employments and Payroll data from Office of Advocacy, U.S, Small Business Administration, Firm Size Data, available at http://www.sba.gov/advo/research/st_06.pdf.

Small firms are present in all industries although they are more common in some than in others. Table 2 shows the percentage of employment in firms with fewer than 10, 20, 100, and 500 employees by major industry. The share of employment in firms with fewer than 20 employees ranges from a high of 51.9 % in Agriculture to a low of 0.5 % in the Management of Companies and Enterprises industry.

Table 2. Share of employment size by major industry

Industry	*Total Employment*	*<10*	*<20*	*<100*	*<500*
Agriculture, Forestry, Fishing, Hunting	165,661	36.4%	51.9%	74.3%	90.7%
Mining	554,333	7.1%	13.0%	29.7%	44.1%
Utilities	614,427	2.3%	3.5%	9.7%	17.8%
Construction	7,338,799	22.7%	36.8%	67.7%	85.4%
Manufacturing	13,631,683	4.1%	8.7%	25.8%	44.4%
Wholesale Trade	6,030,647	11.6%	20.4%	43.5%	61.1%
Retail Trade	15,767,866	11.1%	17.9%	31.7%	40.0%
Transportation and Warehousing	4,306,405	7.5%	12.6%	26.0%	37.8%
Information	3,396,246	4.1%	7.4%	16.8%	26.3%
Finance and Insurance	6,647,098	8.4%	11.9%	21.6%	32.9%
Real Estate and Rental and Leasing	2,216,803	25.8%	35.5%	53.9%	68.6%
Professional, Scientific, and Technical Services	8,054,094	18.8%	28.5%	47.4%	61.6%
Management of Companies and Enterprises	2,915,644	0.3%	0.5%	2.9%	12.1%
Administrative and Support	10,003,626	6.2%	10.3%	21.7%	37.3%
Educational Services	2,979,514	4.4%	8.7%	26.8%	44.8%
Health Care and Social Assistance	16,451,361	9.1%	15.5%	29.7%	48.3%
Arts, Entertainment, and Recreation	1,973,655	10.2%	18.4%	23.4%	45.4%
Accommodation and Food Services	11,381,226	8.1%	18.1%	45.8%	60.2%
Other Services (except Public Administration)	5,458,558	30.5%	46.7%	73.8%	85.4%

Source: Office of Advocacy, U.S. Small Business Administration,
based on data provided by the U.S. Census Bureau. See Office of Advocacy, U.S, Small Business Administration, Major Industries by NAICs Codes: Private Employer Firms, Establishments, Employment, and Annual Payroll by Firm Size http://www.sba.gov/advo/research/us98_01_06n_mi.pdf.

B. Small Firms, New Firms, and Job Creation

Small firms play an important role in creating new jobs for the economy, in keeping the unemployment rate low, and providing an employment cushion when unemployment rises. In 2006, more than 800,000 new businesses were created in the United States.[12] Of those, more than 642,000 had fewer than 20 employees.[13] Many of these businesses hire workers and expand over

[12] In 2006 there were 824,921 new establishments. Latest Statistics (2005-2006) on the change in U.S. Business Employment are available at http://www2.census.gov/econ/susb/data/dynamic/0506/us_state_totals_emplchange_2005-2006.xls. More recent Census data on US businesses are not available.
[13] *Ibid.*

time. Although the failure rate among these businesses is high overall, these new firms contribute a significant portion of the job growth in the economy.[14]

The importance of small businesses for job creation is evidenced by a further breakdown of these and related figures of net job creation. For example, in 2005, firms with fewer than five employees in the previous year accounted for 36.7% of total net job creation, and those with fewer than 20 employees accounted for 45.3% of net job creation.[15] Moreover, it turns out that most of the net job generation comes primarily from startups. The Census Bureau shows that in 2005, startups generated more than 3.6 million net jobs out of 2.5 million total net jobs created.[16] And of all startups, the smallest size firms create most of the new jobs.[17] Haltiwanger, Jarmin and Miranda find that between 1987 and 2005 new firms accounted for most of the net job creation in the United States. As shown in Figure 1, most of the net jobs came from startups. For example, startups with fewer than 20 employees account for 86.7% of net job creation. Many new firms go through a phase where the owner starts the firm and develops it before hiring workers. Self-employment therefore provides a nurturing stage for businesses that eventually expands and generates significant net jobs.[18]

[14] See US Census Bureau, Business Dynamics Statistics Briefing: High Growth and Failure of Young Firms, Figure 1 at.1, available at http://www.ces.census.gov/docs/bds/bds_high_growth_and_failure_ces.pdf.

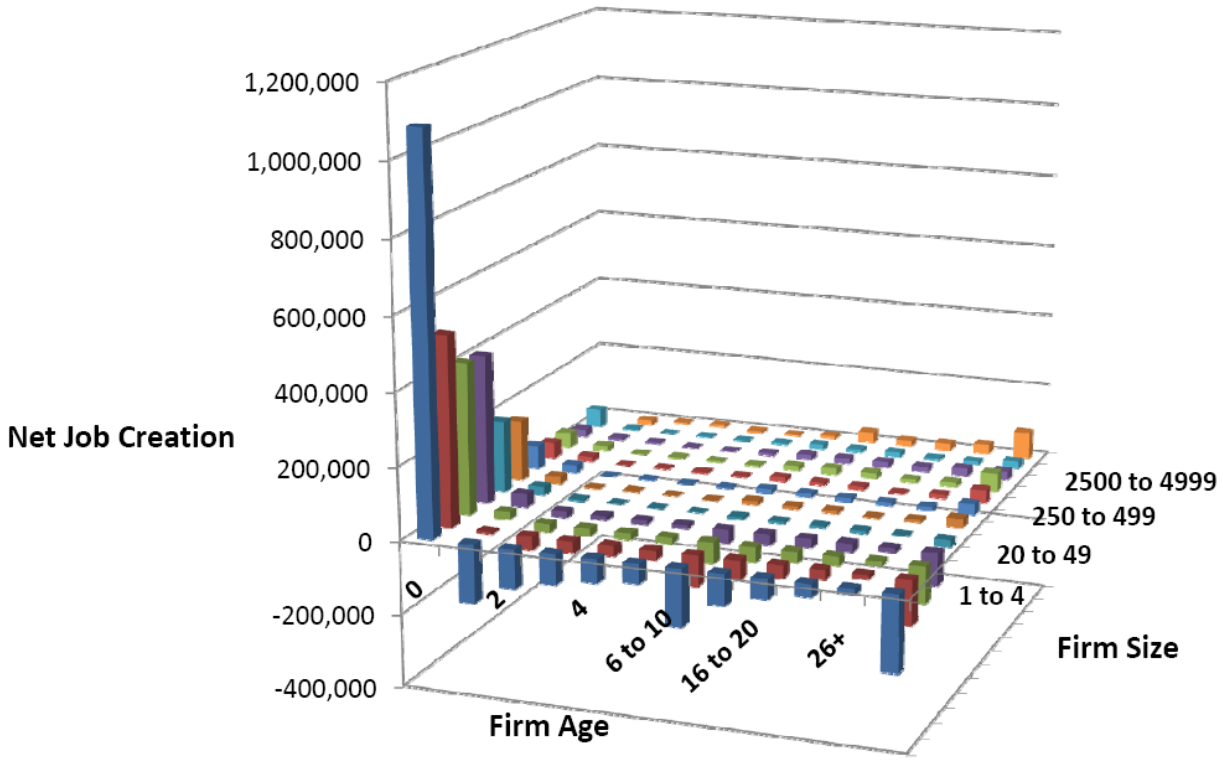
[15] The formation of new firms and the expansion of existing ones over time contribute to new job creation. On the other hand, firm closures and the contraction of employment lead to job losses. Net job creation equals the difference between job creation and destruction. For statistics see Dynamic Business Statistics that have numbers of business openings and closings, startups, job creation and job destruction by firms size. In 2005, total net job creation was 2.4 million, 910,431 of those were created by firms that had less than five employees in 2004. See US. Census Bureau, Dynamic Business Statistics, BDS Dataset List, Initial Firm Size, available at http://www.ces.census.gov/index.php/bds/bds_database_list.

[16] Net job creation by new firms exceeds net total job creation since we observe negative job creation by all non-startups, due to job destruction. Calculations are based on data from the Business Dynamic Statistics. See US. Census Bureau, Dynamic Business Statistics, BDS Dataset List, Firm Age Dataset, available at http://www.ces.census.gov/index.php/bds/bds_database_list.

[17] John Haltiwanger, Ron Jarmin and Javier Miranda, "Business Dynamics Statistics Briefing: Jobs Created from Business Startups in the United States," Ewing Marion Kauffman Foundation (January 2009), available at http://ssrn.com/abstract=1352538.

[18] See Stefan Fölster, "Do Entrepreneurs Create Jobs," *Small Business Economics* 14 (2000):137-148; David B. Audretsch, Max C. Keilbach, Erik Lehmann, *Entrepreneurship and Economic Growth* (Oxford University Press, 2006)

Figure 1. Net job creation by firm and by size



Note: Net job creation is averaged over the years 1987-2005, by firm size and firm age.
Source: US. Census Bureau, Dynamic Business Statistics, BDS Dataset List, Firm Age By Firm Size, available at http://www.ces.census.gov/index.php/bds/bds_database_list. See also Figure 15 in John Haltiwanger, Ron Jarmin, and Javier Miranda, "Business Formation and Dynamics by Business Age: Results from the New Business Dynamic Statistics," Working Paper, (May 2008), available at http://econweb.umd.edu/~haltiwan/bds_paper_CAED_may2008_may20.pdf.

C. Startups and High Growth Companies

The last three decades have been marked by the formation of new companies that create totally new products or services. These include firms that started as part of the information-technology revolution that began in the mid 1970s with the decline in microprocessor prices, the Internet revolution that began in the early 1990s as a result of the development of web technologies, and other technological changes such as the biotech revolution. Table 3 shows the 50 largest companies by market capitalization in 2008. Of these, 10, accounting for 18% of the market capitalization of the top 50, did not exist in 1975. Of course many other highly successful firms that were started over this time period such as well publicized YouTube and Facebook, to take two recent examples, do not appear on this list and some of the established firms have increased their market capitalization by buying new firms.

Table 3. The 50 largest companies by market capitalization, 2008

Rank	*Company*	*Market Capitalization, $M*	*Year Founded*
1	Exxon Mobil	406,067	1870
2	Wal-Mart Stores	219,898	1962
3	Procter & Gamble	184,576	1837
4	Microsoft	172,930	1975
5	AT&T	167,950	1885
6	Johnson & Johnson	166,002	1886
7	General Electric	161,278	1911
8	Chevron	150,292	1879
9	Berkshire Hathaway	149,600	1888
10	Pfizer	119,417	1849
11	JP Morgan Chase	117,681	1823
12	IBM	113,065	1896
13	Coca-Cola	104,735	1886
14	Wells Fargo	98,028	1852
15	Verizon Communications	96,292	1918*
16	Cisco Systems	95,438	1984
17	Oracle Corporation	89,469	1977
18	Philip Morris International	88,022	1881
19	Hewlett-Packard	87,684	1939
20	Genentech	87,224	1976
21	Pepsico	85,064	1958
22	Abbott Laboratories	82,808	1888
23	Intel Corporation	81,539	1968
24	ConocoPhillips	77,224	1875
25	Apple	75,871	1976
26	Google	73,693	1998
27	Bank of America	70,647	1929
28	McDonald's	69,314	1940
29	Merck	64,271	1917
30	Amgen	61,187	1980
31	Qualcomm	59,316	1985
32	United Technologies	50,953	1929
33	Schlumberger	50,634	1926
34	Wyeth	49,944	1860
35	Occidental Petroleum	48,585	1920
36	Comcast	47,860	1963
37	Gilead Sciences	46,564	1987
38	Bristol-Myers-Squibb	46,026	1887
39	Eli Lilly	45,785	1879
40	U. S. Bancorp	43,569	1890
41	Walt Disney	42,000	1923
42	CVS/Caremark	41,277	1963
43	3M	39,873	1902
44	Kraft Foods	39,446	1903
45	Home Depot	39,029	1978
46	Monsanto	38,548	1901
47	United Parcel Service	37,372	1907
48	Exelon	36,587	1887
49	Citigroup	36,566	1812
50	Time Warner	36,090	1922**

Note: * Verizon Communications was formed by the merger of GTE with Bell Atlantic Corporation in 2000. GTE started in 1918; Bell Atlantic was one of the original several Regional Bell Operating Companies that were divested from AT&T in 1984 after an antitrust decree. See "History of Verizon Communications Inc," Verizon Media Relations, February 2009, available at http://investor.verizon.com/profile/history/pdf/verizonhistorictimeline.pdf.

** Time Warner came out of the merger between Time Inc. and Warner Communications in 1990. Time Inc. was founded in1923. See chronology of key events in the history of Time Warner Inc. and America Online Inc at http://money.cnn.com/2000/01/10/deals/aol_warner/timeline.htm.

Market value is estimated at December 31, 2008 prices.

Source: FT Global 500 December 2008, available at http://www.ft.com/reports/ft5002008.

These firms typically started out small. There is no systematic data on the start-up phases of these successful firms but a few examples remind the reader of the early beginnings of these

firms. Google® started in 1995 when Larry Page and Sergey Brin collaborated to develop a search engine. It was not until more than two years later that they had any investment capital or paid employees.[19] Microsoft® was founded in 1975 by Bill Gates and Paul Allen, who started by writing programs for the early Apple® and Commodore® machines and expanded BASIC programming language to run on microcomputers. The company started with just three employees and revenue of $16,000 in the first year.[20] The start-up funds came mainly from personal finances. As Bill Gates described, "...[f]rom the start Paul and I funded everything ourselves. Each of us had saved some money. Paul had been paid well at Honeywell, and some of the money I invested in our startup came from late-night poker games in the dorm."[21] Hewlett and Packard started working together with $538 and a used Sears Craftsman drill press in 1938 and did not even formalize the partnership until the next year.[22] Ben and Jerry's used $12,000 in cash, with $4,000 of it borrowed, to open their first ice cream shop in 1977.[23]

III. Access to Capital and Small Firms

Small firms typically have trouble borrowing money. They are what economists call "liquidity constrained."[24] They either cannot borrow any money, they cannot borrow as much as they need at reasonable rates, or they can only borrow at exorbitant rates.

Most new small firms do not have a credit history and often do not even have a history of revenue and profits to show to lenders. They have difficulty borrowing money from traditional sources unless they can secure it with collateral, which they generally do not have in their business. Such firms typically turn to several alternative sources depending on their situation. They include financing themselves from personal savings, turning to friends and relatives, relying on consumer loan products, or in the cases of entrepreneurial startups, seeking angel- or venture-capital funding.

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[19] Google Corporate Information, "Google Milestones," available at http://www.google.com/corporate/history.html.

[20] See Cusumano and Selby, *supra* note 7, at 3.

[21] Bill Gates, and Nathan Myhrvold, *The Road Ahead* (Penguin Books, 1996), at 19.

[22] HP Company Information, "Rebuilding HP's Garage," available at http://www.hp.com/hpinfo/abouthp/histnfacts/garage/.

[23] Ben & Jerry's Company History, available at http://www.benjerry.com/company/history/.

[24] David S. Evans and Boyan Jovanovic, "An Estimated Model of Entrepreneurial Choice under Liquidity Constraints," *Journal of Political Economy* 97 (1989): 808-827; D. Holtz-Eakin, D. Joulfaian, and H. S. Rosen, "Sticking it out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy*, 102 (1994):53-75; D. Blanchflower, and A. Oswald, "What makes an entrepreneur?", *Journal of Labor Economics*, 16 (1998) :26-60; Steven M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment." *Brookings Papers on Economic Activity* 1 (1988): 141-205.

Many established small firms also have trouble borrowing. Lending to small firms can be risky because they have a high failure rate and are therefore more likely to run into arrears or default. That is why banks very quickly cut off loans to many small businesses with the onset of the financial crisis.[25]

The *Surveys of Small Business Finance* conducted by the Federal Reserve Board show the extent to which small firms have difficulty borrowing.[26] Taken from this source, Table 4 shows that close to 20% of firms with fewer than 20 employees did not even try to apply for credit because they expected to be denied. Of those that applied multiple times for credit, firms with fewer than 20 employees had at least one application turned down about one third of the time. These figures are for 2003 when the U.S. economy was robust. One would expect that small businesses would be more credit-constrained in poor economic times such as the current environment.

[25] Report to the Congress on the Availability of Credit to Small Business, Board of Governors of the Federal Reserve System, October 2007, p. 21.

[26] The Federal Reserve Board collects information on the use of various financing methods periodically. Surveys were done in 1987, 1993, 1998 and 2003. I rely on the 2003 survey, which is the most recent one. The survey is based on data from 4420 small businesses. The Federal Reserve Board takes a stratified sample of businesses and then weights the data to provide population estimates. See Lieu N. Hazelwood, Traci L. Mach, and John D. Wolken, "Alternative Methods of Unit Nonresponse Weighting Adjustments: An Application from the 2003 Survey of Small Business Finances," Federal Reserve Board - Finance and Economics Discussion Series, 2007-10, available at http://www.federalreserve.gov/pubs/feds/2007/200710/200710abs.html.

Table 4. Percentage of small businesses with various types of outcomes in terms of credit applications, 2003, by firm size

		Applied once		*Applied multiple times*			
Number of employees[4]	*Applied for credit*	*Share of all firms*	*Application approved[1]*	*Share of all firms*	*All applications approved[2]*	*Some applications approved[3]*	*Did not apply for fear of denial*
All firms	21.4	12.3	87.1	9.1	65.0	17.1	17.9
0-1	13.5	8.8	89.4	4.7	67.0	17.8	17.8
2-4	18.1	11.3	81.5	6.7	62.7	18.3	18.7
5-9	26.2	14.5	91.2	11.6	54.4	15.9	20.0
10-19	29.8	14.4	88.3	15.4	66.2	23.2	17.3
20-49	31.0	16.1	89.4	14.9	77.5	12.7	10.6
50-99	39.2	20.0	98.5	19.1	94.8	1.9	11.3
100-499	41.7	15.5	91.3	26.1	90.6	7.8	9.5

Note: (1) Percent based on small businesses that applied once for credit. (2) Percent based on small businesses that applied multiple times for credit. (3) Survey respondents were asked if they had foregone applying for credit at any point in the previous four years (2000-03) for fear of denial. (4). Number of owners working in the business plus number of full- and part-time workers. Survey respondents were asked about their credit application experience from 1996 to 1998. Data are weighted to adjust for differences in sampling and response rates and reflect population rather than sample measures.

Source: Table A.9. in "Report to the Congress on the Availability of Credit to Small Business," Board of Governors of the Federal Reserve System, October 2007, available at http://www.federalreserve.gov/boarddocs/rptcongress/smallbusinesscredit/sbfreport2007.pdf

Table 5 shows similar statistics based on the age of the firm. The results are striking for the firms that are less than five years old and that, as seen in Figure 1, account for a significant portion of net job growth. More than one quarter of these firms did not even bother applying for credit as businesses because they expected to be denied. Of those that applied once, about 15% were denied credit. Of those that applied multiple times, more than half had at least one application rejected.

Table 5. Percentage of small businesses with various types of outcomes in terms of credit applications, 2003, by age of firm

		Applied once		Applied multiple times			
Years under current owner	Applied for credit	Share of all firms	Application approved(1)	Share of all firms	All applications approved(2)	Some applications approved(3)	Did not apply for fear of denial(4)
0-4	22.6	14.6	84.5	8.0	48.0	20.0	26.5
5-9	21.6	11.1	87.3	10.5	57.0	18.4	22.1
10-14	22.2	12.9	85.7	9.3	66.5	22.6	18.9
15-19	21.8	13.2	91.2	8.6	73.3	13.5	16.0
20-24	19.5	10.9	89.9	8.6	76.3	12.2	11.3
25+	19.8	10.6	86.8	9.2	80.1	12.5	7.3

Notes: (1) Percent based on small businesses that applied once for credit. (2) Percent based on small businesses that applied multiple times for credit. (3) Survey respondents were asked if they had forgone applying for credit at any point in the previous four years (2000-03) for fear of denial. (4). Number of owners working in the business plus number of full- and part-time workers. Survey respondents were asked about their credit application experience from 1996 to 1998. Data are weighted to adjust for differences in sampling and response rates and reflect population rather than sample measures.

Source: Table A.9. in "Report to the Congress on the Availability of Credit to Small Business," Board of Governors of the Federal Reserve System, October 2007, available at http://www.federalreserve.gov/boarddocs/rptcongress/smallbusinesscredit/sbfreport2007.pdf.

IV. Small Businesses and the Use of Consumer Lending Products

Almost 90% of small businesses used some form of credit in 2003 based on data from the Federal Reserve Board's SSBF.[27] Small business owners had almost $1.3 trillion in loans outstanding during that year.[28] Table 6 summarizes the sources of credit for these firms by size level. Several aspects of these results are noteworthy. As one would expect, given the difficulty that small firms have in getting access to credit, the extent of the use of credit increases as firms get larger, this is also likely to be a result of their getting older as well. Only 81% of firms without employees have credit compared with 97% of firms with 20 or more employees. About 60% of the firms have a traditional business loan. Standard sources of working capital such as lines of credit are used the least by small firms. Only 42.5% of firms without employees have a

[27] See "Small Business in Focus: Finance, A Compendium of Research by the Small Business Administration's Office of Advocacy," Office of Advocacy, U.S. Small Business Administration, July 2009, available at http://www.sba.gov/ADVO/research/09finfocus.pdf.

[28] See Table A in "Small Business and Micro Business Lending in the United States, for Data Years 2003-2004," Office of Advocacy, US Small Business Administration, November 2005.

traditional loan and 59.1% of firms with one to four employees. That percentage increases to 93.8% for firms with 100 to 499 employees.

Table 6. Share of all small firms using credit, by credit type 2003

		Firms by Employment Size					
Loan Type	***Any firm***	***0***	***1-4***	***5-9***	***10-19***	***20-99***	***100-499***
Any credit	89.0	80.9	89.9	94.3	96.5	97.2	97.7
Any traditional loan	60.4	42.5	59.1	74.7	77.1	84.1	93.8
Line of credit	34.3	17.9	32.5	45.3	49.5	60.2	82.5
Mortgage	13.3	6.8	14.8	15.4	19.0	20.9	28.1
Vehicle loan	25.5	17.2	24.5	31.7	35.9	36.3	35.7
Equipment loan	10.3	4.1	6.2	14.9	20.2	26.6	32.4
Lease	8.7	4.4	7.2	12.3	12.5	17.7	28.0
Other	10.1	7.2	7.5	14.1	15.3	16.0	18.7
Any nontraditional loan	80.0	70.9	82.2	85.3	89.6	85.3	87.1
Owner loan	16.8	4.7	17.0	25.6	27.4	32.8	27.8
Personal credit card	46.7	49.6	47.6	47.1	44.8	34.3	32.1
Business credit card	48.1	33.3	50.1	59.3	58.4	62.6	71.7

Source: Charles Ou and Victoria Williams, "Lending to Small Businesses by Financial Institutions in the United States," in *Small Businesses in Focus: Finance, A Compendium of Research by the Small Business Administration's Office of Advocacy*, (July, 2009).

The remainder of this section focuses on the extent to which small firms rely on consumer lending products for sources of credit.

A. Personal Credit Cards

Small businesses use credit cards extensively as shown in Table 7, which is based on 2003 data for the Federal Reserve's Survey of Small Business Finances. About 77% of all small businesses used at least one credit card in 2003. About 47% used personal credit cards and about 48% relied on business credit cards. Personal credit card use was most prevalent among the small firms with fewer than 10 employees, especially the smallest firms. Almost half of these firms relied on a personal credit card. Interestingly, almost one third of firms with 100 to 500 employees also relied in part on personal credit cards.[29] The widespread use of cards is not surprising. This source of financing is much easier to obtain than others. It does not require submitting a business plan to a bank or trying to convince family members to lend money.

[29] Furthermore, Scott III discusses that small businesses have limited access to formal credit markets, which has led to a dramatic increase in the use of credit cards to subsidize their insufficient liquidity. Credit cards are useful for small businesses because of their near-universal acceptance, accessibility and anonymity. See Robert H. Scott III, "The Use of Credit Card Debt by New Firms: Sixth in a Series of Reports Using Data from the Kauffman Firm Survey," (August 4, 2009) *available at* http://ssrn.com/abstract=1446780.

Credit cards are used in two ways. First, they provide small businesses with an essentially free source of working capital. Small businesses can use these cards to charge things over the course of the month then pay the bills in full. This gives these businesses free float of about two weeks on average. While this does not seem like much, that free float is likely to be very important to small businesses to manage their cash flow. The cost of this method of financing is close to zero for most credit cards. About 70% of businesses with fewer than 10 employees pay the balances in full as shown in Table 7. That increases to more than 90% for firms with 100 to 500 employees.

Second, credit cards provide a source of credit for some businesses in the form of a revolving loan. About 30% of the smallest businesses avail themselves of this credit feature. Given the difficulty that these very small businesses have in obtaining other sources of capital this source of lending is likely to be important to many of them.

Table 7. Use of credit cards by small businesses, 2003, percentage of all small companies, by firm size

Number of employees	*Any*	*Personal*	*Business*	*Paid balance*
All firms	77.3	46.7	48.1	70.7
0-1	69.5	48.6	32.0	69.6
2-4	76.4	48.1	45.7	65.9
5-9	81.0	47.8	56.8	68.5
10-19	85.0	45.6	59.7	79.4
20-49	81.5	34.4	61.7	85.2
50-99	81.9	34.6	63.5	93.9
100-499	82.8	32.2	71.4	92.4

Source: Table 4 in "Report to the Congress on the Availability of Credit to Small Business," Board of Governors of the Federal Reserve System, October 2007, available at http://www.federalreserve.gov/boarddocs/rptcongress/smallbusinesscredit/sbfreport2007.pdf.

Looking at credit cards from the consumer side reveals consistent findings. Research by Blanchflower and Evans demonstrates that the availability of credit cards relaxes the liquidity constraints that small businesses face in the U.S.[30] Using data from the Survey of Consumer Finances, they find that households headed by self-employed individuals tend to have credit cards more frequently than households overall. For example, in 2001, 86% of self-employed households had credit cards while 76% of wage workers did. In addition, businesses that had

[30] See David Blanchflower and David S. Evans, "The Role of Credit Cards in Providing Financing for Small Businesses," *The Payment Card Economics Review* 2 (Winter 2004):77-95, available at http://ssrn.com/abstract=1474450.

been denied credit were more likely to have personal and business credit cards and to charge more on those cards than businesses that were not denied credit.

As noted earlier most jobs generated in the U.S. economy come from new firms that usually start out small and grow. Although systematic data are not available, it seems highly likely that personal credit cards are a critical source of capital for these businesses. These new businesses typically cannot obtain traditional business loans because their businesses have no credit history. Lenders are understandably reluctant to lend money to such businesses. New firms have a high rate of failure—about one-third of businesses with employees fail in the first two years, and 56% fail within four years.[31] At the same time, there is very little information available to the lender on the likely success of the business and its potential ability to repay loans. As a result, new small businesses cannot obtain significant funding from traditional commercial lenders unless the owners can provide collateral. From a common sense perspective, if you are starting a new business and need to buy computers, office equipment, and supplies, you are most likely to put those charges on your personal credit cards. Most people have personal credit cards with lines of credit, and they can use those lines of credit to start a new small business instead of charging consumer goods. The data above indicate that, in fact, that is what many small businesses do—especially those with no employees.

Several popular accounts of the start of small businesses demonstrate the importance of personal credit cards in helping new firms establish a financial foundation. Sergey Brin and Larry Page used plastic to start Google® in the mid 1990s. They ran their credit cards to the maximum and, mindful of their limits, they chose to buy used computers and use open-source software. The two worked on the BackRub® search engine, then set out to sell licenses to the technology. Their immediate goal was to move out of the dorms and pay off the credit card debt they had amassed trying to expand their network.[32] YouTube® founders, Steve Chen and Chad Hurle also relied on personal finances in the early days of their video-sharing business. As one industry observer noted, investment from Sequoia Capital® came "...just in time for Steve to avoid having to increase his credit-card limit yet again to pay for various tech expenses."[33]

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[31] Amy E. Knaup, "Survival and Longevity in the Business Employment Dynamics Data", *Monthly Labor Review* 128 (2005):50.

[32] Laurie J. Flynn, "The Google I.P.O.: The Founders; 2 Wild and Crazy Guys (Soon to be Billionaires), and Hoping to Keep It That Way," *The New York Times*, April 30, 2004, available at http://www.nytimes.com/2004/04/30/business/google-ipo-founders-2-wild-crazy-guys-soon-be-billionaires-hoping-keep-it-that.html.

[33] See John Cloud, "The Gurus of You Tube," *The Time Magazine*, December 16, 2006, available at http://www.time.com/time/magazine/article/0,9171,1570721,00.html.

B. Home Equity Loans

The 2007 Survey of Consumer Finances (2007 SCF) reveals a few more dimensions of the way self-employed individuals—typically owners with no employees—rely on various credit products. Families headed by a self-employed individual had larger amounts of debt secured by residential property, on average, than families overall in 2007. For example, families overall held about $107,000 in debt secured by the primary residence, whereas self-employed families held $135,000 on average. Families overall held about $100,000 in debt secured by other residential property, whereas families headed by a self-employed individual held $151,600 on average.[34]

Families where the head was self-employed were more likely than families overall to have a home-equity line of credit; 20.4% of self-employed families had one as opposed to 12.6% overall in 2007.[35] Furthermore, families headed by a self-employed individual were also more likely to be borrowing against that line—11% of self-employed families versus 8.5% of all families in 2007.[36] In addition, although borrowing on lines of credit other than a home equity line was quite unusual among families in 2007, it was somewhat more common among families headed by a self-employed individual.[37]

The use of real estate as collateral in securing loans for business needs is further corroborated by actual loan data. For example, about 90% of loans approved by Southern California Reinvestment CDFI®, a community development organization in Santa Ana that lends to small companies, are backed in part by the borrower's residential real estate.[38]

The availability of home-secured loans for business financing has been considered a driver of businesses in the United States. As Hernando de Soto remarked,

[34] Home-secured debt consists of first-lien and junior-lien mortgages and home-equity lines of credit. See Table 13 B in Brian Bucks, Arthur Kennickell, Traci Mach, and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin February 2009, available at http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf.

[35] *Ibid*., at A44.

[36] *Ibid*., at A44.

[37] *Ibid*., at A47.

[38] Amy Barrett and Jeremy Quittner, "Hungry for Cash, Startup Capital Grows Scarce," BusinessWeek, October/November 2007, available at http://www.businessweek.com/magazine/content/07_44/b4056413.htm.

> The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house. These assets can also provide a link to the owner's credit history, an accountable address for the collection of debts and taxes, the basis for the creation of reliable and universal public utilities, and a foundation for the creation of securities (like mortgage-backed bonds) that can then be rediscounted and sold in secondary markets. By this process, the West injects life into assets and makes them generate capital.[39]

C. Other Consumer Credit Products

Small businesses sometimes use consumer credit products that might be considered fringe financial products. For instance, small independent businesses such as landscaping, plumbing, and handyman services may use auto title loans as a source of short-term working capital. An independent landscaping company may need several hundred dollars to purchase sod and bushes for a job, or for temporary cash to meet payroll while finishing a job, or awaiting payment. In these cases, the proprietor may pledge his pick-up truck to obtain the necessary capital to buy the supplies to complete the job. Then when the job is complete—often only days later—payment is made and the owner can redeem the collateral. The likelihood of default and repossession is extremely low, and the likelihood of revolving the loan is very low as well.[40] Since many of these businesses may be seasonal and volatile in nature, using short-term credit (even at relatively high cost) can be more useful and appropriate than long-term bank loans or other types of credit.

Title loan industry members report that these small independent businesses that use title loans as a source of short-term operating capital may be as much as 25 to 30% of their customer base and an even greater percentage of loan amount and value because they are larger and more frequent customers, often borrowing for very short time periods of a few days.[41] Title lending may be a useful source of credit for these independent businesses. Title loans usually are closed

[39] Hernando de Soto, *The Mystery of the Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (Basic Books, 2003) at 6; reprinted by The New York Times, Online Edition, available at http://www.nytimes.com/books/first/d/desoto-capital.html.

[40] See Todd J. Zywicki, "Consumer Welfare and the Regulation of Title Pledge Lending," Working Paper (September 2009).

[41] *Ibid*.

on the spot within 30 minutes, providing the small business proprietor with direct access to cash. Bank loans, by contrast, often require a lengthy underwriting process that delays immediate access to cash. Moreover, title loans only charge interest and do not charge up-front fees or prepayment penalties; thus, they are uniquely useful for those who expect to repay the loan within a few days or a week. Independent businesses may at times use several title loans in sequence, making it appear that they are in a debt trap of sorts as can be the case with other short-term loan products. In reality, they are engaging in a series of independent transactions to gain working capital for a series of independent jobs.[42]

D. Use of Consumer Financial Products by Small Businesses

In sum, small businesses, especially those with fewer than 20 employees, rely extensively on consumer lending products. These businesses use these sources of credit in very different ways than do households. Small firms, for example, are less likely to use their credit cards to revolve than are regular households. Even for firms with no employees, 70.7% pay off their balances at the end of the month[43] compared with 53.8% for consumers.[44] When they do revolve these accounts, small firms are not using these cards for changing the timing of consumption, but rather for investing in the firm's production. The title loan phenomenon is a good example.

Proprietors use these loans for operating capital. Small business owners use consumer lines of credit to invest in their businesses and therefore generate additional income. The way small business owners think about and use personal credit cards, home equity loans, and automobile title loans is very different from the mindset of regular consumers.

Small businesses typically rely on consumer loan products for two reasons. First, they frequently cannot obtain access to commercial lending products, which often (although certainly not always) carry lower interest costs.[45,46] A new small business owner is much more likely to be

[42] *Ibid*.

[43] The figure refers to 2003. "Report to the Congress on the Availability of Credit to Small Business," Board of Governors of the Federal Reserve System, October 2007, available at http://www.federalreserve.gov/boarddocs/rptcongress/smallbusinesscredit/sbfreport2007.pdf, at 30.

[44] According to the Survey of Consumer Finance 46.2 % of families had credit card balances outstanding in 2004. See Federal Reserve Board, Survey of Consumer Finance, 2007, available at http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html.

[45] Smaller firms typically rely more on personal loans and personal credit cards than on commercial lending products. See Table A176 in 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.

able to get a $10,000 line of credit on a personal credit card than to get a $10,000 line of credit for a business from a local bank. Second, consumer loan products are often more convenient than other alternatives. New small business owners can dip into their own cash reserves, but that is risky since they may need those funds for daily living expenses or personal emergencies. Further, family and friends may not want to or be able to provide loans when needed, in the amount needed, or for the purposes it is needed. Borrowing from friends and family can also be considered humiliating and potentially damaging to personal relationships.[47] Entrepreneurs can sometimes obtain angel- or venture-capital funding, but they usually must give up a significant part of the upside of their business in the bargain.

V. The Effect of the CFPA on Small Business Financing

The proposed CFPA Act of 2009 would create a new federal agency to regulate consumer financial products and services. It would transfer the powers of existing federal agencies that enforce consumer lending laws to this new agency, provide considerable regulatory powers to the new agency, and would allow states and localities to adopt consumer protection rules more stringent than those adopted by the new agency.

A. General Effect of the CFPA on the Availability of Consumer Credit

If enacted, legal changes and accompanying uncertainty under the CFPA Act would likely make it more expensive for lenders to offer credit to consumers. Greater expense would result in lenders not making certain forms of lending available to some consumers that they would have made available in the absence of the CFPA Act.

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[46] For example, the average short-term rate on business loans was 5.09%, whereas the 24-month rate on personal loans was 11.37% in 2008. For a historical time series of short-term business rates see Federal Reserve, "Bank Prime Loan, available at http://www.federalreserve.gov/releases/H15/data/Annual/H15_PRIME_NA.txt. For rates on 24-month personal loans see Federal Reserve, G.19 Release, September 8, 2009, available at http://www.federalreserve.gov/releases/g19/Current/.

[47] See Todd J. Zywicki, "The Case Against New Restrictions on Payday Lending," Working Paper (July 9, 2009), available at http://www.mercatus.org/PublicationDetails.aspx?id=27570.

Two legal changes would make lending a much more expensive proposition. First, the CFPA sets an "abusive" practices restriction in addition to the current "unfair and deceptive" practices restriction. There is extensive case law, and thus relative certainty on what is unlawful, under the current "unfair and deceptive" restriction. The "abusive" restriction in the CFPA Act is vague and there is no case law to provide certainty. Ultimately, such a standard would depend initially upon the views of the individuals in charge in the new agency and subsequent interpretation by courts. Lenders would face uncertainty as to whether their lending practices pass muster under the new law.

Second, the CFPA Act gives the states, as well as localities, the authority to issue more restrictive consumer protection regulations than those adopted by the CFPA. As a result, lenders would be subject to varying regulations and litigation exposure across the 50 states. The combination of these two changes means that lenders would face considerable risks from regulatory fines and litigation from extending credit. Such litigation, regulatory exposure, and uncertainty would raise the cost of financial products.

As an indication of what can happen with a new regulation, the history of the federal Truth in Lending Act is enlightening.[48] No financial regulation could be conceptually simpler—disclosure of costs and other terms of credit contracted for in a "clear and conspicuous manner" with federal preemption of state actions in the area.

Despite the conceptual simplicity and the sensible purpose it was designed to achieve, the Truth in Lending law quickly became a bureaucratic mess. In 1969, there were 34 official interpretations of the regulation one week before its effective date. A decade later, in June 1979, more than 13,000 Truth-in-Lending lawsuits had been filed in Federal courts, representing 2% of the Federal civil caseload, but up to 50% of the cases in some districts, according to the Administrative Office of the United States Courts. This produced a set of judicial decisions, interpretations, and reinterpretations, each of which could mandate costly new paperwork, procedures, and employee training. To settle arguments and reduce uncertainty (often caused by the lawsuits), the Federal Reserve Board and staff had published by early 1980 more than 1,500

[48] The statute is contained in the Title I of the Consumer Credit Protection Act, as mended (15 U.S.C. § 1601 et seq.), available at, http://www.fdic.gov/regulations/laws/rules/6500-200.html.

interpretations with varying degrees of legal authority.[49] That effort still could not prevent judicial disagreement, or resulting mandatory new legal directives, in large part because of uncertain legal authority of the interpretations. The mass of the material together with its technical nature and frequent changes have contributed to the growth of a very expensive industry of lawyers, consultants, trade associations, and printing and software companies to aid creditors trying to comply. And all this arose from a seemingly straightforward direction from Congress. The snowball effect of financial laws seen from the Truth in Lending Act example understates the potential consequences of the CFPA Act for paperwork and complexity because the Truth in Lending Act did not allow state and local authorities to issue additional regulations the way the CFPA Act proposes.

Even if there were no legal uncertainties, the CFPA itself would raise the cost of lending and likely have a negative effect on some products in several ways. The purpose of the CFPA is to engage in new and stronger regulation of consumer financial products, which likely means more restrictive regulations. First, the new agency would conduct reviews of loan products and could consider mandating the redesign of these products or their prohibition. Lenders would need to incur costs for these reviews, and it would seem likely, given statements by proponents of the CFPA, that lending options would be eliminated.[50] Second, the CFPA would require mandatory disclosures for financial products and these would need to be preapproved for new products that actually could merely be variations of existing products. These would raise the cost of introducing new products and possibly deter their introduction. Third, the CFPA would engage in the ongoing promulgation of rules and regulations that would likely raise the cost of lending.

In short, the CFPA regulation of loan products combined with the legal changes that allow states and localities to adopt more stringent consumer protection regulations, and that create a vague "abuse" standard would likely substantially raise the cost to lenders of making credit available. The new regulations of the CFPA would raise the fixed and variable costs of making credit available to consumers. The more credit a lender issues, the more exposure it has to litigation and other costs. But small lenders will be affected most by increased costs because

[49] See, generally Ralph J. Rohner, ed. The Law of Truth in Lending (Boston: Warren, Gorham and Lamont, 1984). See also, Jonathan M. Landers, The Scope of Coverage of the Truth in Lending Act, American Bar Foundation Research Journal (Volume 1, Number 2, 1976) and Jonathan M. Landers and Ralph J. Rohner, "A Functional Analysis of Truth in Lending," UCLA Law Review, April, 1979.

[50] Oren Bar-Gill & Elizabeth Warren, "Making Credit Safer," University of Pennsylvania Law Review, 157 (2008):39.

they do not have the scale to spread the increased fixed costs broadly. These increased costs would create pressure for lenders to raise the prices they charge in order to lend profitably.

It is also likely that the CFPA would cause lenders to withdraw some credit products from the market. In order to offer a loan product to a particular group of consumers, expected revenues must exceed expected costs by enough to provide a competitive profit after adjustment for risk. There are two reasons to believe that for some credit products, the CFPA would prevent lenders from earning enough profits on those products to make them available. First, the CFPA would raise costs of offering products and extending credit as mentioned above. It may not be possible for lenders to raise fees and interest rates enough to compensate for those higher costs in some cases. Second, the CFPA would also require lenders to offer standardized credit products—that the CFPA would design—to consumers before or at the same time as the lender offers its own version of these products.[51] There is no guarantee that the CFPA's standard product would be profitable. At the same time, the standard product could siphon off enough customers for other versions of that product offered by the lender that those versions lack enough demand to make them profitable. As a result, lenders may choose not to offer a product at all if they have to offer a standardized product alongside it.

Small businesses would therefore likely have less credit available to them, and higher-priced credit for the same reasons consumers would if the CFPA Act became law.

B. Impact of Reduced Credit Availability to Small Businesses

The financial needs of small businesses, and how they use consumer credit products, are different from those of ordinary, household consumers. Some small businesses have needs for credit that vary across the year in different ways than consumers. For example, landscape companies and wedding planners have seasonal business where they make the bulk of their sales within a short window of the year. Similar seasonal uncertainty is also true for art dealers, who may or may not make a purchase during an auction, and for whom resale of purchased pieces of

[51] See Section 1036(b)(1) in United States Department of the Treasury, Consumer *Financial Protection Agency Act of 2009* (2009), available at http://www.financialstability.gov/docs/CFPA-Act.pdf .

art may occur quickly or may take an extended period of time. That is true for repair contractors, tree surgeons, and snow removal companies, for example. What all these small business owners need is a flexible set of credit products that permit them to swallow short-term fluctuations in their credit needs, but not a large outstanding line of credit to be maintained all year long. These factors result in small business owners having different risk profiles and credit needs than ordinary consumers.

A major concern with the CFPA is that it would adopt a one-size-fits-all approach to credit products. It is likely that its regulations would cover all consumer loan products regardless of whether they are used by small businesses, and that its standardized products would be designed for the average consumer. Even if its approach were the right one for the average consumer, it is unlikely that its approach would be the right one for small business owners who have different needs and risks.

A couple of examples illustrate the concern. Consider auto title loans. Although the CFPA could not impose usury regulations, it could impose regulations that could reduce the usefulness of this product to small businesses. Although the contours of the CFPA's proposed power to regulate "abusive" lending products remains vague, it might empower the agency to ban the rollover of loan balances from one month to the next, prohibit the extension of more than a certain number of title loans to a given borrower within a given period of time, or require repayment according to installment schedules. For an independent small business that uses title loans as a source of flexible, short-term working capital, any of these restrictions could reduce the availability and usefulness of the product.

Home equity loans are another example. The CFPA could impose regulations that result in lenders not being able to make high-priced high equity loans available to high-risk consumers. One could suppose that doing so is appropriate for safeguarding consumers for whatever reason. Small businesses are in a different situation. A high-priced home equity loan may be a cheaper source of capital to them than obtaining angel investment funding and may be more convenient, and less personally painful, than seeking a loan from family or friends. The loan may also make the difference between being able to start a business—with the risky upside—and not being able to start a business. It is difficult to see how the CFPA could be sensitive to these differences between small businesses and ordinary consumers.

It appears likely that the CFPA, if created, would lead to a regulatory regime and a set of rules that would be incompatible with the needs of small businesses. Small businesses would face higher costs of credit and find that some credit products are not available to them for the reasons discussed above. The standardization of products that are geared toward the ordinary consumer could result in small businesses losing access to products that are the most sensible and affordable alternative for them.

VI. Conclusion

Census Bureau data show that new businesses, most of which are small, have provided much of the growth of employment in the American economy in recent decades. Federal Reserve Board data also show that small businesses often have difficulty finding necessary commercial financing. Credit turndowns are related inversely to size and age of the business, which indicates why many small businesses use consumer credit products for financing new business. These products notably include credit cards, as well as home equity credit lines, and other forms of traditional consumer credit.

The proposed Consumer Financial Protection Agency Act would, if enacted, likely cause disruptions in consumer credit markets due to extensive legal uncertainty arising from provisions of the proposed Act. It would apply an unclear "abusive" standard to prohibit products and practices without existing legal precedents for guidance, and it would permit state and municipal governments to form their own standards that might often conflict with the federal requirements. Both of these aspects of the Act are likely to raise the costs of producing consumer credit significantly and chill markets for consumer credit.

Even if the CFPA provides overall benefits to ordinary consumers, it is likely that small businesses, especially new ones, would face collateral damage. They would likely have less access to credit, not for consumption, but for building and operating their business, and would likely face higher costs for the credit they can obtain. That would be unfortunate because these firms are the ones that are the most important creators of jobs.

This is not the time to heap additional business difficulties on what has long been a highly dynamic part of the American economy. As outlined earlier, small businesses account for

the bulk of new jobs in the economy and small businesses regularly use consumer credit products to smooth and finance the activities of the enterprises. A new regulatory regime that adversely affects this important economic sector with higher costs and new financial difficulties through unavailable products while that sector is struggling to overcome the aftermath of a significant recession is simply the wrong remedy at the wrong time.

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