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Credit Card Financing by Small Businesses Gets Crunched

Lower limits and higher interest rates pose problems for some small-business owners

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Like many other lenders today, the credit card industry is spooked. Credit card companies are cracking down on card limits—even on customers who have never had a problem with paying their bills. At the same time, there is evidence that credit card issuers are being more aggressive with increasing interest rates—making it much more dangerous for any customer who is late on a payment.

Small-business owners are likely to feel the effects of these changes more than almost any other group of Americans. A survey released this spring by the National Small Business Association found that 44 percent of small-business owners use credit cards to finance their businesses—more than any other type of financing. They are also relying more on credit cards as other types of credit become harder to get or less attractive. The NSBA survey found that while all other types of borrowing like bank loans, SBA loans, and private loans declined in usage from 2007 to 2008, credit card borrowing was the one type that stayed constant.

Credit cards fill a void in small-business owners' borrowing needs. But that doesn't mean they're a safe haven. Broader economic problems are leading credit card companies to solicit fewer customers, hold on to their high-quality borrowers, and raise the standards for everyone else, says John Ulzheimer, president of consumer education for Credit.com. "Even folks with a good credit history are finding that the limits they can get are lower than those in the past," he says.

Just two weeks ago, John Nicholson, owner of Company Flowers in Arlington, Va., found himself in that position. He needs to borrow to pay the suppliers for his flower and gift store during the lean, nonholiday months when sales are slow. But because most of his inventory is perishable, and thus can't be used as collateral, bank loans have never been an option. Instead, he has a system of nine personal credit cards. It's never been a problem because he always pays at least the minimum for each month, and often more. But right when Wall Street was losing its mind in late September, he noticed that his card issuer had changed something. "Ordinarily we would have a $20,000 limit—but we noticed the limit was dropped down to $10,000," says Nicholson. That one change threw a wrench in his budget, and now he has to make changes to avoid borrowing elsewhere. For example, Nicholson says he's already planning not to hire as much extra help this December. "In the next month or two, I expect to get squeezed," he adds.

If lower limits prevent them from borrowing enough money to finance basic operations, what can small-business owners do? One strategy might be to simply open up new credit card accounts. If you're in otherwise healthy financial standing, this could be advantageous—if the new cards open you up to more credit than you need, the unused credit will make you look like a less risky borrower. But if you're opening new accounts as an act of desperation, you are probably not going to have credit left over. That means you could be digging yourself a deeper hole by adding new cards. "The more you put yourself out there, the worse your credit score gets," says Jerry Silberman, founder of Corporate Turnaround, a firm that helps businesses get out of debt.

Becoming more dependent on credit cards also increases the danger of failing to make a minimum payment. That's especially risky now because credit card issuers are more willing to jack up interest rates on customers who show any signs of problems. "They're keeping them on a shorter leash," says Ulzheimer.

You cannot even assume that just because you've always paid off your balance your interest rates won't increase. "Most people have no idea what their credit score is and they think it's good because they pay their bills on time," says Silberman. But if you use all your available credit, he explains, banks will notice that and may charge higher rates.

But small-business owners—and consumers generally—may see their credit card situation change. The House in September passed a Credit Cardholder's Bill of Rights that would end practices deemed "unfair" by the bill's sponsor, Congresswoman Carolyn Maloney, a New York Democrat. One such practice is "universal cross-default," when a default completely unrelated to a borrower's credit card use counts as a default with his or her card account, driving up interest rates as a result.

At hearings regarding the bill earlier this year, bank representatives argued that the bill's changes would make credit cards harder to get by interfering with the issuers' pricing model. But Adam Levitin, associate professor at Georgetown University Law Center, argues that the bill has provisions that could help small businesses relying on credit cards. "Small businesses don't want to have to worry that a dispute with a supplier or a late rent payment or the like will result in higher costs of borrowing on credit cards," says Levitin.

But even if the bill passes the Senate and becomes law, its provisions won't go into effect for another year after its passage. No matter what Washington does, small-business owners will have plenty of reason to pay close attention to changes being made by their credit card companies. "Who knows what they're going to do in the future?" says Nicholson.