Testimony of

PayNet, Inc.
presented by William Phelan

Before the
United States House of Representatives
House Committee on Small Business

Hearing on
Putting America Back to Work:
The State of the Small Business Economy

February 16, 2011

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TAKING THE RISK OUT OF SMALL BUSINESS LENDING

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Introduction and Purpose

Members of the Committee, my name is William Phelan, President and Co-Founder of PayNet, Inc. based in Skokie, Illinois, a suburb of Chicago. I appreciate the opportunity to speak today on behalf of PayNet, Inc. which provides small business credit information to banks, commercial finance and corporate credit lenders throughout the nation. My role today is to provide you with insight into the state of the small business economy with quantifiable data, trends and analysis. PayNet will provide the perspective and impact of credit and capital availability to the small business economy based on data derived from the PayNet's database.

Background

PayNet, Inc. maintains the largest repository of historical lease and loan payment information based on the U.S. small-business community; collecting real-time small business loan and lease information from more than 250 leading U.S. lenders. PayNet's data provides a unique window into the world of small business lending/credit trends compiled from our "real-time" proprietary database consisting of over 17.8 million term debt contracts worth nearly $800 billion in loan value.

Access to small business credit information increases access to capital, spurring economic growth and jobs, and significantly reduces the cost of doing business. PayNet collects and tracks this data on small business loans from hundreds of U.S. and Canadian lenders each month, turning it into actionable intelligence.

Small business credit data has been notoriously hard to obtain. Prior to services like PayNet, lenders relied on credit reference calls or trade data reports to make long-term lending decisions. Credit reference calls require competitors to share sensitive customer information via discussion between credit staff. These calls are costly and non-standard. A trade data report tells a lender how an applicant has paid utility bills, information technology services, or overnight express bills. Both methods for making small business credit data available resulted in a high cost of doing business, limited access to credit and added risk for the lender.

PayNet has compiled one of the largest proprietary databases of information on business loans primarily on small privately-held business. Our research shows that decisions made using loan data outperform credit reference calls and trade data reports similar to how car insurance underwriters look to prior accidents to underwrite new car insurance policies.

Key statistics about the PayNet Database are as follows:

- Average number of months of history per lender is 86.
- Database contains nearly $800 billion in financial obligations.
- Average transaction size per contract is $44,200.
- Average term per contract is 3.6 years.
- Average monthly payment per contract is $1,028.

Small businesses in America are a primary driver of economic growth and have become the centerpiece of the economic recovery. According to the U.S. Small Business Administration's Office of Advocacy's most recent estimate, there were 29.6 million businesses in 2008. Small businesses accounted for half of all U.S. private-sector employment and produced 64 percent of net job growth between 1993 and 2008. An additional study shows that 40 percent of the companies that issued at least 15 patents over a five-year period were small businesses.[i] These small firms produced significantly more patents per employee than the larger firms in the sample. This and other studies show that small businesses are more likely to develop emerging technologies than their larger counterparts.

The perplexing aspect of the small business economy is not its importance as the engine of U.S. growth, innovation and competitive edge, but how little we know about this important economic engine. Limited knowledge hinders the ability of bodies such as this Committee to create policies that help small businesses. I applaud the efforts of this Committee to better understand the small business economy and in doing so create policies that promote small businesses.

Small Business Credit and its Importance to the Economy

To understand small business access to credit, we must first understand the types and sources of financial products used by small businesses. Research on types and sources of financial products is derived from reports published by the Small Business Administration Office of Advocacy, or other government agencies. Financial products are best summarized in the May Oversight Report by the Congressional Oversight Panel.[ii] Financial products include: liquid asset accounts, credit lines, loans and capital leases, and financial management services. Liquid asset accounts constitute checking and savings accounts; credit lines, loans, and capital leases include lines of credit, mortgages used for business purposes, motor vehicle loans, equipment loans, capital leases, and other loans; and financial management services involve transaction services, credit card and debit card processing services and other similar services.

Suppliers of financial services include depository institutions, which consist of banks, thrifts and credit unions, and non-depository institutions, which include finance companies and factors, leasing companies, and insurance and mortgage companies. Small businesses also use additional non-depository sources, including credit cards, family, individuals, business firms, government sources, and venture capital firms. The exact volume of small business financing that comes from each of these sources is impossible to determine. For example, a loan from an angel investor, friend, or family member will not appear on a bank's call report, nor will drawing down on personal savings in order to finance small business activity. Similarly, trade credit is a significant source of small business financing. Trade credit can take many forms, depending on the business or industry, but is business-to-business and typically involves a 30 to 60 day delay between the date services or goods are provided and the payment date.

One important source of capital from which small businesses are shut-out is access to the public bond markets. The vast majority of smaller businesses which do not have access to public bond markets must rely instead on the sources cited above for their credit. The use of home equity lines of credit has been severely curtailed; the fall in housing prices has drastically reduced the amount of equity extracted from homes, and it is no longer a significant source of financing for small businesses. Banks, small and large, are therefore currently the most important source for small business credit; according to the Federal Reserve, small businesses receive over 90 percent of their funding from banks.

Small businesses borrow from both large and small banks, and while large and small banks each represent approximately 50 percent of the dollar value of loans to small businesses, this equivalence obscures the involvement each sort of bank has with small business lending. For example, relative to their assets, community banks have an outsized share of small business lending. According to the Federal Deposit Insurance Corporation (FDIC), community banks account for 38 percent of small business and farm loans, despite representing only 11 percent of bank industry assets. Medium and larger banks, however, still have over 50 percent of the market, even if it is a smaller share relative to their assets. Large banks' share of the market grew substantially over the course of the last decade. Small businesses borrow from depository institutions through a variety of mechanisms. The first is a conventional loan, through which a bank provides capital to a small business in exchange for regular interest payments and collateral. A small business can also seek a loan from a bank with the assistance of the SBA. For FY2010, Congress authorized the SBA to guarantee up to $17.5 billion for the 7(a) loan program which represents a very small share of total loans to small businesses.[iii]

Thomson Reuters/PayNet Small Business Lending Index (SBLI)

The SBLI, utilizing small business loan origination data from major lenders, measures the volume of loans to Small Businesses normalized to a base year - 2005. Seasonally adjusted, the index is presented as an absolute as well as by a percent change versus the prior year. It is published monthly. Because small businesses generally respond to changes in economic conditions more rapidly than larger businesses do, the Thomson Reuters/PayNet Small Business Lending Index serves as a leading indicator of the economy.

A recurring question is to what extent banks have reduced the availability of credit to small businesses, and in doing so, amplified the recession. The Thomson Reuters/PayNet Small Business Lending Index (SBLI) measures new borrowing activity on millions of U.S. small businesses. The Index declined from a peak of 131 in January 2007 to 66 in May 2009 which is a fall of approximately 50%. The Index allows us to calculate demand for credit by factoring in credit approval rates. Factoring in credit approval rates indicates applications for credit fell from a comparable index level of 176 before the recession to 103 by May 2009. Cases of small businesses cut-off by their bank certainly existed during the recession.

For the broader small business economy, it is clear that lower applications are an indication of falling demand for credit, rather than banks' desire to withhold credit. At this same time banking system supply of capital grew 1,800% through the expansion of excess reserves.[iv] The figure below shows falling demand for credit among small business, even while excess bank reserves expanded dramatically during the recession.

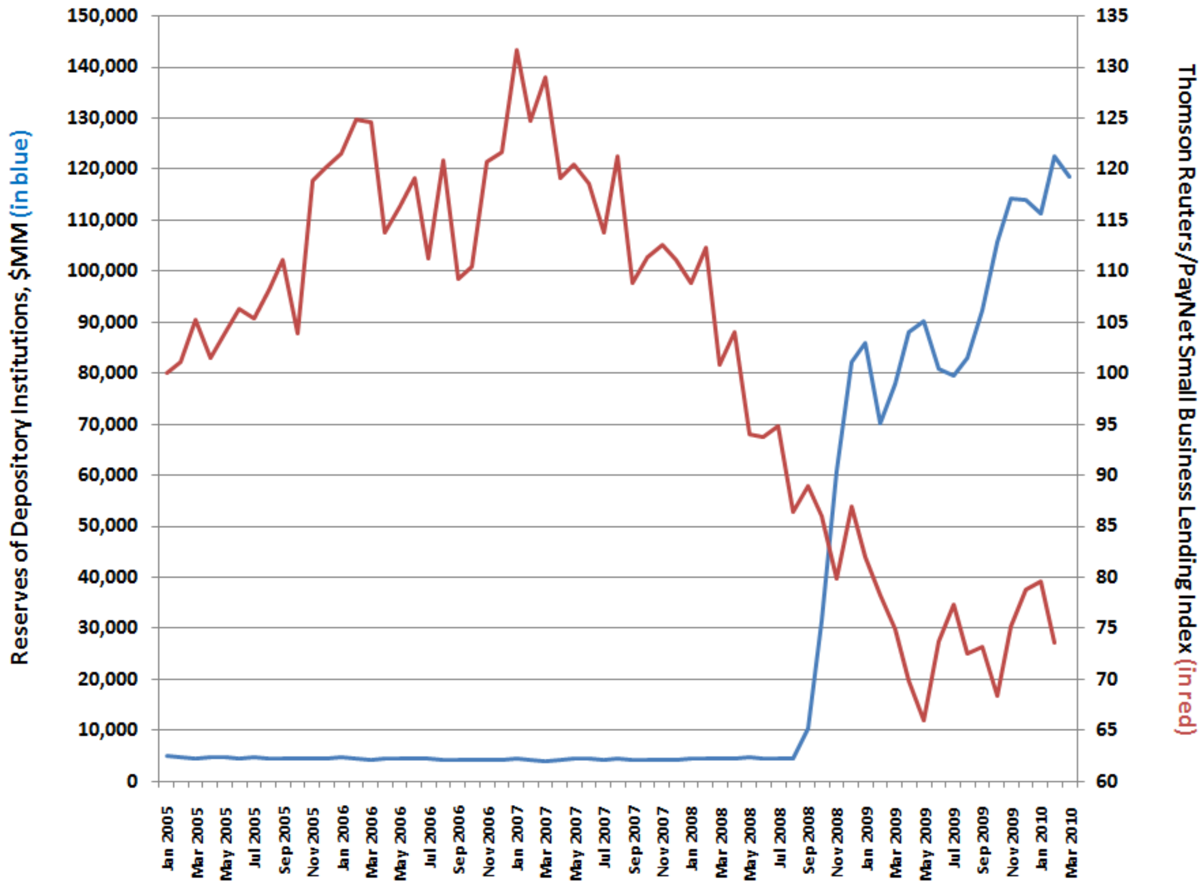


Figure 1: Comparison of Lending Demand vs. Bank Reserves

A recent study from PayNet shows banks were the primary source of credit to small businesses during the recession. While loans to small businesses overall were down 24% from 2007 to 2008, the lending from banks declined the least providing the largest source of credit to small businesses during the recession. Further findings from this study indicate credit constraints resulted from the inability of finance companies and corporations to access capital markets or warehouse lines during the recession.

Annual Lending Volume

	2008/2007
Banks	-11%
Corporate Credit	-28%
Independent Finance Cos.	-44%
Total	-24%

source: PayNet, Inc.

Figure 2: PayNet Annual Lending Volume

Current State of the Small Business Economy

Even though businesses are beginning to borrow more and are finding it easier to pay their bills, small business owners are not ready to declare victory yet. The latest Thomson Reuters/PayNet Small Business Lending Index (SBLI), as of December 2010, confirms the recovery in small business is growing and remains on solid financial footing.

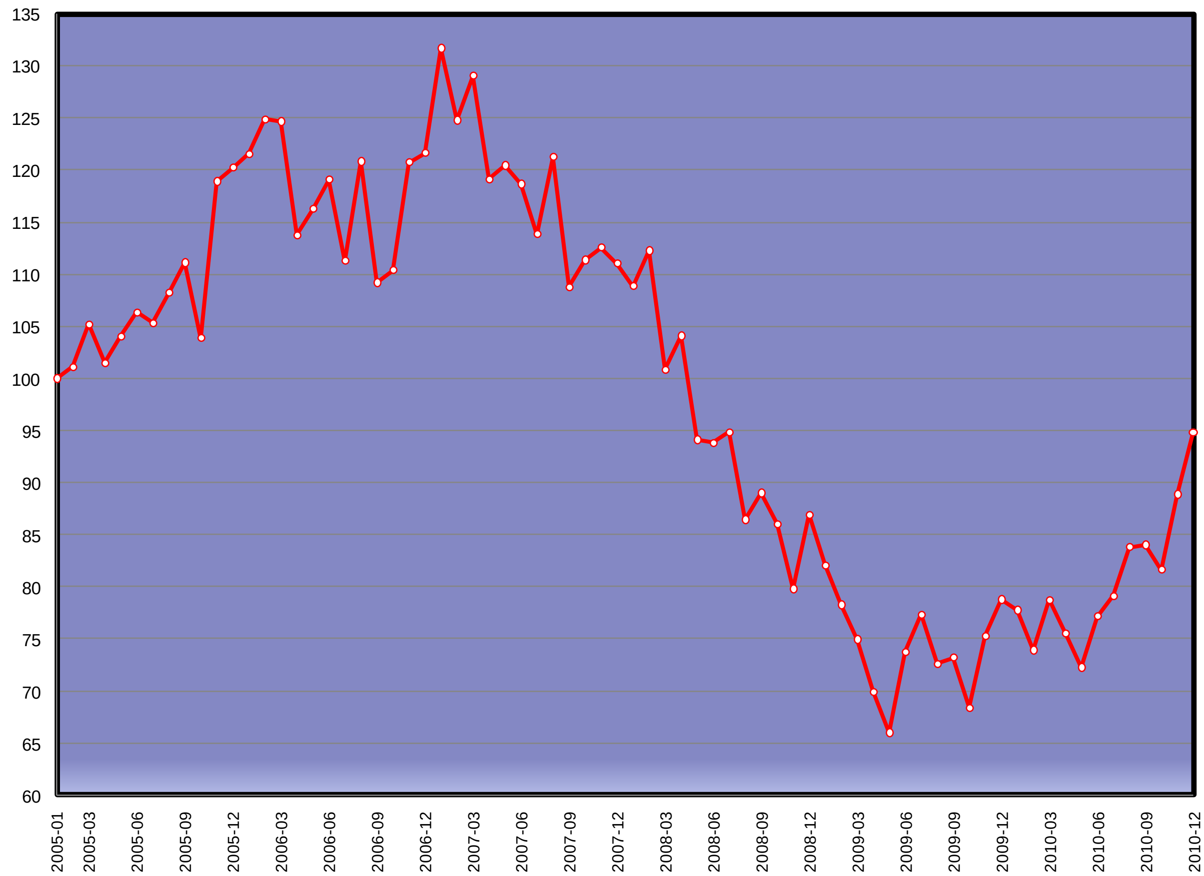


Figure 3: Thomson Reuters/PayNet Small Business Lending Index

Leaving the Bunker

The data indicate small businesses are in the early stages of an economic recovery. Small business owners are finally opening the bunker door and starting to look outside. Based on the 20% increase in the SBLI during December 2010 compared to December 2009, we can infer business owners are beginning to like what they see. Evidence of the elusive green shoots is emerging as owners see profitable investment opportunities again.

Analysis of the SBLI yields the following observations:

- The Construction industry increased more than any other sector as small borrower originations jumped. However this increase is compared to a very low level as borrowings in 4Q10 were still less than half of what they were 5 years ago.

- Transportation, health care and farms all expanded borrowings about the same, but truck borrowings were still significantly below their peak in 2005.

- Surprisingly, professional service companies' borrowings to purchase computer and office equipment were essentially flat in 4Q10 compared to the year before, and well below levels recorded 5 years ago.

Small business lending demand is increasing but mostly because of those small firms which are, more or less, participating in the global economy such as firms with activity that is related to export (e.g., commodities, transportation) and upstream suppliers to large corporations (e.g., specialized machining). Small business lending demand by the majority of firms which are primarily dependent on domestic, local or regional economic activity is reported as being weak to stagnant.

Not Ready to Declare Victory

Sobering facts on the state of the economy still persist - high unemployment, improving but still low consumer confidence, modest income growth, and lower housing wealth. Another sobering fact – the Index is 5% *below* the level it stood 6 years ago in January 2005. Most small businesses are dependent on domestic demand and often lack the resources to deal with trade barriers and tariffs and are shut-out of booming growth in emerging economies. The 20% uptick may prove illusory as a major capital equipment manufacturer revealed that strong December buying was directed at replacing old, worn-out equipment, rather than growth investment. In addition, year-end buying to fill capital budgets likely drove some of the December increase and is unlikely to continue at the same pace.

Small Business Owner - The American Hero

When you consider the economic carnage from the recession, small business owners' survival is a testimony to their resilience and grit. Demand cratered, regulations increased, uncertainty abounded, and payment terms extended to 60 days. Yet the small business owner managed to not only stay afloat, but to reach solid financial footing. During the economic crisis, defaults by American small businesses peaked at 6.5%.[v] To put this into perspective, defaults of speculative grade corporate bonds peaked near 12.97%.[vi] Small businesses have cut costs and debt levels and they are re-tooling to be leaner. Asset quality has improved as loan delinquency is now down below pre-recession levels. Default risk on small business loans has fallen to levels lower than 2008 and 2009.

Trends in Small Business Delinquency Exhibit Continued Financial Health

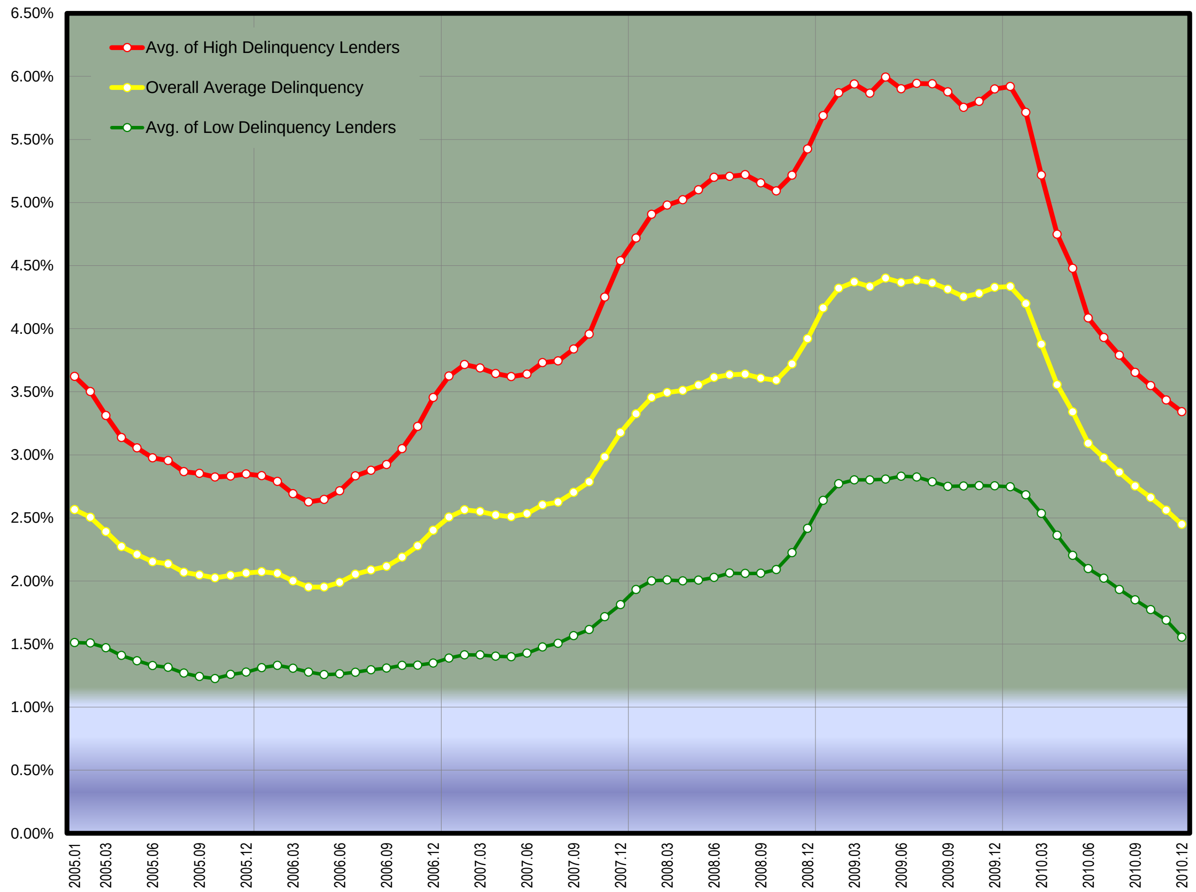


Figure 4: Small Business 30 Day Delinquency

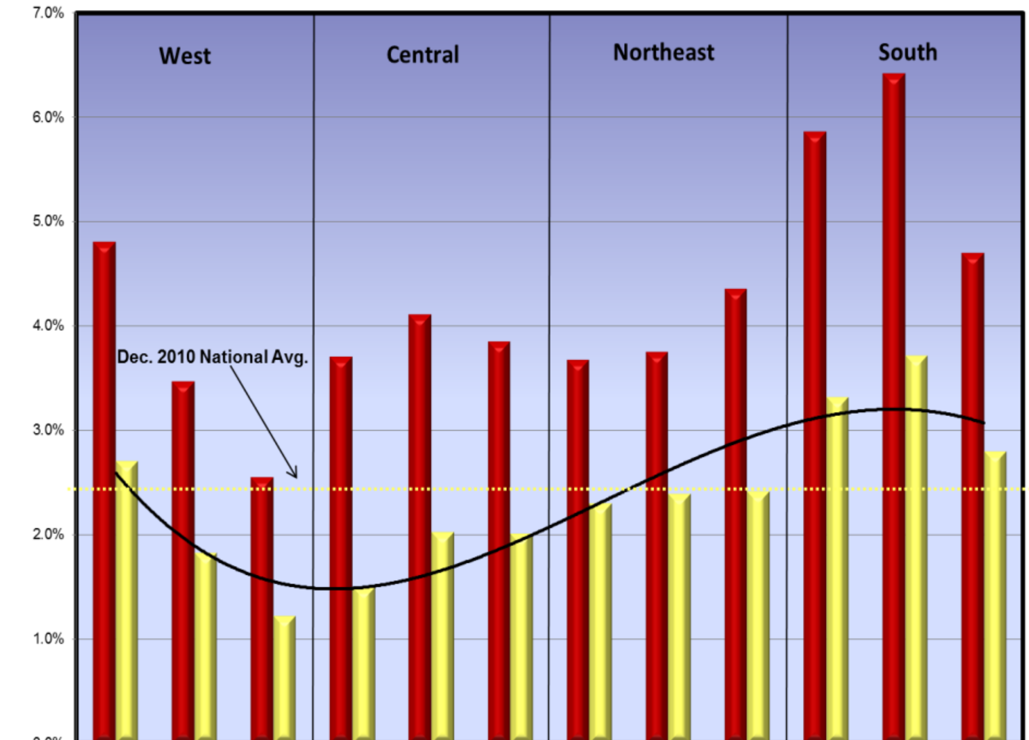
- 30 day delinquency continued to decrease in December, down to 2.45% - levels last seen in late 2006.

- Loan delinquency was down 43% in December 2010 compared to December 2009, the largest year-over-year decrease on record.

- The 1.55% delinquency among banks was even better than the average, nearing the low point seen in 2005.

Small Business 30 Day Delinquency by Federal Reserve District

This past recession has been easier on certain small business industries as indicated by their historical default performance. Construction firms, which represent the second largest industry by number of companies, have been one of the hardest hit segments of the small business economy. We have seen 1 out of 10 construction companies go out of business or default on their loans in 2009 alone. Transportation and warehousing companies are in the same category with about 1 in 10 also going out of business. The current lack of demand for construction and transportation services has intensified competition for the few remaining orders.



	San Francisco	Kansas City	Minneapolis	Chicago	St. Louis	Cleveland	Boston	New York	Philadelphia	Richmond	Atlanta	Dallas
High Qtr.	4.8%	3.5%	2.6%	3.7%	4.1%	3.9%	3.7%	3.8%	4.4%	5.9%	6.4%	4.7%
Dec. 2010	2.7%	1.8%	1.2%	1.5%	2.0%	2.0%	2.3%	2.4%	2.4%	3.3%	3.7%	2.8%

Figure 5: Small Business 30 Day Delinquency by Federal Reserve District

Small business recovery is impacted by the geographic region of the country in which the business operates. Although small businesses as a group have shown 50% improvement in 30 day delinquency since the recession on a national basis, the recovery has been better in Western and Central Federal Reserve Districts than in others. The Chicago and St. Louis Fed Districts are now more than 50% below their peak loan delinquencies, and Kansas City and Cleveland are almost 50% below. The South has the highest delinquency, with Atlanta and Richmond at 3.7% and 3.3% respectively, followed then by Dallas at 2.8% and San Francisco at 2.7%. These four Districts also had the four highest peak delinquency levels, ranging from 4.7% to 6.4% and improvement in these hardest hit areas has come at a slower rate.

All Districts report reduced delinquency for nine months or more, with peak delinquency levels reached earliest in New York, Atlanta and San Francisco, which peaked in 2008 or early 2009, compared to Richmond, St. Louis, Dallas and Boston which were the last to peak, in late 2009 or early 2010.

From March 2010 to October 2010, each of the 12 Districts showed improvement in each successive month. In November, however, Richmond showed a slight increase, and in December Philadelphia, Boston and New York all saw slight increases. Conceivably weather could have been a factor, or it is also possible that so much improvement has already been seen in those Districts, that not much more improvement, at least in terms of commercial loan delinquency, is possible.

2011 Small Business Outlook

Transition best describes the small business economy. Rising regulatory costs, higher taxes, technological change and increased competition are forcing small businesses to seek more efficient and sustainable ways to do business. More efficient and sustainable ways to do business require know-how and tools like software.

Industry	AbsolutePD® Forecasted Default Rates
	2011
Construction	4.1%
Retail	4.0%
Transportation	3.8%
General	2.9%
Health Care	2.9%
Agriculture	2.0%
All Industries	**3.2%**

Figure 6: Small Business Risk Outlook

For example, construction companies are adopting Building Information Modeling (BIM) technology and lean construction techniques to be more cost efficient and sustainable. Efficiency and sustainability lower risks resulting in a falling forecast for loan defaults across all industries.

Small businesses are in a definitive recovery. However, market conditions, such as regulatory costs, health insurance regulations, and fewer markets for products present challenges to growth and survival. The recession has forced small businesses to get leaner and smarter. Introducing technology cuts costs and increases productivity but also reduces jobs. The trick will be to help unemployed workers acquire skills for the jobs of the future.

Conclusion

If availability of capital is not the principal problem then what is holding back small business job creation and economic growth? Uncertainty impacts all business decisions. Although no study exists to support this claim, uncertainty probably hinders small businesses more than larger businesses, since they have fewer resources to handle unforeseen issues. Certainty, of course, is desired because it improves the chances for business success. Unknown future costs for regulations, health care and taxes heighten uncertainty for small businesses, with cash hoarding as the best indicator of the uncertainty felt by businesses. Businesses are building cash, to levels not seen since 1963,[vii] rather than spend, borrow, or hire employees.

The question of credit availability becomes somewhat irrelevant, given the excess cash reserves on-hand, since businesses will be expected to first draw on their cash reserves before borrowing, adding to the weak loan demand. Removing uncertainty, wherever it exists, will go far towards encouraging businesses to spend, borrow or hire which, in the long run, will assist to create jobs and further economic growth.

BIOGRAPHY-William Phelan is President and Co-Founder of PayNet, Inc.

William Phelan is president and co-founder of PayNet, Inc. the premier provider of risk management tools and market insight to the commercial credit industry, collecting real-time loan information from the largest U.S. commercial lenders and turning it into actionable business intelligence. As President, Mr. Phelan has grown PayNet into a firm with the largest collection of commercial loans and leases, encompassing more than 17 million contracts worth $800 billion in loan value. Under his strategic direction, Mr. Phelan oversees the sales, marketing, analytics and information technology functions of the business.

Prior to co-founding PayNet, Mr. Phelan managed an investment portfolio of fixed income securities for Trustmark Insurance Company in Lake Forest, Ill. In this fiduciary role at Trustmark, Mr. Phelan managed asset and mortgage backed securities and corporate bonds to achieve policy holder goals of total return and safety of principal. From 1993 to 1995 Mr. Phelan worked at Dain Rauscher Securities helping pension funds, banks and asset managers meet their client's investment needs. As a consultant at Ernst & Young from 1988 to 1993, Mr. Phelan advised privately-held companies on acquisitions and valuations to help them expand their business and conduct estate planning. Prior to that time, Mr. Phelan worked for International Business Machines Corp. and started his career in 1982 as an operations director in the retail industry. In 1992 Mr. Phelan became a Chartered Financial Analyst from the CFA Institute. He completed a Masters in Business Administration in 1987 from Loyola University Graduate School of Business where he was a member of the Dean's List and received the MBA designation with a concentration in Finance. He has a Bachelor of Arts degree from Carleton College in Northfield, MN.

Mr. Phelan provides commentary to national financial media including *Reuters, CNBC, Bloomberg Business News, FOX Business News, and Business Week.*

Mr. Phelan regularly speaks throughout the nation on the latest trends at national industry events including: Equipment Leasing and Finance Association Annual Conferences, Synovus Business Banking C&I Forum, and Consortium on Bank Regulation. National articles Phelan authored include: *The RMA Journal-The Economic Recovery and Changing Landscape of the U.S. Small Business Economy, December, 2010; Business Loan Delinquency Rates Continue to Edge Up, October 2006; Banks' Small-Business Lending Practices at Odds with Growth Aspirations, July 2006; Leasing and the Economy... Benchmarks Show Varied, but Improving, Credit Trends, May 2004; Technology & Credit: Pooling Lease Payment History, November 2000.*

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[i] Testimony of Dr. Winslow Sargeant, Chief Counsel for Advocacy, U.S. Small Business Administration.
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[iii] www.sba.gov
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[vi] Moody's Investors Services, Corporate Default and Recovery Rates, 1920-2009.
[vii] *US Firms Build Up Record Cash Piles,* The Wall Street Journal, June 10, 2010.