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New Insights on Online Lender Applicants from the Small Business Credit Survey

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OVERVIEW

How do small businesses that apply to online alternative lenders compare to those that apply to traditional financial institutions only? And in what ways do their experiences with lenders differ? This analysis draws from data in the Federal Reserve's 2015 Small Business Credit Survey to examine these questions. Among the main findings: Firms using online lenders tend to be smaller, younger, and less profitable than firms using traditional lenders, and are more likely to be minority-owned. Furthermore, firms that sought credit from online lenders reported lower overall approval rates—despite the perception among many small-business owners that they have a higher chance of being funded by an online lender. Finally, successful applicants reported lower levels of satisfaction with their online lenders, citing in particular concerns with high interest rates.

ONLINE ALTERNATIVE LENDERS AND SMALL-BUSINESS BORROWERS

Nonbank online lenders, also referred to as online alternative or "fintech" lenders, represent a small share of total small-business lending, but are a growing source of financing for small firms across the U.S. These lenders utilize data-driven processes and technology for underwriting, pricing, servicing, and delivering funds to borrowers. They offer various small-dollar credit products to small-business customers such as short- and fixed-term loans, lines of credit, and merchant cash advances.

Small-business owners may turn to online alternative lenders for a variety of reasons. Curtailed bank lending to small businesses may be a factor driving these firms to alternative lenders. Small firms that emerged from the recession with impaired credit may still find it challenging to meet the underwriting criteria of traditional banks. Finally, small businesses may perceive banks as less likely to lend to small firms now than in the past, while others may prefer the speed and simplicity of an online credit-application process.[1] Since the online alternative finance industry is emerging, limited data are available on and relatively little is known about which firms tend to use online lenders, why and where they have chosen to apply, how successful they are in obtaining funds, and how satisfied they are with their experiences as borrowers. This analysis helps to address these gaps.

[1] For additional background on the alternative lending industry, its products and features, and business owners' perceptions of alternative lenders, see *Alternative Lending through the Eyes of "Mom & Pop" Small-Business Owners: Findings from Online Focus Groups* by Barbara Lipman and Ann Marie Wiersch, available at **http://ow.ly/55jU3052awH**.

ABOUT THIS REPORT

This analysis draws on a subset of the data from the 2015 Small Business Credit Survey (SBCS) to shed new light on whether online lender applicants differ from traditional lender applicants and, if so, how they differ. The survey, conducted from September to November 2015 by the Federal Reserve Banks of New York, Atlanta, Cleveland, Philadelphia, St. Louis, Boston, and Richmond, gathered responses from 5,420 small employer and non-employer firms in 26 states. Though the SBCS is not a random-sample survey, the responses are weighted to reflect the full population of small businesses in the states of coverage. The questionnaire asked about business conditions and credit experiences, including experiences with online lenders. The participating Reserve Banks released in March 2016 the findings for the sample's 3,459 employer firms. Overall findings and additional details about the survey and methodology are available in the *2015 Small Business Credit Survey: Report on Employer Firms.*[2]

This analysis of online lender applicants utilizes the weighted dataset compiled from the 2015 SBCS responses from employer firms only.[3] Specifically, the analysis explores the decisions and outcomes of those employer firms that applied for financing in the prior 12 months. Of the SBCS employer firm respondents, 47 percent applied for credit in the 12 months prior to completing the survey (identified in this report as "applicants"). Applicants were asked questions about the credit source(s) they applied to and the credit products they sought.

In the SBCS questionnaire, an online lender is described as a "nonbank online lender, including alternative and marketplace lenders." Respondents were given examples of online lenders to provide greater clarity.[4]

This analysis compares online lender applicants with traditional lender applicants—those small businesses that applied only to a traditional financial institution such as a large bank, a small bank, or a credit union. For purposes of this analysis, any respondent that submitted an application at an online lender is included with the online lender applicants, even if the respondent also reported submitting an application at a traditional lender during the last 12 months. This is often the case, as **60 percent of online lender applicants also applied to a traditional lender, while the other 40 percent applied to online lenders only.**

[2] The 2015 SBCS aggregate data on employer firms and the questionnaire used for the survey are available on the Federal Reserve Bank of Cleveland website, accessible via **www.clevelandfed.org/smallbusiness.**

[3] The SBCS is not a random-sample survey and the data are not a statistical representation of firms, therefore results should be viewed as suggestive. To minimize the effects of biases resulting from the convenience sample, the data are weighted along dimensions of industry, age, and employee size to match the distribution of small firms in the coverage area. For more details on the SBCS methodology, see *2015 Small Business Credit Survey: Report on Employer Firms,* March 2016, available via **http://ow.ly/fFqm3052bEE**.

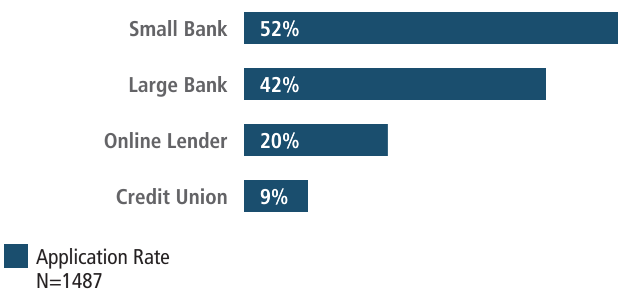
SURVEY FINDINGS

WHERE SMALL BUSINESSES SEEK CREDIT

While a majority of small firms applied for credit at banks, one in five turned to an online lender.

Banks were the most common credit source, as 52 percent of employer firms applied to a small bank and 42 percent applied to a large bank. Twenty percent sought credit from an online alternative lender and fewer than one in ten firms (9 percent) applied to a credit union.[5] Note that the figures below add up to more than 100 percent because many applicants apply to multiple sources when seeking funding.

APPLICATION RATES BY SOURCE, ALL EMPLOYER FIRMS



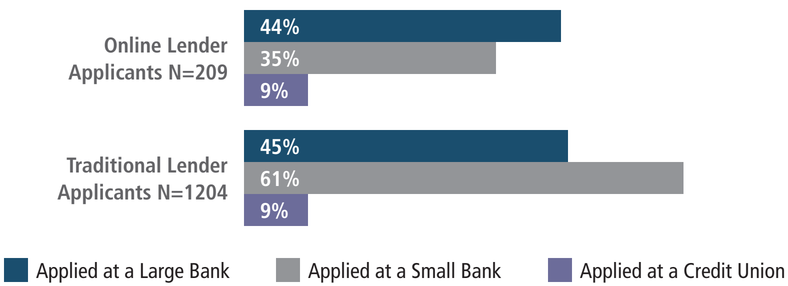
Source: 2015 Small Business Credit Survey, responses for employer firms

Note: Select answer choices shown. Respondents could choose multiple options.

Online lender applicants that also applied to traditional financial institutions were less likely than traditional-lender-only applicants to seek funding from a small bank.

While the shares of both groups applying to large banks and credit unions are similar, only about one-third of online applicants applied to smaller banks, compared to 61 percent of the traditional applicants.

APPLICATION RATES AT TRADITIONAL LENDERS



Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations.

Note: Select answer choices shown. Respondents could choose multiple options. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders; 74 firms that applied only to "other" lenders are excluded.

[4] Examples of online lenders provided in the questionnaire include Lending Club, OnDeck, CAN Capital, and PayPal Working Capital.

[5] The online lender application rate of 20 percent corresponds to the weighted frequency and should not necessarily be compared to the N values for online lender applicants in subsequent charts.

CHARACTERISTICS OF SMALL BUSINESSES THAT APPLY ONLINE

Online lender applicants are smaller, younger, and more likely to be minority-owned.

Small businesses that submitted financing applications to online lenders differ from those that applied to traditional lenders only. Online lender applicants are smaller firms: 83 percent of them have annual revenues of $1 million or less, compared with 61 percent of those applicants that sought credit only with a traditional lender. Furthermore, 48 percent of the online lender applicant pool is comprised of young firms—those in existence five or fewer years—higher than the share of traditional lender applicants that are young (36 percent). While the share of online lender applicants reporting revenue growth is similar to that of the traditional lender applicants, the online applicants are less likely to be profitable and twice as likely to cite credit availability as a top business challenge. Finally, minority-owned firms comprise a larger share of the online applicant pool (36 percent) than of the traditional-source applicants (14 percent).

CHARACTERISTICS OF CREDIT APPLICANTS

Firms that applied with an online lender N=209[6]		Firms that applied with a traditional lender N=1204[7]
83%	**ARE SMALL FIRMS** Share of applicants with annual revenues below $1M	61%
48%	**ARE YOUNG FIRMS** Share of applicants in existence 5 or fewer years	36%
54%	**ARE FIRMS WITH GROWING REVENUES** Share of applicants reporting an increase in revenues in the past 12 months	58%
38%	**ARE PROFITABLE FIRMS** Share of applicants operating at a profit	58%
25%	**ARE FIRMS WITH CREDIT CHALLENGES** Share of applicants reporting credit availability is a significant challenge	12%
36%	**ARE MINORITY-OWNED FIRMS** Share of applicants that are minority-owned firms	14%

Note: Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

[6] In total, 209 firms applied for financing with an online lender, defined as a nonbank online lender, including alternative and marketplace lenders. The N values for each variable shown in the table vary from 185 to 209, depending on the number of respondents that answered the question.

[7] In total, 1,278 firms applied for financing with a traditional lender (large banks, small banks, and credit unions). The N values for each variable shown in the table vary from 1,109 to 1,204, depending on the number of respondents that answered the question. Firms that applied only to “other” lenders (including government loan funds and community development financial institutions) are excluded.

Online lender applicants are just as likely to carry debt, but hold smaller amounts.

While firms that apply with online lenders are as likely as traditional applicants to hold debt—82 percent of both online applicants and traditional applicants report holding debt—the online applicants report holding smaller amounts. Nearly two-thirds of the online applicants report debt levels below $100,000 compared to 43 percent of applicants to traditional lenders. The online lender applicant firms are less likely to have pledged collateral on the debt they hold.

APPLICANTS' DEBT HELD AT THE TIME OF THE SURVEY

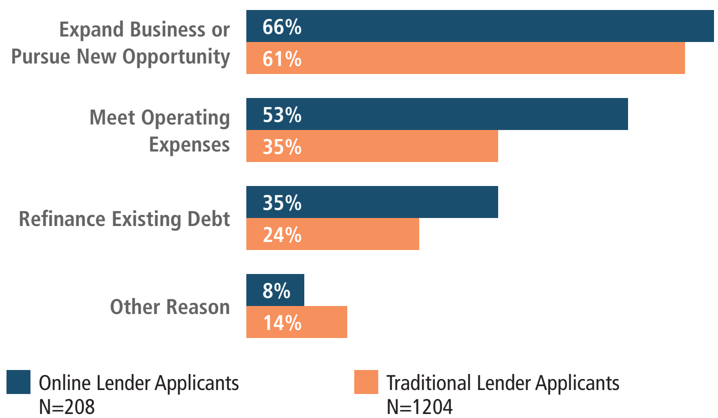
Firms that applied with an online lender N=209[8]		Firms that applied with a traditional lender N=1204[9]
82%	**ARE FIRMS WITH DEBT** Share of firms with any outstanding debt at the time of the survey	82%
64%	**ARE FIRMS WITH SMALLER AMOUNTS OF DEBT** Share of debt-holding firms with $100K or less in outstanding debt	43%
39%	**ARE FIRMS THAT PLEDGED BUSINESS COLLATERAL** Share of firms that pledged business assets to secure debt	64%

Note: Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

Online lender applicants are more likely to seek funding for operating expenses or to refinance debt.

Although applicants in both groups cited business expansion as their top reason for borrowing, online lender applicants are more likely to have sought financing to meet their operating expenses and to refinance debt. It also is the case that applicants to online lenders are more likely to cite multiple reasons for seeking funds.

REASONS FOR APPLYING FOR FINANCING



Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

Note: Select answer choices shown. Respondents could choose multiple options. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

[8] In total, 209 firms applied for financing with an online lender, defined as a nonbank online lender including alternative and marketplace lenders. The N values for each variable shown in the table vary from 185 to 209, depending on the number of respondents that answered the question.

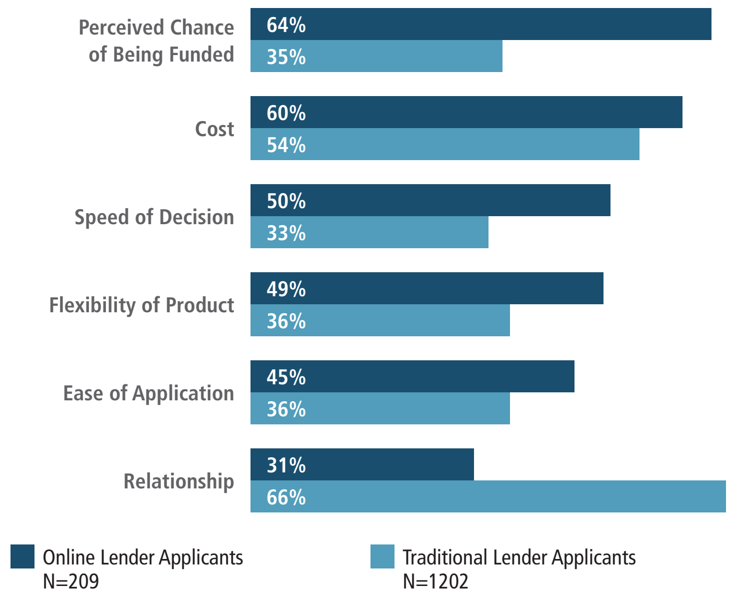
[9] In total, 1,278 firms applied for financing with a traditional lender (large banks, small banks, and credit unions). The N values for each variable shown in the table vary from 1,130 to 1,204, depending on the number of respondents that answered the question. Firms that applied only to "other" lenders (including government loan funds and community development financial institutions) are excluded.

THE ONLINE BORROWING PROCESS

Online lender applicants choose their lender based on their perceived chance of being funded.

While both online and traditional applicants cite cost as one of the most important considerations when applying for credit, other factors were considerably more important to online applicants, such as the flexibility of the product, the speed of a decision, and the ease of the application process. The top priority of the online applicants, though, was the perceived chance that they would be funded. Traditional lender applicants' top reason was their existing relationship with their lender— a factor they were more than twice as likely as online applicants to consider in their borrowing decision.

IMPORTANT FACTORS INFLUENCING WHERE FIRMS APPLY



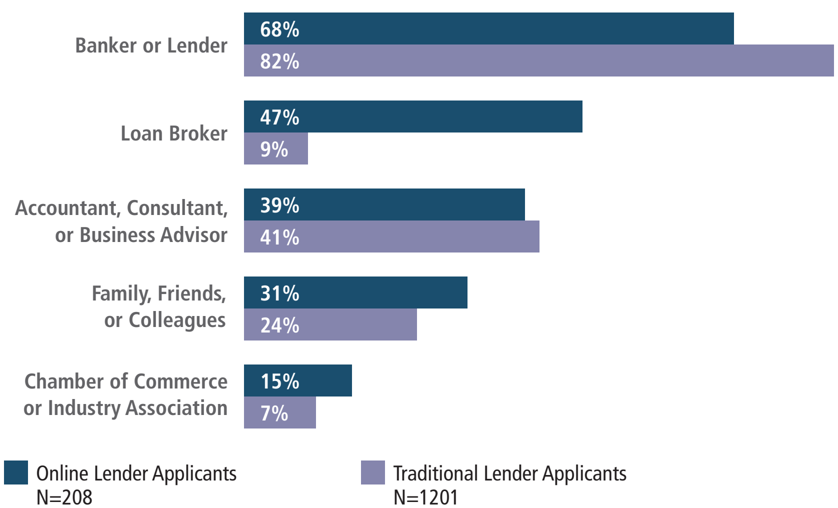
Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

Note: Select answer choices shown. Respondents could choose multiple options. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

Nearly half of all online lender applicants seek financial advice from a loan broker.

When considering credit products and financing sources, applicants often seek advice from small-business service providers, their colleagues, or others. Among both groups of applicants, a banker or lender was the most-cited source of financing advice, though for the traditional lender applicants, this was the top source of advice by a wide margin. Online lender applicants reported seeking advice from a greater number of sources, and were more likely to turn to industry associations. The most pronounced difference between online and traditional applicants is the former's reliance on loan brokers. While 47 percent of online applicants reported they received advice from a loan broker, only 9 percent of traditional lender applicants did.

SOURCES OF FINANCING ADVICE



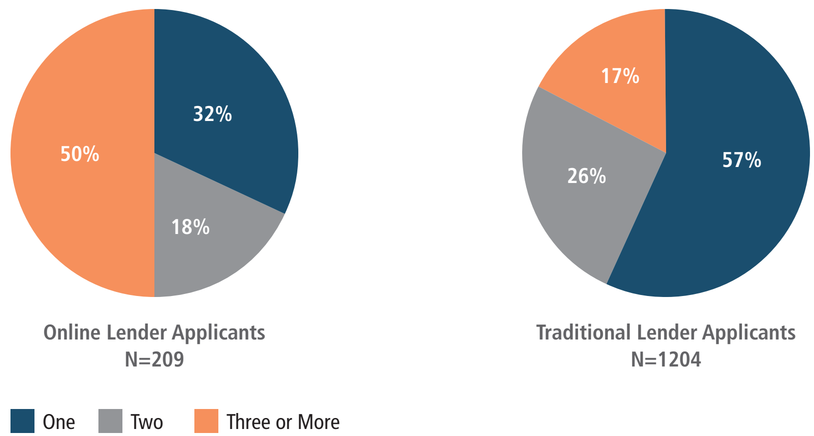
Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

Note: Select answer choices shown. Respondents could choose multiple options. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

Online lender applicants submitted more credit applications.

More than half of the traditional lender applicants submitted only one financing application in the prior 12 months, and only 17 percent applied more than three times. Conversely, 50 percent of the online lender applicant group submitted three or more applications.

NUMBER OF FINANCING APPLICATIONS SUBMITTED



Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

Note: Shares calculated based on the number of products applied for and the number of sources per product. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

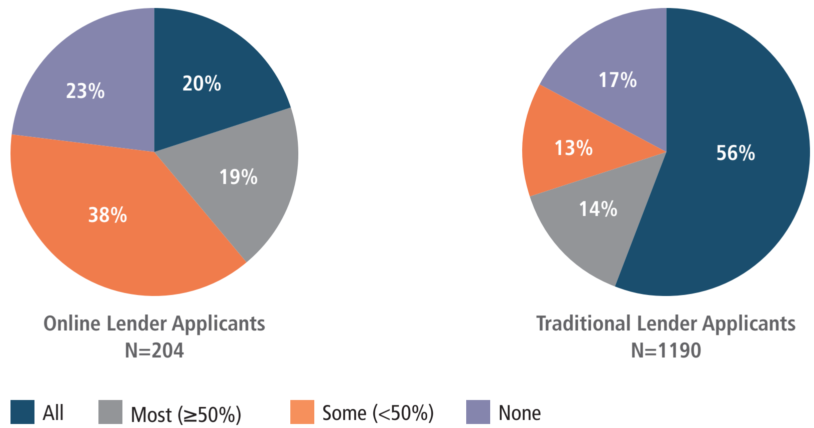
OUTCOMES FOR SMALL BUSINESSES THAT APPLY ONLINE

Online lender applicants reported less success than traditional lender applicants.

Firms that applied to online lenders had lower success rates, although 77 percent of these applicants received at least some credit. Of applicants at traditional lenders, 83 percent of applicants received at least some of the funding they requested. Just 20 percent of the online lender applicants were approved for all the funding they sought, while more than half (56 percent) of the traditional lender applicants were approved for all the funding for which they applied.

The online lender applicant group had much lower approval rates at banks than the traditional lender applicants. The sequence of applications is not known for applicants that sought financing from multiple sources, so it is uncertain whether applicants turned to an online lender after being denied by a bank. However, lower approval rates at banks appear to be associated with the submission of one or more applications at online lenders.

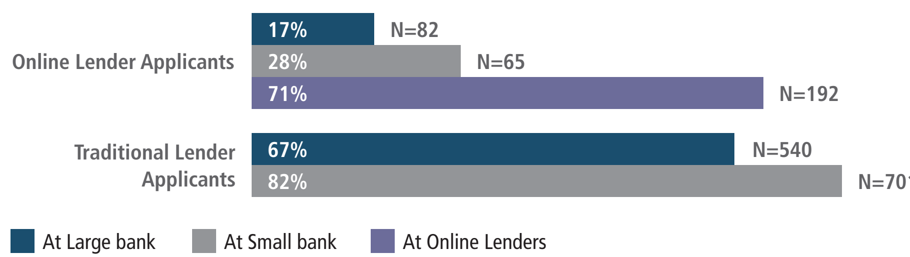
TOTAL FINANCING APPROVED, BY APPLICANT TYPE



Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

Note: Firms that were unsure of the share approved at the time of the survey are excluded from the chart. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

SHARE OF APPLICANTS APPROVED FOR AT LEAST SOME FINANCING, BY SOURCE



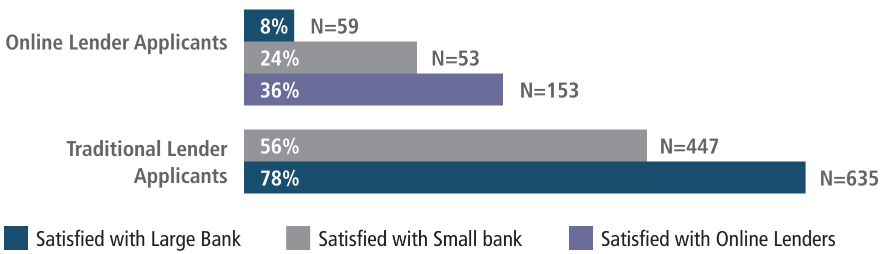
Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

Note: Chart shows share of applicants reporting they were approved for some, most, or all of the funding sought, by applicant type and by source. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

Online lender applicants had lower satisfaction levels with all the lenders they applied to—even when approved.

Among successful applicants, defined as those approved for at least some funding, the online lender applicants reported considerably lower satisfaction levels. While the majority of traditional lender applicants were satisfied with the banks they applied to, online lender applicants reported low levels of satisfaction with the banks to which they applied, even when their applications were approved. This group cited the highest satisfaction with online lenders, though only 36 percent reported being satisfied. It is worth noting that the sample size does not enable more granular analysis. Therefore, it is not known whether satisfaction is materially different across types of online lenders—for example, whether applicants were more satisfied with nonbank online lenders that offer term loans versus those that provide merchant cash advances.

SATISFACTION WITH LENDERS



Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

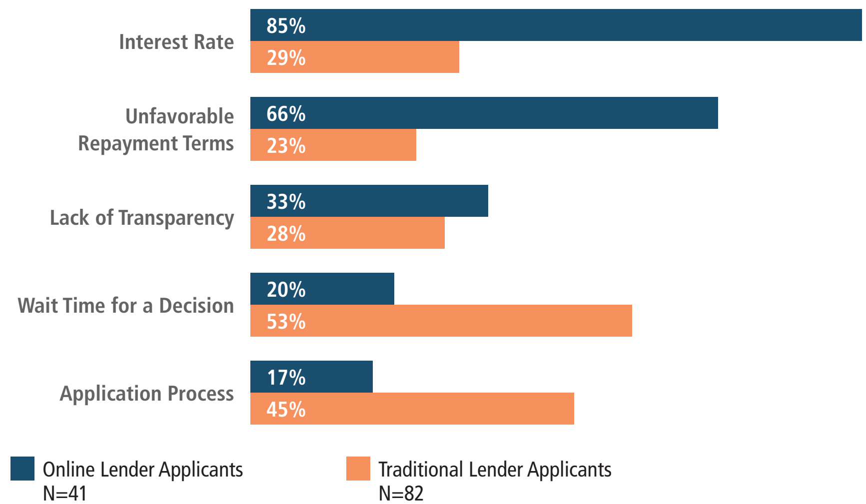
Note: Chart shows share of successful applicants (those approved for at least some financing) that responded they were "satisfied" with the lender, as opposed to "dissatisfied" or "neutral." Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

Many online lender applicants were dissatisfied with interest rates and repayment terms.

Dissatisfied online lender applicants reported high interest rates as the primary reason for their discontent, with 85 percent citing this concern. Interestingly, when limiting the analysis to successful applicants who reported cost as an important factor in their choice of lender, dissatisfaction with interest rates jumped even higher, to 92 percent.

Online lender applicants also noted dissatisfaction with repayment terms, while among the traditional lender applicants, a long wait for a credit decision and a difficult application process were top reasons for their dissatisfaction.

REASONS FOR DISSATISFACTION, SUCCESSFUL APPLICANTS*



* The small sample size is due to the inclusion of only those applicants who were both approved **and** dissatisfied. Results should be viewed as suggestive, rather than representative.

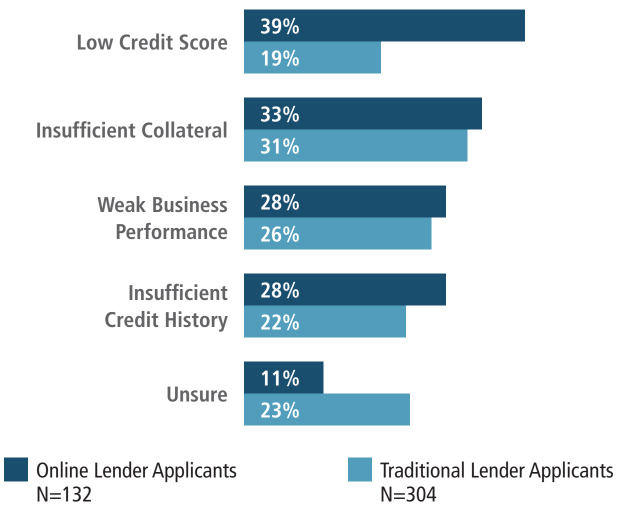
Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

Note: Select answer choices shown. Respondents could choose multiple options. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

A low credit score was the top-reported reason online lender applicants were denied credit.

Among those applicants reporting a financing shortfall, defined as approval for less funding than an applicant sought, differences were observed between the applicant groups. Online lender applicants who were not fully funded most often attributed their financing shortfall to low credit scores, with 39 percent citing this as a reason. Only 19 percent of traditional lender applicants with a financing shortfall cited a low credit score as the reason for denial. Among these applicants, insufficient collateral was the most frequently cited (33 percent) barrier to approval. While a similar share of online lender applicants reported insufficient collateral was a reason for denial, this response was more prevalent among those online applicants that also applied to traditional lenders.

REASON FINANCING APPLICATION WAS DENIED



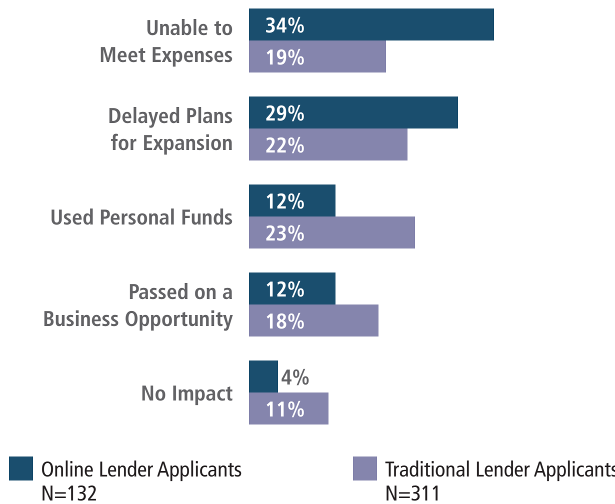
Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

Note: Select answer choices shown for applicants approved for less than full amount sought. Respondents could choose multiple options. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

Denial was more likely to result in difficulty meeting expenses among online lender applicants.

A far greater share of firms in the online lender applicant group than in the traditional lender group (34 percent and 19 percent, respectively) noted that their businesses would not be able to cover expenses as a result of their inability to secure the credit they sought. Traditional lender applicants, on the other hand, were far more likely to say they used personal funds to make up the shortfall. Both groups reported that financing shortfalls would delay plans for expansion of their businesses.

IMPACT OF FINANCING SHORTFALLS



Source: 2015 Small Business Credit Survey, responses for employer firms; authors' calculations

Note: Select answer choices shown for applicants approved for less than full amount sought. Online lender applicants are defined as those firms that applied for financing at one or more online lenders, including firms that applied at both online and traditional lenders.

ISSUES FOR FURTHER CONSIDERATION

Data from the SBCS provided an opportunity to examine the characteristics of small-business credit applicants, their reasons for choosing to apply to online and traditional lenders, their satisfaction with the outcomes if approved for the credit they sought, and, in instances where they were denied credit, their perceptions of the reasons why. The results of this analysis, considered together with the results of a separate focus group study of potential small-business borrowers (see sidebar), suggest specific areas of online lending that could benefit from additional inquiry and attention on the part of both policymakers and researchers.

Highlights from Small-Business Online Focus Groups

Considered together, two Federal Reserve System examinations of small-business credit offer unique insights into firms' credit decisions. The findings from the analysis of the Small Business Credit Survey (SBCS), presented in this report, are supplemented by an earlier study conducted by the Federal Reserve Board of Governors and the Federal Reserve Bank of Cleveland using online focus groups of potential small-business borrowers. The focus group findings are summarized in *Alternative Lending through the Eyes of "Mom & Pop" Small-Business Owners: Findings from Online Focus Groups* (August 2015).

That focus group study, conducted in 2014 and 2015, set out to gauge small-business owners' perceptions and understanding of online alternative lenders and the small-dollar credit products these lenders offer. It gathered insights from 44 "Mom & Pop" business owners with 20 or fewer employees and annual revenues of under $2 million. This study was entirely separate and distinct from the SBCS, asking differently-worded questions of different populations. Furthermore, the focus group study used a qualitative method while the SBCS used a quantitative method. Nevertheless, the in-depth responses provided by focus group participants can shed light on a number of the issues raised in the SBCS. Relevant insights from that focus group study are featured in the sidebars throughout this section.

ONLINE CREDIT: EXPANDED CREDIT VS. EXPANDED RISK

Firms in the SBCS that apply to online lenders tend to be younger (in business less than five years), smaller (as measured by revenues below $1 million), and disproportionately minority-owned compared to firms that apply to traditional lenders. These characteristics are notable because segments of the alternative-finance industry market their products to businesses that fit this profile, emphasizing the lenders' willingness to serve borrowers that traditional banks are not are not serving as well as advertising their ability to lend to younger, smaller firms, or firms with minimal credit history.[10] Many online providers of merchant cash advances (MCAs), in particular, focus on subprime borrowers and underwrite primarily based on a business's cash flow.[11] A low credit score usually is not a barrier to borrowing, although it may affect the pricing of the MCA.

It should be noted that not all borrowers using online alternative products are subprime. Some borrowers are drawn to the expediency offered by online lenders, preferring the faster, simpler processes to those they see as cumbersome processes at traditional lenders (see sidebar). As such, online lenders serve a mix of prime, mid-prime, and sub-prime borrowers. However, if competitive pressures and investor demand for returns increase, some online lenders may ease their underwriting standards in an effort to compete for a deeper pool of customers. These developments bear watching to ascertain whether risky lending practices emerge that could harm both lenders and borrowers.

When asked about their perceptions of online lenders, some participants reported favorable impressions with respect to the ease of application and speed of funding.

"When I hear 'online lender,' I often think of a lender who does not have a high overhead and wants to do business quickly."

– Owner of an accounting firm in Georgia

"When I hear online lender I am thinking that the submission process will be a little more relaxed than a bank and getting through the application to funding should be relatively simple."

– Owner of a real estate company in California

"Non-traditional lending companies are typically easier to work with if you have good credit. Interest rates vary but may be comparable to banks. Not the red-tape that you get with banks. Get money quickly."

– Owner of a craft supplies and design business in California

Source: *Alternative Lending through the Eyes of "Mom & Pop" Small-Business Owners: Findings from Online Focus Groups,* a joint publication of the Federal Reserve Board of Governors and the Federal Reserve Bank of Cleveland (2015).

[10] For example, the **website** of OnDeck, a prominent small-business alternative finance company, promotes its funding programs for firms in business at least one year and with $100,000 or more in annual revenue. The **website** of CAN Capital notes that the company requires at least four months in business and $4,500 in monthly revenues.

[11] Merchant cash advances, or MCAs, are the sale of a set percentage of the borrower's future sales receivables for a specified dollar amount. For example, $50,000 in capital is provided in exchange for $65,000, repaid with daily swipes of 10 percent of credit card sales.

REASONS FOR BORROWING, REASONS FOR CONCERN

Notably, the SBCS responses reveal that online applicants are more likely than traditional applicants to report multiple reasons for borrowing, simultaneously citing operating expenses, refinancing debt, and funding expansion. This finding simply may reflect the fact that online applicant firms are younger and have a greater set of needs for cash. For a subset of online applicants, though, these multiple financing needs may indicate that their businesses are financially precarious. Although it is a positive sign that debt loads of online applicants do not appear to be larger relative to revenues than those of traditional applicants,[12] the SBCS does not enable analysis of whether the debt is carried longer or is continuously revolving. A further concern is that although online lender applicants are as likely as traditional applicants to report increasing revenues, they also are less likely to report their firms are operating at a profit. Therefore, beyond credit scores and current cash flows at the time of application, the long-term financial position of online applicants compared to traditional applicants merits further investigation.

BROKERS AND BANKS AS SOURCES OF FINANCIAL ADVICE

The SBCS results show that banks and other lenders are a common source of financial advice for the vast majority of traditional lender applicants (82 percent) as well as for more than two-thirds (68 percent) of online applicants. This finding is echoed in the focus group study, where small-business owners indicated that, in addition to colleagues, friends, and families, their banks were a typical source of financial advice or information.

However, a number of these focus group participants who would turn to their bank for advice also said they would not necessarily expect to receive funding from a bank if they needed credit (see sidebar on page 14).

The SBCS responses suggest where these small-business owners may be likely to go instead for financing advice: a loan broker, cited by nearly half (47 percent) of online applicants as their second major source of financial information. Brokers often compete actively to deliver clients to online alternative lenders, and can obtain substantial upfront referral fees. Bank officers, of course, routinely suggest their banks' own products. However, because brokers may refer borrowers to certain online lenders based on higher commissions rather than on product suitability, their role in online lending is controversial. Recent research suggests that the majority of small-business borrowers do not comparison-shop online when applying for a loan.[13] The implication is that by relying on brokers instead of comparison-shopping, small businesses may not end up with the most appropriate, affordable product.

A further concern is that some borrowers—particularly those who have subprime credit and who lack alternatives—may be vulnerable to questionable practices on the part of brokers. Some brokers encourage "stacking," a practice by which a lender provides a credit product, often a cash advance, to a small business that already has an outstanding cash advance, usually with another company. As a result, these borrowers may become trapped in a cycle of borrowing to pay off debt.

[12] About one-quarter (26%) of the SBCS online lender applicants have revenues under $100,000 and about one-third (31%) have debt levels under $25,000. Among traditional applicants, 13 percent have revenues under $100,000 and a roughly similar share (15%) has debt under $25,000. By this metric, a larger share of online applicants has smaller debt loads relative to their revenue size.

[13] See **2015 Small Business Survey** from Lending Tree.

Participants would consult a variety of sources, including their banks, for advice on short-term credit.

"We have a great relationship with our local bank and I would probably go to them first."

– Manager of a law firm in Illinois

"I would talk to a trusted business person who is a friend and ask their advice."

– Part-owner of a funeral services business in North Carolina

"First I would call my local bank [with] whom I have had a long-term relationship."

– Manager of a management consulting firm in Virginia

"For advice, I would most likely go to a friend or financial advisor."

– Owner of a remodeling business in North Carolina

Some participants did not view banks as a likely source of short-term credit for their businesses.

"Lenders are so much more cautious these days. It has been very difficult to obtain funds simply for cash flow management in a small business. They are more willing to lend for things like capital improvement, but unsecured loans are very hard to get."

– Owner of a medical practice in New Jersey

"Biggest problem I have is lack of collateral to secure a loan with."

– Owner of an office supply business in Georgia

"By the time you need the loan a lot of banks do not want to give it to you. Also, the interest rate and the payment on the loan are so high that it's not feasible."

– Owner of a home-remodeling business in North Carolina

Source: *Alternative Lending through the Eyes of "Mom & Pop" Small-Business Owners: Findings from Online Focus Groups*, a joint publication of the Federal Reserve Board of Governors and the Federal Reserve Bank of Cleveland (2015).

CHANGING PERCEPTIONS, CHANGING FINANCIAL RELATIONSHIPS

In the SBCS, the vast majority of applicants received at least some credit. However, the success rate was lower among online applicants, with just 20 percent reporting they received all the funding they requested compared to more than half (56 percent) of traditional applicants receiving the full amount. While the survey analysis does not control for applicants' creditworthiness, lower approval rates and less-than-full funding certainly are consistent with the higher risk profile of some online applicants that have newer and less-profitable small businesses than those of some traditional applicants.

Still, this finding is intriguing because it is contrary to the perception among online applicants that it is easier to qualify online. Nearly two-thirds (64 percent) of online applicants cited "perceived chance of being funded" as a reason for applying online—making it the top-ranked consideration for these applicants. Similar perceptions prevailed in the online focus groups after participants had a chance to visit the websites of online lenders, evidenced by the comments in the sidebar. These impressions may stem partly from the images online lenders themselves promote—that their approval rates are higher and that they are flexible, in ways traditional banks are not, in their ability to provide credit to those with blemished credit histories.

Both the SBCS and focus groups suggest that some (and possibly weaker) small businesses may self-select out of applying to banks to avoid what they believe is a time-consuming application process likely to end in refusal. At the same time, many types of services traditionally provided by banks—payments processing, financial advising, cash management, and lending—now can be obtained online or offline from alternative providers. Some small businesses, perhaps especially newer ones, may therefore be less tied to a bank relationship and more likely to apply to online lenders. More research is needed on how these factors are affecting the relationships between small firms and banks as well as the availability of credit.

After visiting online alternative lender websites, a number of participants shared their perceptions about the availability of credit with these lenders.

"You'd be surprised how much money you can get and how fast you can get it from some of these online lenders. There's a ton of competition and it seems like everyone wants your business."

– Manager of an entertainment business in California

"They offer great deals to businesses with not-so-great credit scores. They seem to give small businesses hope. I feel like this would be a great alternative to a traditional bank loan."

– Owner of an event-planning business in Pennsylvania

"I'm really so excited and impressed with the new online ways to get financing, which are based on your business history and not on your credit reports or on your other debt."

– Owner of a craft supplies and design business in California

Source: *Alternative Lending through the Eyes of "Mom & Pop" Small-Business Owners: Findings from Online Focus Groups,* a joint publication of the Federal Reserve Board of Governors and the Federal Reserve Bank of Cleveland (2015).

DISSATISFACTION AMONG THE SUCCESSFUL

As the SBCS shows, most online applicants, even when funded, reported relatively low satisfaction levels with their experience. When asked why, 85 percent cited the interest rate and two-thirds (66 percent) unfavorable repayment terms. That the majority of successful applicants flag these issues raises the troubling prospect that many borrowers may not fully understand the cost of credit products they are considering. Underscoring this concern is a parallel finding from the online focus groups. As part of that study, participants were presented with several mock products based on actual products offered by online lenders. They then were asked to compare the products on cost and other features. Although most of the participants said it was "easy" to compare products, many of these same participants said they were "not sure" or answered incorrectly when asked a series of questions designed to gauge their understanding of product costs. Virtually all participants said they would like to see clearly stated features and costs and an easier way to compare product offerings (see sidebar).

Whether to improve disclosure for small-business credit products—and how to do this—is a topic of discussion among small-business advocates, online lenders, and government policymakers alike. Credit extended for a business or commercial purpose is not covered by the disclosure requirements of the federal Truth in Lending Act. In practice, then, online alternative small-business lenders have considerable leeway when it comes to the content and format of disclosures about their products' features and costs.

Participants recommended that information about loan products—especially costs—be stated clearly.

"They should have minimum requirements to clearly spell out the terms, fees, APR, prepayment scenarios, and borrower requirements."

– Owner of a vacation rental business in Connecticut

"APR and total repayment cost need to be easily available and displayed."

– Manager of a law firm in Illinois

Participants said they don't want to feel they can be taken advantage of.

"Requiring certain figures (APR, total cost, etc.) is a really good idea because the American public is generally in the dark about simple math and calculations. It may be too easy for lenders to use that to their advantage and use tricky or unclear wording."

– Manager of an education-services business in Illinois

"The loan business depends on the borrowers paying as much 'extra' as possible, I understand that. However, it should be ensured that disclosure is not intentionally deceptive or misleading."

– Owner of a retail electronics business in Indiana

Source: *Alternative Lending through the Eyes of "Mom & Pop" Small-Business Owners: Findings from Online Focus Groups*, a joint publication of the Federal Reserve Board of Governors and the Federal Reserve Bank of Cleveland (2015).

Currently, efforts are underway among some firms in the industry to gather signatories to a Borrowers' Bill of Rights and to develop a format for voluntary disclosures in loan documents that would present APR and other repayment terms.[14] At the same time, policymakers in Congress and at regulatory agencies are questioning whether standardized disclosure language should be required for small-business loans based on the size of the loan, the size of the borrowing firm, or other criteria.[15]

If standardized disclosures were adopted, more study would be needed on whether and how such information might prompt potential borrowers to comparison-shop and make better borrowing decisions.

BLURRED LINES BETWEEN BANKS AND ONLINE LENDERS

Initially positioned to disrupt traditional banking, online alternative lenders have begun forming partnerships with traditional banks.[16] For online alternative lenders, these partnerships provide access to capital and a customer base; for banks, these partnerships may enable them to retain customers they might not be able to serve otherwise. These partnerships have a further advantage in that banks can buy into online lenders' underlying technology rather than invest in their own systems, and offer the online products under the bank's brand name (a practice known as "white labeling").

For small-business borrowers, the upshot of these partnerships is that the lines between banks and online lenders could become increasingly blurred. The focus-group research, for example, revealed that at least some participants did not readily recognize "online" as a distinct lender category. Rather, they viewed online as a place where they can shop for or obtain credit from both the website of a traditional bank as well as alternative online sources.

For policymakers, issues of disparate treatment may arise if banks offer traditional credit products to some customers, but online alternatives—which often are more expensive—to others. It is not clear to what extent automated underwriting methods, such as those used by online lenders, raise or address fair-lending concerns. In addition, different sets of disclosure rules, practices, and regulatory regimes could apply depending upon whether the loan is considered to have been originated on- or offline. For researchers, too, the convergence of online and traditional lending may recast questions about access to credit among small-business borrowers. Developing metrics based on where and how potential borrowers apply for credit and through which channels may become all the more challenging in the future.

For additional research and analyses, visit **www.clevelandfed.org/smallbusiness.**

[14] See Small Business Borrowers **Bill of Rights** and announcement from Association for Enterprise Opportunity and the Innovative Lending Platform Association on development of the **SMART Box** disclosure.

[15] See **Request for Information** and subsequent **White Paper** from the US Treasury, and July 21, 2016, **letter** from US Senate Banking, Housing, and Urban Affairs Committee members requesting information from federal financial regulators.

[16] See, for example, the April 12, 2016 **article** from American Banker on the partnership between JP Morgan Chase and OnDeck for small business lending.

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