CLICKING FOR CREDIT:

EXPERIENCES OF ONLINE LENDER APPLICANTS FROM THE SMALL BUSINESS CREDIT SURVEY

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About this report

The Federal Reserve has an interest in the availability of financing for small businesses. These firms play an important role in local economies as employers and as providers of goods and services. Small businesses' ability to borrow, and to do so affordably, is essential to their financial health and future growth prospects.

The Federal Reserve has been monitoring developments in the online small business lending industry since the industry's emergence after the 2008 financial crisis. While the funding provided by the online lending industry is small compared to the entirety of financing extended to small businesses, online lenders have become an important part of the credit landscape, particularly for very small firms. Moreover, the industry is of interest to the Federal Reserve because online lenders may have expanded access to credit for some borrowers, spurring cooperative relationships with—and competitive responses from—traditional banks.

This analysis draws on a subset of the data from the 2021 Small Business Credit Survey (SBCS) conducted in September through November 2021 using the weighted dataset for nearly 11,000 employer firms—those small businesses with at least one employee other than the owner(s). Of employer firms in the 2021 SBCS, 34 percent applied for financing in the prior 12 months—down from 43 percent and 37 percent in 2019 and 2020, respectively.

For more details on the figures included in this report, including sample sizes and supplemental data, please see the Appendix.

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Overview

Nonbank online lenders serve as an important source of capital for small businesses. Online lenders, also referred to as fintech lenders, provide a variety of credit products, such as short- and fixed-term loans, lines of credit, and merchant cash advances. They use data-driven processes and technology for underwriting, pricing, servicing, and delivering funds to borrowers. The number of small businesses seeking credit online steadily grew in the years leading up to the COVID-19 pandemic.

Following the onset of the pandemic, supply of and demand for online credit changed in several ways. Online lender approvals declined in response to rising delinquencies and weak investor interest. On the demand side, fewer firms applied for credit due to economic uncertainty and the availability of government relief funding—notably, the Paycheck Protection Program (PPP). However, a number of fintech lenders did originate PPP loans, and they did so to not only existing customers but to many new ones. In fact, more than two thirds of businesses that applied for PPP loans at online lenders had no prior relationship with their lender.[1] While many fintech lenders focused on PPP lending and restricted their approvals for non-PPP financing, most of these lenders continued to offer their usual credit products to some extent. The analysis presented here focuses on applications for financing other than pandemic-related financial assistance.

This report builds on previous publications to further examine the characteristics, financing experiences, and credit outcomes for three subsets of small business credit applicant firms: those that applied to only online lenders, those that applied to only banks, and those that applied to both online lenders and banks.[2]

1 Federal Reserve Banks. 2021. *Small Business Credit Survey 2021 Report on Employer Firms*. February 3. https://www.fedsmallbusiness.org/survey/2021/report-on-employer-firms.

2 Wiersch, Ann Marie, Barbara J. Lipman, and Scott Lieberman. 2019. *Click, Submit 2.0: An Update on Online Lender Applicants from the Small Business Credit Survey*. Federal Reserve Bank of Cleveland. December 19. https://www.clevelandfed.org/newsroom-and-events/publications/special-reports/sr-20191216-click-submit-2.aspx; Lipman, Barbara J., and Ann Marie Wiersch. 2019. *Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites*. Board of Governors of the Federal Reserve System. December. https://www.federalreserve.gov/publications/what-small-business-borrowers-find-when-browsing-online-lender-websites.htm.

Key findings

SMALLER, NEWER, BLACK-OWNED, AND HISPANIC-OWNED FIRMS ARE MORE LIKELY TO APPLY TO ONLINE LENDERS.

Consistent with prior years' survey findings, firms that apply to online lenders are more likely to be newer and have fewer employees, lower revenues, and weaker credit scores. Higher shares of Black- and Hispanic-owned firms apply to online lenders compared to white- and Asian-owned firms.

APPROVAL RATES AT ONLINE LENDERS—WHICH PAST SURVEYS SHOW WERE AN IMPORTANT FACTOR IN APPLICANTS' CHOICE OF LENDER—HAVE DECLINED.

Prior to the pandemic, online lenders approved higher shares of applicants than banks did. However, the latest SBCS findings indicate that online lenders were less likely than large and small banks to fully approve applicants for all of the financing they sought.

ONLINE LENDER APPLICANTS WERE LESS SATISFIED WITH THEIR EXPERIENCES THAN WERE BANK APPLICANTS.

Overall satisfaction rates remain lower for online lender applicants than for large and small bank applicants. Among applicant firms that were at least partially approved, 76 percent of small bank applicant firms reported satisfaction with their lenders, compared to only 39 percent of online lender applicants.

ONLINE LENDER APPLICANT FIRMS OFTEN REPORTED CHALLENGES WITH HIGH INTEREST RATES AND UNFAVORABLE REPAYMENT TERMS.

Overall, approved applicants cited fewer challenges with their lender experiences than did applicants that were denied. The only exception was at online lenders, where approved applicants were more likely than denied applicants to cite challenges with high interest rates and unfavorable repayment terms. This finding suggests that online lender applicants may have been offered pricing and terms that differed from what they expected.

While small businesses most often applied for financing at banks, nearly one quarter applied at online lenders.

Credit sources applied to[3]

% of loan, line of credit, and cash advance applicants

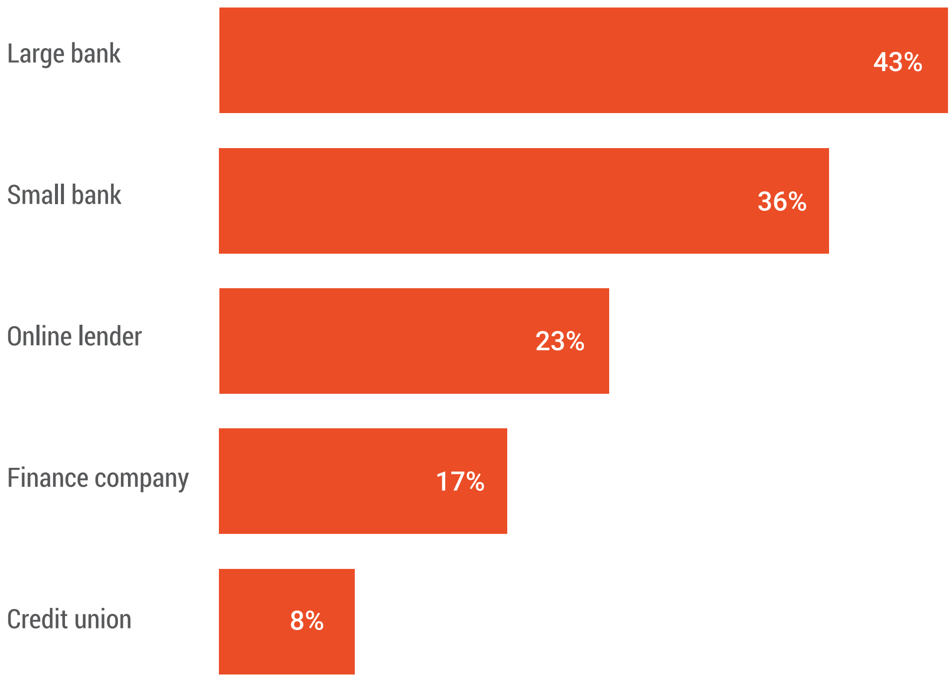


Chart notes: Respondents could select multiple sources. Community Development Financial Institutions (CDFIs) and other lenders not shown. See the *Small Business Credit Survey 2022 Report on Employer Firms* for more details.

3 Federal Reserve Banks. 2022. *Small Business Credit Survey 2022 Report on Employer Firms*. February 22. https://www.fedsmallbusiness.org/survey/2022/report-on-employer-firms.

Overall, the SBCS finds that among employer firms, 34 percent applied for financing in the prior 12 months.[3] This report focuses on applicant firms and the three types of lenders at which small businesses most commonly sought financing: large banks, small banks, and online lenders.

As shown in the chart, small businesses most often turned to banks for financing. While the use of online lenders has declined somewhat (to 23 percent, down from 33 percent of applicants prior to the pandemic), the 2021 SBCS finds that nearly one quarter of applicants applied at an online lender in the prior 12 months.

SMALL BUSINESS CREDIT SURVEY LENDER DEFINITIONS

Large bank	Large banks are defined as those with at least $10B in total deposits.
Small bank	Small banks are those with less than $10B in total deposits.
Online lender	Online lenders/fintech companies are nonbanks that operate online. Examples provided to respondents vary by question but include OnDeck, Kabbage, CAN Capital, PayPal, and Square.
Finance company	Finance companies are nonbanks that provide loans, leases, and other financial services. Examples include mortgage companies, auto finance companies, investment funds, and insurance companies.
Credit union	Credit unions are nonprofit cooperatives where members can borrow money at competitive rates from pooled deposits.

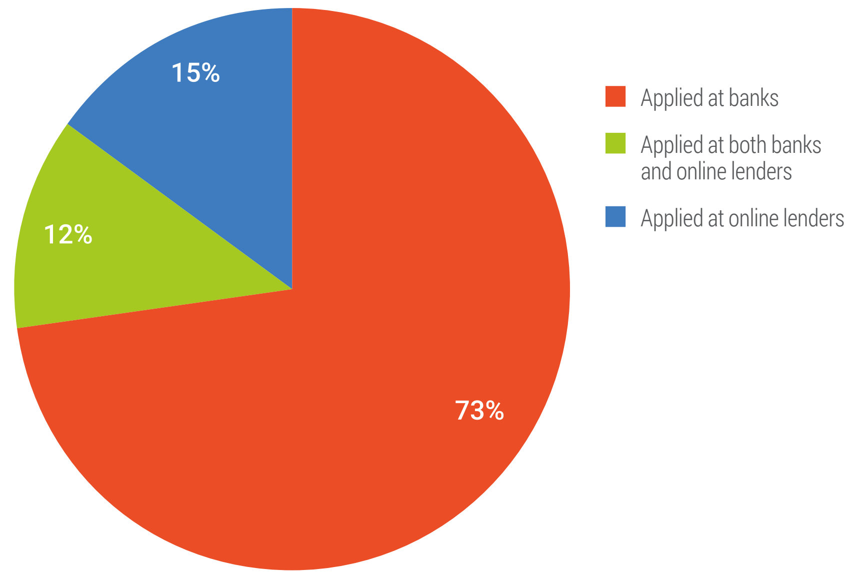
Focusing on applicants that sought financing at banks or online lenders, 73 percent applied at banks but not online lenders, 15 percent applied at online lenders but not banks, and 12 percent applied at both banks and online lenders.

FOR SELECT CHARTS, APPLICANTS ARE DIVIDED INTO THREE CATEGORIES:

Applied at banks	Firms that applied for loans, lines of credit, or cash advances at large or small banks but not at online lenders
Applied at both banks and online lenders	Firms that applied at a bank (large or small) and an online lender
Applied at online lenders	Firms that applied for loans, lines of credit, or cash advances at online lenders but not at large or small banks

Share of applicants that sought financing at banks, online lenders, or both

% of loan, line of credit, and cash advance applicants at banks and online lenders



Small businesses, in aggregate, apply for many types of financing, including loans, credit cards, trade credit, and leases. And, as shown on the prior page, they turn to several bank and nonbank sources.

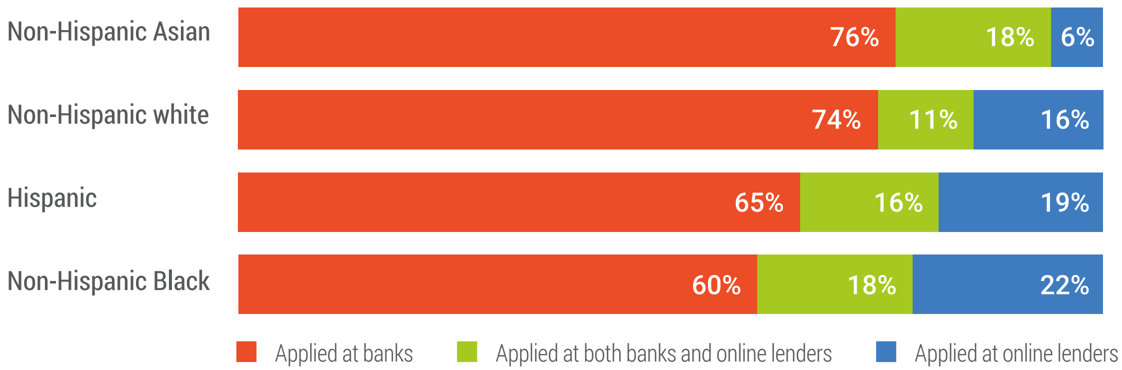
The SBCS gathers more detailed information on applicants' experiences with a subset of products: loans, lines of credit, and merchant cash advances. For purposes of this report, the analysis focuses on firms that sought only these products. Further, to simplify the analysis, the report relays the experiences of only those firms that applied at banks or online lenders. As such, firms that applied at only finance companies, credit unions, CDFIs, and other lenders are excluded from this analysis. However, the appendix of the *Small Business Credit Survey 2022 Report on Employer Firms* presents findings on those applicants' experiences.

Chart notes: This figure and those that follow exclude employer firm applicants that sought loans, lines of credit, or cash advances at finance companies, credit unions, CDFIs, or other lenders (e.g., farm credit institutions, friends/family, private investors), unless they also applied at a bank or an online lender. The excluded applicants account for approximately 15 percent of loan, line of credit, and cash advance applicants in the 2021 SBCS; therefore, percentages in this figure do not correspond to those in the figure on page 4, which represents the share of all loan, line of credit, and cash advance applicants.

Black- and Hispanic-owned firms and smaller-revenue firms were more likely than their white-owned and larger-revenue counterparts to apply for financing at online lenders.

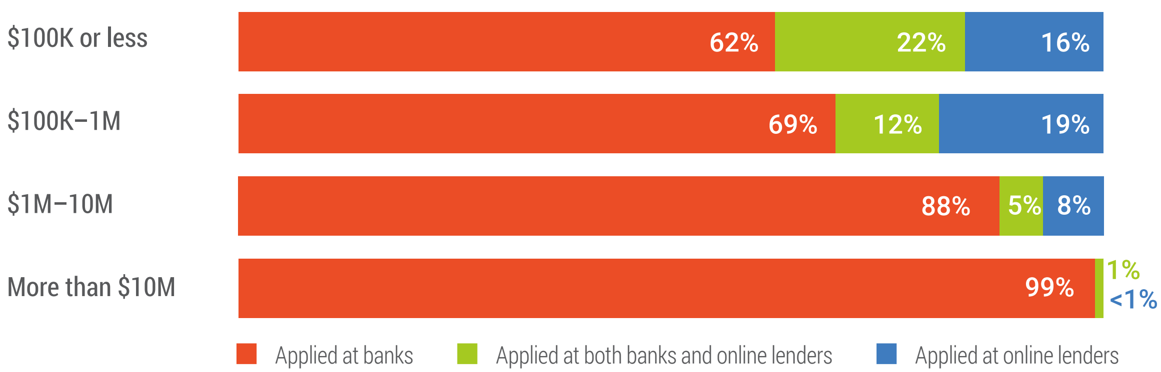
Application rate at source type by race/ethnicity of owner(s), prior 12 months

% of loan, line of credit, and cash advance applicants at banks and online lenders



Application rate at source type by firm revenue size, prior 12 months

% of loan, line of credit, and cash advance applicants at banks and online lenders



Black- and Hispanic-owned firms were more likely than white- and Asian-owned firms to apply at online lenders in the prior 12 months. These findings are consistent with findings from recent survey years. Also, Black- and Hispanic-owned firms were more likely than other firms to cite credit availability as a financial challenge. These firms may have been inclined to turn to online lenders, which—as past SBCS findings indicate—are perceived to offer applicants a greater chance of approval.[4]

Additionally, firms with annual revenues of $1M or less were more likely than larger-revenue firms to apply at online lenders. The smallest-revenue firms—those with revenues of $100K or less—were most likely to apply at online lenders. Compared to larger-revenue firms, smaller-revenue firms and their smaller-dollar credit needs may be better aligned with the offerings of online lenders, which typically extend unsecured credit in amounts up to $100,000.

Chart notes: Percentages shown may not sum to 100 because of rounding. "Prior 12 months" refers to the 12 months leading up the the time respondents answered the survey in September–November 2021.

4 See SBCS reports for survey years 2017–2019 for findings on factors that influenced applicants' choice of lender. https://www.fedsmallbusiness.org/survey.

High-credit-risk firms—those with low credit scores—and newer firms were more likely than low-credit-risk and more established firms to apply at online lenders.

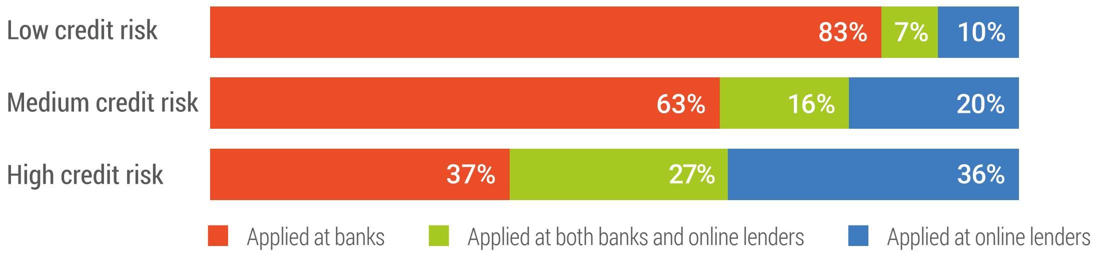
High-credit-risk firms—that is, firms with weaker credit scores—were much more likely than low-credit-risk firms to apply at online lenders. Similarly, newer firms—those in business five years or fewer—were more likely than established firms to apply at online lenders.

Firm age and credit risk are closely related. Newer firms tend to be considered riskier, while more established firms are more likely to have stronger credit scores. In fact, two thirds of high-credit-risk firms in the SBCS sample have been in business for five years or less.[5]

While their approval rates declined after the onset of the pandemic, historically, online lenders have been more likely than banks to approve higher-credit-risk businesses.[6] By emphasizing cash flow over credit scores and by incorporating alternative data into their underwriting models, online lenders may approve applicants for unsecured credit, even if the applicants have limited credit histories and few assets. Because of their risk profiles, these applicants are less likely to be approved at banks.

Application rate at source type by credit risk, prior 12 months

% of loan, line of credit, and cash advance applicants at banks and online lenders



Application rate at source type by firm age, prior 12 months

% of loan, line of credit, and cash advance applicants at banks and online lenders

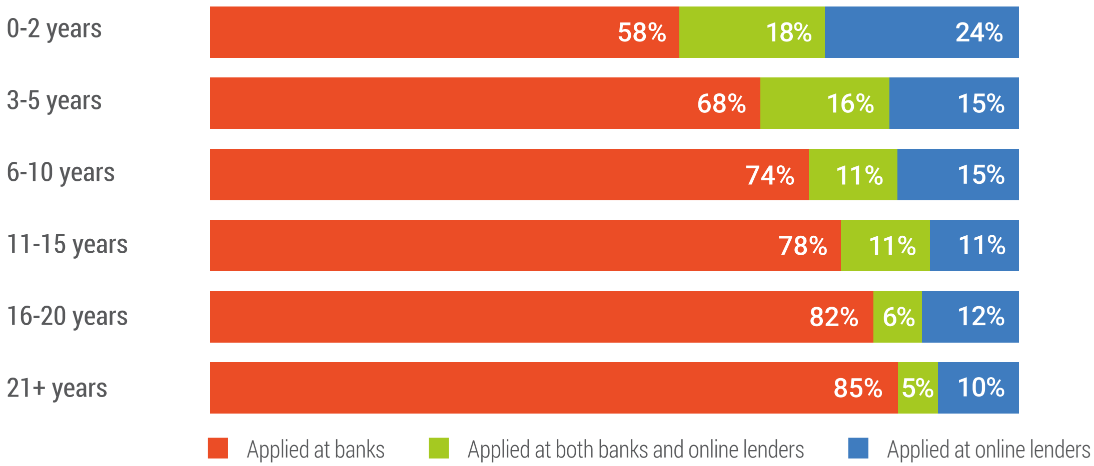


Chart notes: Percentages may not sum to 100 because of rounding. "Prior 12 months" refers to the 12 months leading up the the time respondents answered the survey in September–November 2021.

5 See the Appendix of the *Small Business Credit Survey 2022 Report on Employer Firms*. https://www.fedsmallbusiness.org/survey/2021/report-on-employer-firms.

6 Federal Reserve Banks. 2020. *Small Business Credit Survey 2020 Report on Employer Firms*. April 7. https://www.fedsmallbusiness.org/survey/2022/report-on-employer-firms.

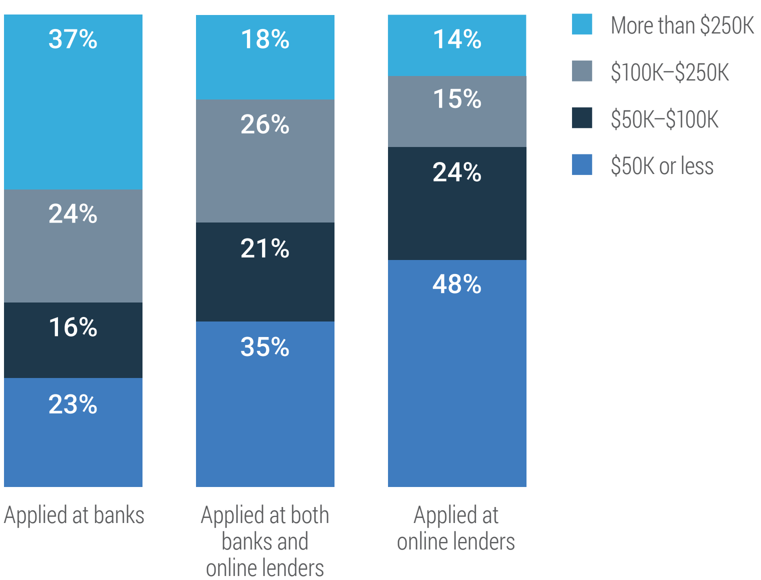
Compared to applicants at banks, firms that applied at online lenders sought smaller amounts of financing and more often sought financing to meet operating expenses.

Compared to bank applicants, online lender applicants sought smaller amounts of financing and were more likely to apply because they needed funds to meet their operating expenses. Online lenders' unsecured credit products are generally available in smaller amounts than traditional products offered by bank lenders.

Additionally, businesses in need of working capital funds may be more inclined to apply at online lenders because they typically offer faster turnaround on applications and because their working capital products may be used for any business purpose.

Total amount of financing sought

% of applicants, by category



Reasons for applying for financing

% of applicants, by category

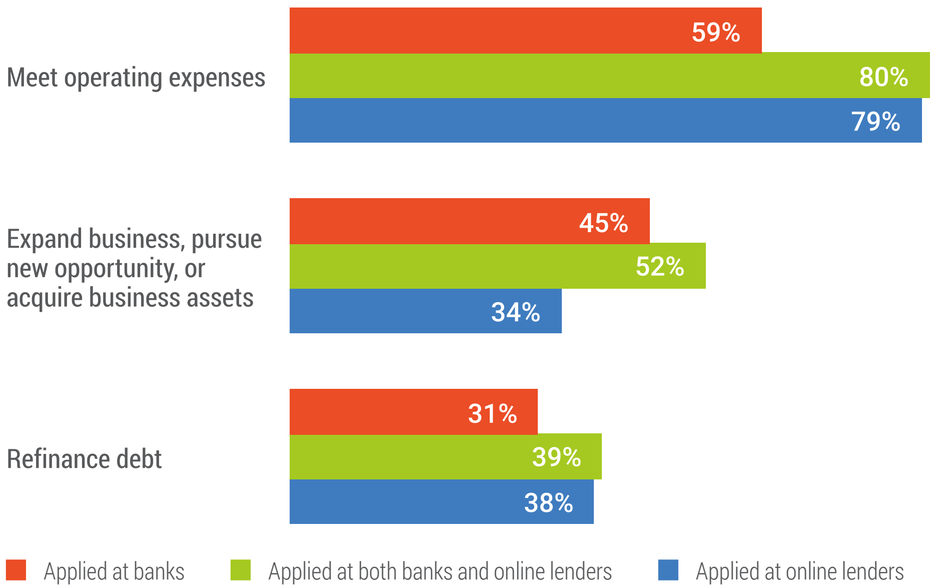
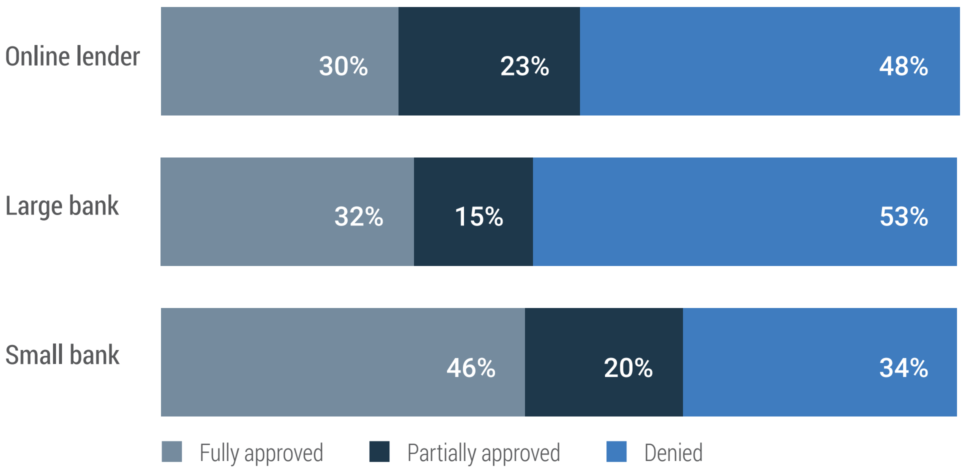


Chart notes: Total amount sought in the 12 months prior to the survey. Percentages shown in first chart may not sum to 100 because of rounding. Financing reasons shown are the top three responses; respondents could select multiple reasons. Prior to the pandemic, firms most often sought financing for business expansion.

Contrary to prepandemic survey results, in 2021, online lenders were ***least*** likely to fully approve applicants for loans, lines of credit, and cash advances compared to large and small banks.

Loan, line of credit, and cash advance applicant approvals at source

% of applicants, by source



Online lenders and large banks approved, partially or fully, about half of loan, line of credit, and cash advance applicants in the prior year. Small banks approved a higher share of their applicants for at least some funding (66 percent).

These findings diverge from prepandemic survey results, which show that online lender applicants consistently reported higher approval rates than applicants at small and large banks. The 2019 SBCS found that 80 percent of online lender applicants in the prior year were at least partially approved; that share is 27 percentage points higher than the share of online lender applicants at least partially approved in 2021.[7] The economic effects of the pandemic may have contributed to this trend, as lenders' liquidity constraints and lower repayment rates on outstanding balances led to credit tightening among online lenders.[8]

While it is the case that higher-credit-risk applicants more often seek financing at online lenders, the decline in approval rates for these applicants has been even more significant than one might expect given past rates of approval. In 2019, 77 percent of medium- and high-credit-risk applicants were at least partially approved at an online lender; in 2021, just 44 percent of medium- and high-credit-risk applicants were at least partially approved.

Chart notes: Percentages may not sum to 100 because of rounding.

7 Federal Reserve Banks. 2020. *Small Business Credit Survey 2020 Report on Employer Firms.* April 7. https://www.fedsmallbusiness.org/survey/2020/report-on-employer-firms.

8 Ben-David, Itzhak, Mark J. Johnson, and René M. Stulz. 2021. *Why Did Small Business Fintech Lending Dry Up During March 2020?* NBER Working Paper No. 29205. September. https://www.nber.org/system/files/working_papers/w29205/w29205.pdf.
Anand,Tanvi and Sachin Goel. 2021. "The Seesaw Journey of Alternative Lenders during the COVID-19 Pandemic." ABFJournal. January 27. https://www.abfjournal.com/articles/the-seesaw-journey-of-alternative-lenders-during-the-covid-19-pandemic/.

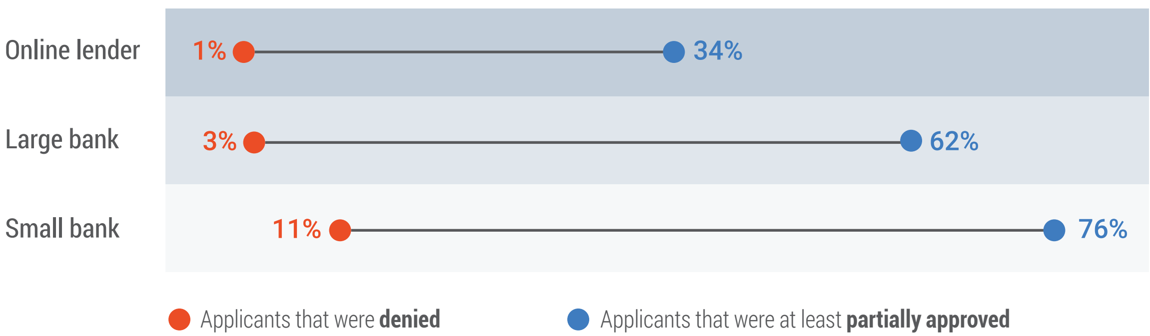
Overall satisfaction rates at all sources were much higher among applicant firms that were at least partially approved than among applicants that were denied funding. Generally, though, online lender applicants were least satisfied.

Not surprisingly, firms that were at least partially approved for a loan, line of credit, or cash advance were consistently more satisfied with their experiences with the lender at which they sought financing than were firms that were denied outright, among bank and online lender applicants alike. These findings indicate that approval status may influence satisfaction with lenders.

It should be noted that although they were not offered financing, denied applicants did rate their satisfaction with their experiences applying at their lenders. Beyond the outcomes of their applications, their ratings may reflect communications with their lenders, support received during the process, or other aspects of their application experiences. As for approved applicants, some may have included their borrowing experiences as part of their satisfaction ratings. It is also the case that some approved applicants may not have been satisfied with, and may not have accepted, the financing offered.

Satisfaction with lenders, by approval

% of loan, line of credit, and cash advance applicants at source



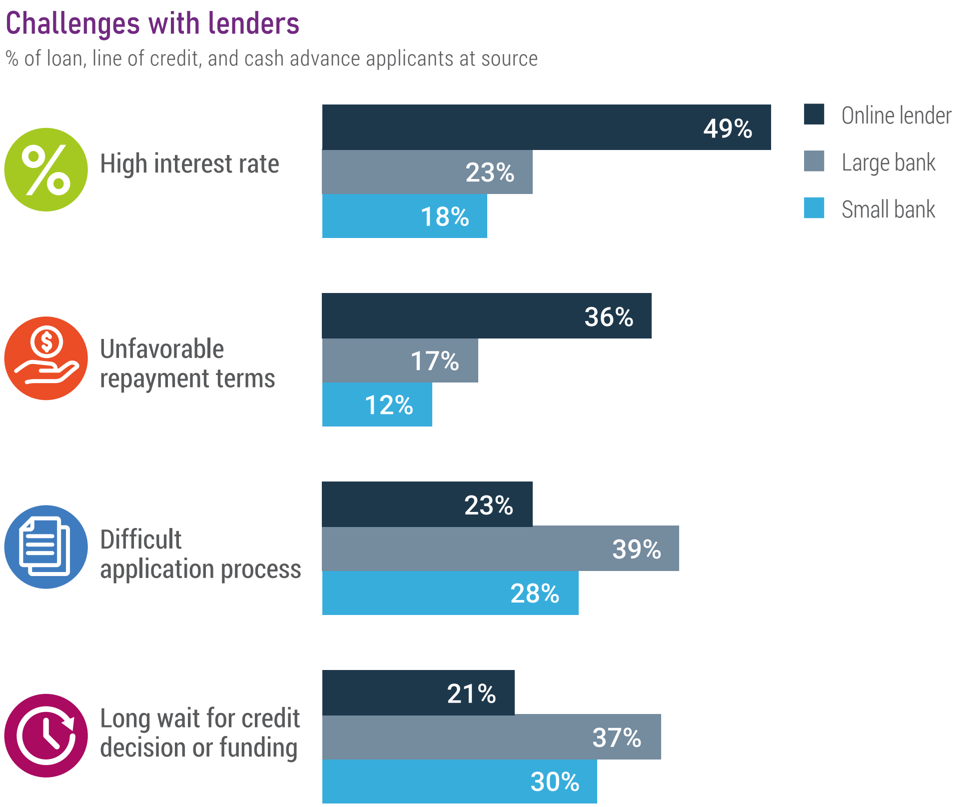
Among applicant firms, those that applied at online lenders were least satisfied, overall.

Only **34%** **of online lender applicants** that were approved for at least some financing were satisfied with their lender, while the same was true for just **1%** **of denied applicants.**

Small bank applicants that were at least partially approved reported the highest satisfaction rates; **76%** **of approved applicants** were satisfied with their lender, while **11%** **of denied applicants** were satisfied.

Chart notes: Shares shown are the shares of applicants that were satisfied with their lender experiences.

In terms of *specific challenges*, online lender applicants more often noted high interest rates and unfavorable repayment terms, while bank applicants typically cited challenges with the application process and long wait times.



Online lender applicants' top challenges were related to the terms of the products offered by their lenders—specifically, high interest rates and unfavorable repayment terms. Conversely, bank applicants' primary challenges were a difficult application process and long wait for a credit decision or funding. Historically, online lender applicants have consistently reported high interest rates and unfavorable terms as their top challenges, and they have been less likely than bank applicants to report challenges with the application process and wait times.

Credit risk is not a strong factor in the challenges applicants experienced. In fact, online lender applicants with strong credit scores were more likely to cite challenges with high interest rates than were bank applicants with weak credit scores.[9]

These findings suggest that online lender applicants—even low-credit-risk applicants—may pay higher interest rates with less favorable repayment terms in exchange for an easier, faster application and funding process. Online lender applicants' experiences reflect the value proposition presented in online lenders' marketing language, which emphasizes streamlined applications and fast funding, often within 24 hours. Additionally, past survey findings indicate that applicants prioritize speed as the highest-ranked factor in their decision to apply to an online lender.[10]

Chart notes: Top challenges shown. Respondents could select multiple challenges.

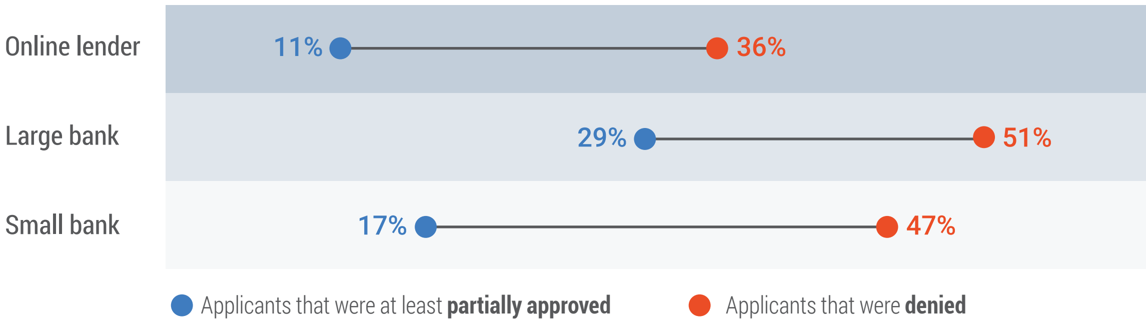
9 See the Appendix of the *Small Business Credit Survey 2022 Report on Employer Firms*. https://www.fedsmallbusiness.org/survey/2022/report-on-employer-firms.
10 Federal Reserve Banks. 2020. *Small Business Credit Survey 2020 Report on Employer Firms*. April 7. https://www.fedsmallbusiness.org/survey/2020/report-on-employer-firms.

Compared to applicants that were denied financing, approved applicants—regardless of the type of lender they applied to—reported fewer challenges with the application process and wait time for a decision or funding.

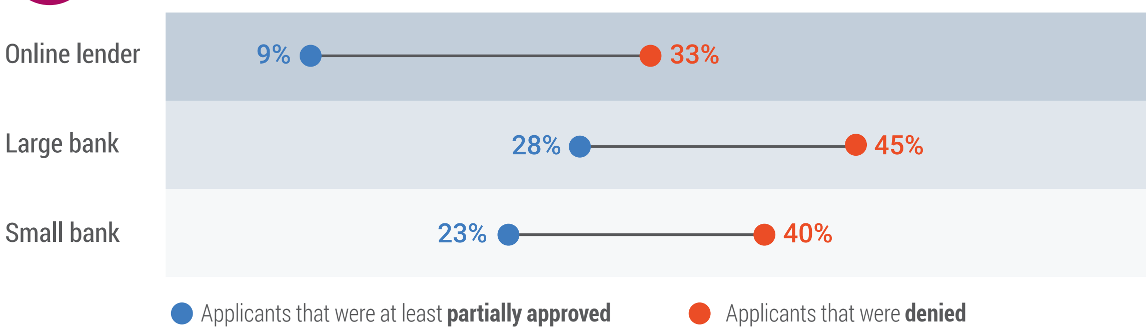
Challenges with lenders, by source and approval

% of loan, line of credit, and cash advance applicants at source that were denied/approved

Difficult application process



Long wait for credit decision or funding

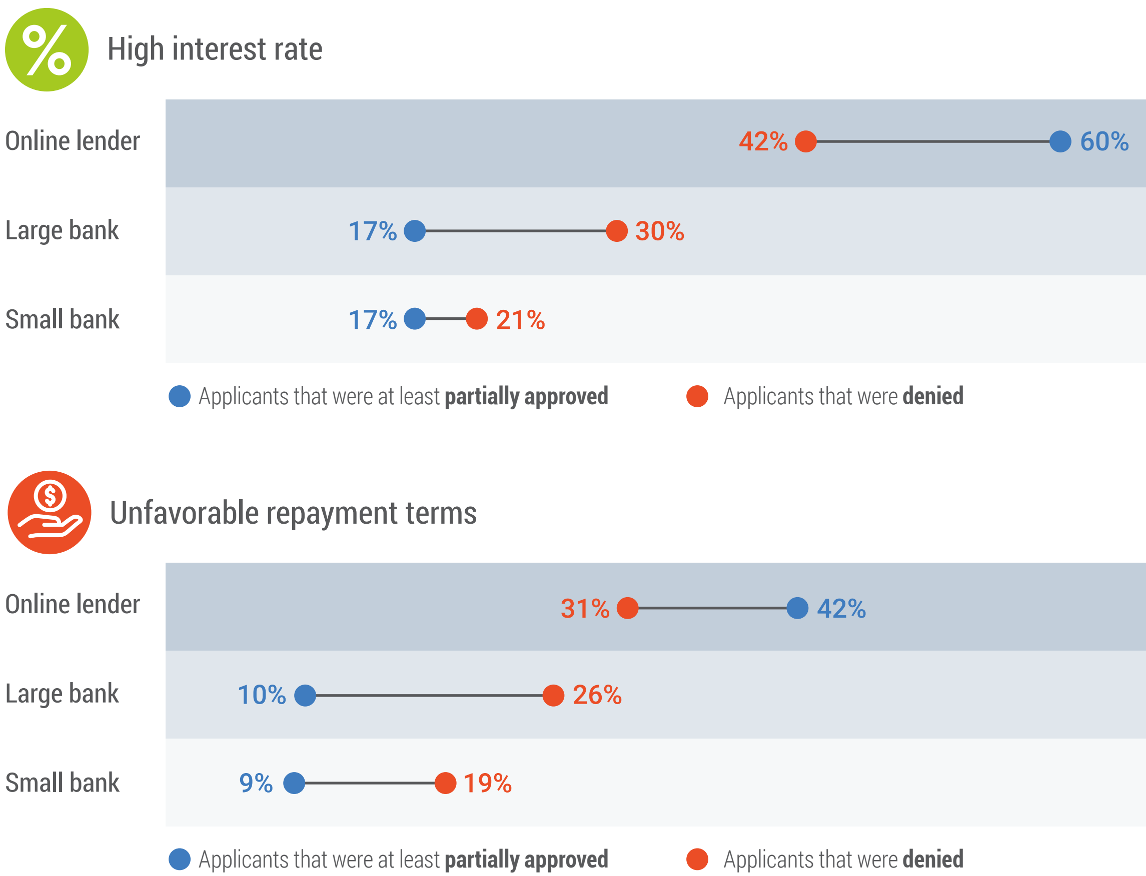


Consistent with the overall satisfaction ratings that reflect greater dissatisfaction among firms that were denied financing (page 10), denied applicants were more likely than approved applicants to report challenges with a difficult application process and a long wait for a decision or funding.

Unlike the pattern observed with bank applicants, online lender applicants that were approved were *more* likely than denied applicants to cite challenges with interest rates and repayment terms.

Challenges with lenders, by source and approval

% of loan, line of credit, and cash advance applicants at source that were denied/approved



Online lender applicants that were approved for financing were more likely than those that were denied financing to cite high interest rates and unfavorable repayment terms as challenges with their lender.[11] This finding suggests that online lender applicants may be offered products or terms that differ from the products or terms for which they believed they had applied.

11 In 2019, it was also true that approved online lender applicants reported more interest rate challenges than denied online lender applicants, while similar shares of approved and denied applicants reported challenges with repayment terms. The question about lender challenges was not asked in the 2020 SBCS.

Policy implications

This report highlights the experiences of small businesses that sought financing from banks and online lenders. After the onset of the pandemic, approval rates declined across all lenders, but online lenders' approval rates declined the most. This has implications for smaller-revenue, newer, and minority-owned firms which, according to the SBCS, disproportionately sought financing at online lenders.

Moreover, the SBCS has consistently found that small businesses are less satisfied with their experiences at online lenders in comparison to their experiences at large and small banks. Online lender applicants are more likely to cite challenges with high interest rates and unfavorable repayment terms. Importantly, **approved** online lender applicants are more likely to report these challenges than online lender applicants that are denied financing. This suggests that **small businesses may not fully understand the cost and terms of some online financing products until after they are approved or funded**. Online lender applicants, then, may carry a higher risk of taking out financing with costs and terms that they may not fully understand at the time of the application or that the business may be unable to afford. This potential lack of understanding of pricing and terms is especially notable given that, as indicated above, certain segments of small businesses apply at online lenders more often than others.

Issues with prospective borrowers' understanding of online lender product costs and terms are longstanding. Prior to the pandemic, the Federal Reserve Board and the Federal Reserve Bank of Cleveland conducted qualitative studies with 86 prospective or actual small business credit applicants.[12] In a simulated credit-shopping exercise, participants viewed online lender websites and sample credit products and were asked about their understanding of the products' costs and features.

Many participants reported that they found it challenging to locate the details they had been looking for on product terms, interest rates, overall cost of the credit, and repayment arrangements on the lenders' websites. Cost descriptions expressed in terms such as "repayment percentage options," "simple interest," and "factor rate" were confusing to some participants who conflated these with the annual percentage rate (APR). In fact, some participants were initially impressed with the advertised rates, but became frustrated when calculating and comparing total product costs. Finally, participants tended to make (sometimes mistaken) assumptions that paying more quickly would result in savings, likely based on their past experiences with traditional bank loans.

12 See Lipman, Barbara J., and Ann Marie Wiersch. 2018. *Browsing to Borrow: "Mom & Pop" Small Business Perspectives on Online Lenders.* Board of Governors of the Federal Reserve System. June. https://www.federalreserve.gov/publications/small-business-perspectives-on-online-lenders.htm and Lipman, Barbara J., and Ann Marie Wiersch. 2015. *Alternative Lending through the Eyes of "Mom-and-Pop" Small-Business Owners: Findings from Online Focus Groups*. Federal Reserve Bank of Cleveland. August. https://www.clevelandfed.org/en/newsroom-and-events/publications/special-reports/sr-20150825-alternative-lending-through-the-eyes-of-mom-and-pop-small-business-owners.aspx.

Policy implications (continued)

Nearly all focus group participants noted that clear disclosure of product costs and terms would be helpful, particularly early in the application process, rather than at closing, when businesses may have already committed the anticipated funds. Focus group participants indicated that even estimated costs, provided as ranges or averages based on a typical customer of the lender, would be useful.

A separate study examining select online lender websites found significant differences in the information that lenders presented to prospective borrowers.[13] The study corroborated the focus group participants' observations, finding variation across websites with respect to the type of information, level of detail, and terminology used in descriptions of product costs and terms. Unlike consumer credit, credit extended for a business or commercial purpose is not covered by the disclosure requirements of the federal Truth in Lending Act. As a result, online small business lenders have more flexibility in how they describe product costs and features.

The need for consistent disclosures for small business credit products is a topic of discussion among small business advocates, online lenders, and government policymakers alike. A number of states, including New York and California, have enacted small business lending disclosure laws.[14] As these laws take effect and as other state legislatures consider actions, future studies could help to shed light on whether standardized disclosures would be beneficial.

The issues raised here are important, considering that the overall share of small firms applying to online lenders may increase as credit markets evolve. One source of demand may be the new relationships that fintech lenders established with PPP borrowers. Also, expiring COVID-19 relief programs, coupled with a decline in approval rates at banks, could lead more small businesses to turn to online credit as a financing option.

13 Lipman, Barbara J., and Ann Marie Wiersch. 2019. *Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites*. Board of Governors of the Federal Reserve System. December. https://www.federalreserve.gov/publications/what-small-business-borrowers-find-when-browsing-online-lender-websites.htm.

14 As of this writing, four states have passed legislation requiring small business financing disclosures: California SB-1235 (2018), New York SB 5470 (2020), Utah SB 183 (2022), and Virginia House Bill 1027 (2022). Other states, including North Carolina, New Jersey, and Missouri, have proposed legislation on small business lending disclosures.

SBCS methodology

The SBCS is a national survey, conducted since 2016, that gathers information from small businesses on credit needs and financing and provides their perspectives on borrowing experiences—including outcomes, satisfaction, and challenges with both bank and nonbank lenders.

The SBCS uses a convenience sample of establishments. A diverse set of organizations that serve the small business community invite small businesses to participate in the survey by email. The Federal Reserve Banks also directly contact prior SBCS participants.

The sample for the SBCS is not selected randomly; thus, the SBCS may be subject to biases not present with surveys that do sample firms randomly. To control for potential biases, the sample data are weighted so the weighted distribution of firms in the SBCS matches the distribution of the small-firm (1 to 499 employees) population in the United States by number of employees, age, industry, geographic location (census division and urban or rural location), gender of owner(s), and race or ethnicity of owner(s).