

Experiences of Small Businesses that Seek Credit from Online Lenders

March 2020

Ann Marie Wiersch, *Community Development Policy Advisor*,
Federal Reserve Bank of Cleveland

Barbara Lipman, *Manager, Policy Analysis, Division of Consumer & Community Affairs*, Federal Reserve Board of Governors

View March 4 webinar [here](#)



Disclaimer

The information, analyses, and conclusions set forth are those of the presenters and do not necessarily indicate concurrence by the Board of Governors of the Federal Reserve System, the Federal Reserve Banks, or members of their staffs.

Mention or display of a trademark, proprietary product, or firm in this presentation does not constitute an endorsement or criticism by the Federal Reserve System and does not imply approval to the exclusion of other suitable products or firms.

Notes:

- Verbatim quotes from focus group participants are presented with minimal editing for space and clarity.
- This presentation includes partial screenshots from online lender websites. These images have been cropped to show relevant examples of specific content or text.

Agenda

- Which businesses are more likely to seek credit online
- Experiences of business owners that apply at online lenders
- How fintech lenders describe their products' features and costs, and how well potential borrowers understand these products
- Policy implications and debates



Spotlight on fintech in small business finance

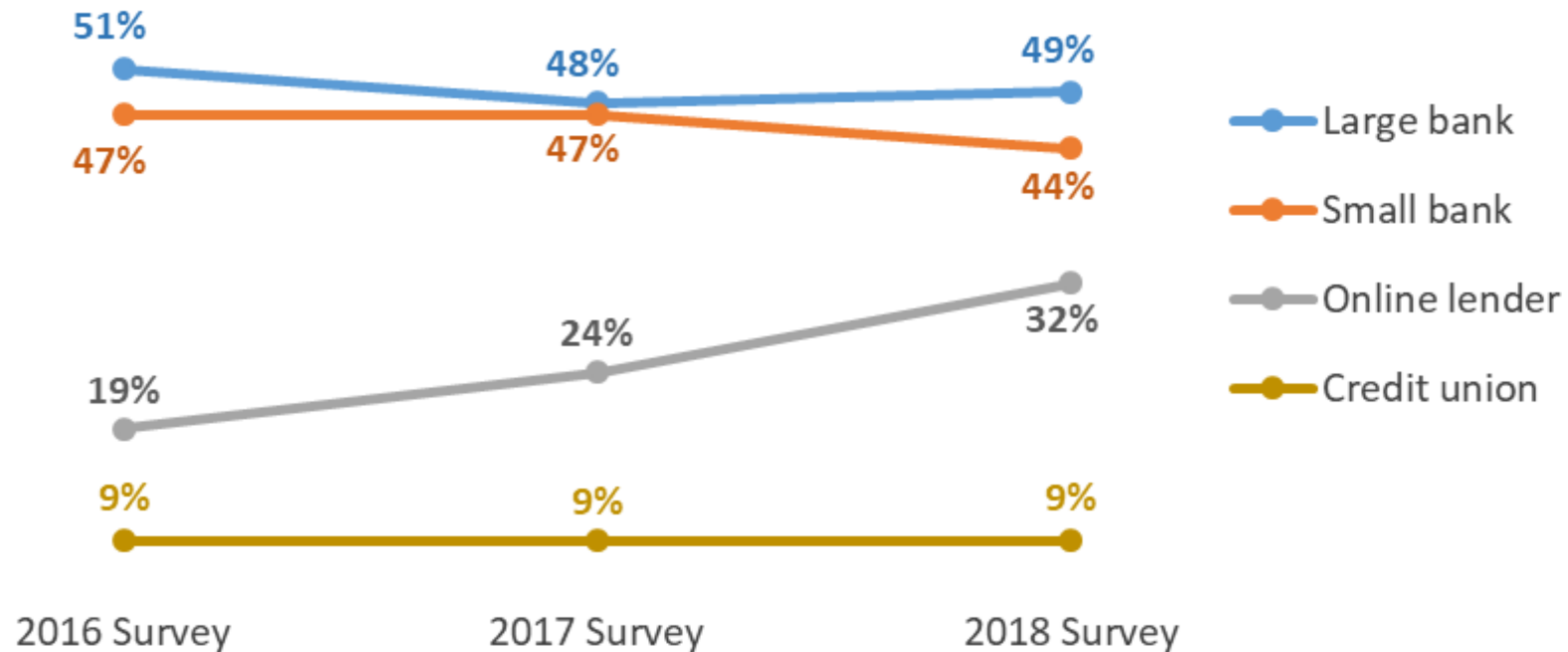
- **Online lenders** (also called fintech lenders) are nonbank providers of small business funding that serve customers via online platforms
 - Usually small-dollar products (typically under \$100K)
 - Carry higher interest rates than bank credit
 - Products and practices vary widely by lender
- Unique issues in small business credit:
 - Truth in Lending Act (TILA) rules that apply to consumer credit generally do not apply to business credit

Examples of small business online lenders:



Online lenders' increasing role in the small business credit market

Credit Sources Applied To
Three-year trend

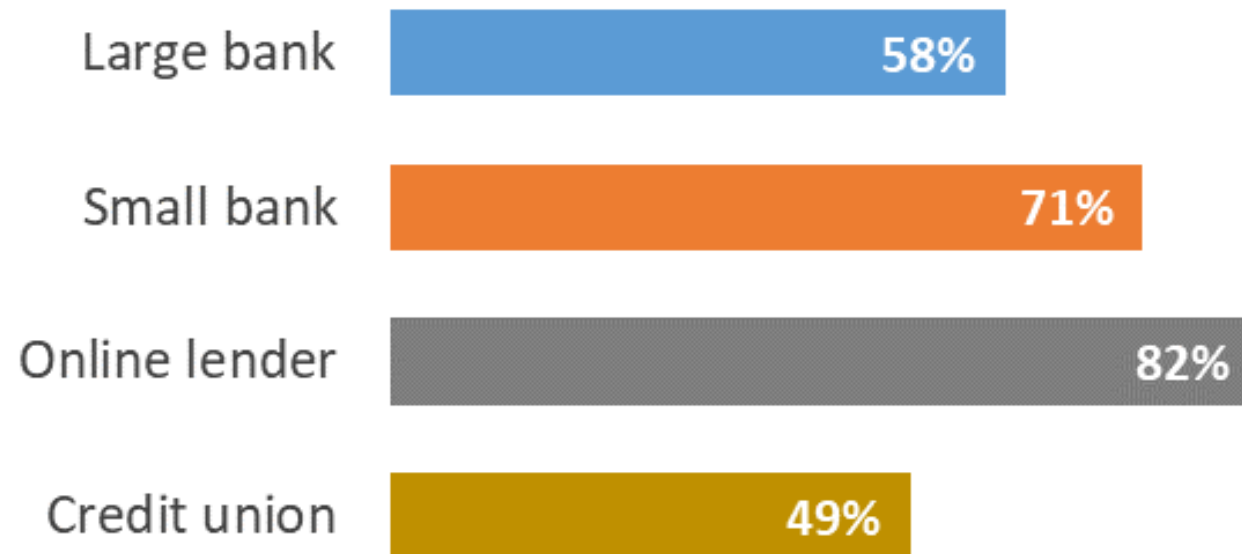


Which firms turn to online lenders?

- According to the 2018 SBCS, online lender applicants are more likely to be:
 - **Smaller firms** (less than \$1M in annual revenue)
 - **Newer firms** (in business 10 years or less)
 - **Black- and Hispanic-owned firms**
- Compared to traditional lender applicants, online lender applicants:
 - Have **lower credit scores**
 - Are **less profitable**
 - Have **more financial challenges**
 - Are more likely to seek credit to cover **operating expenses** (rather than funds for expansion)

Online-lender applicants report higher approval rates than traditional-lender applicants

Application approval rates by source



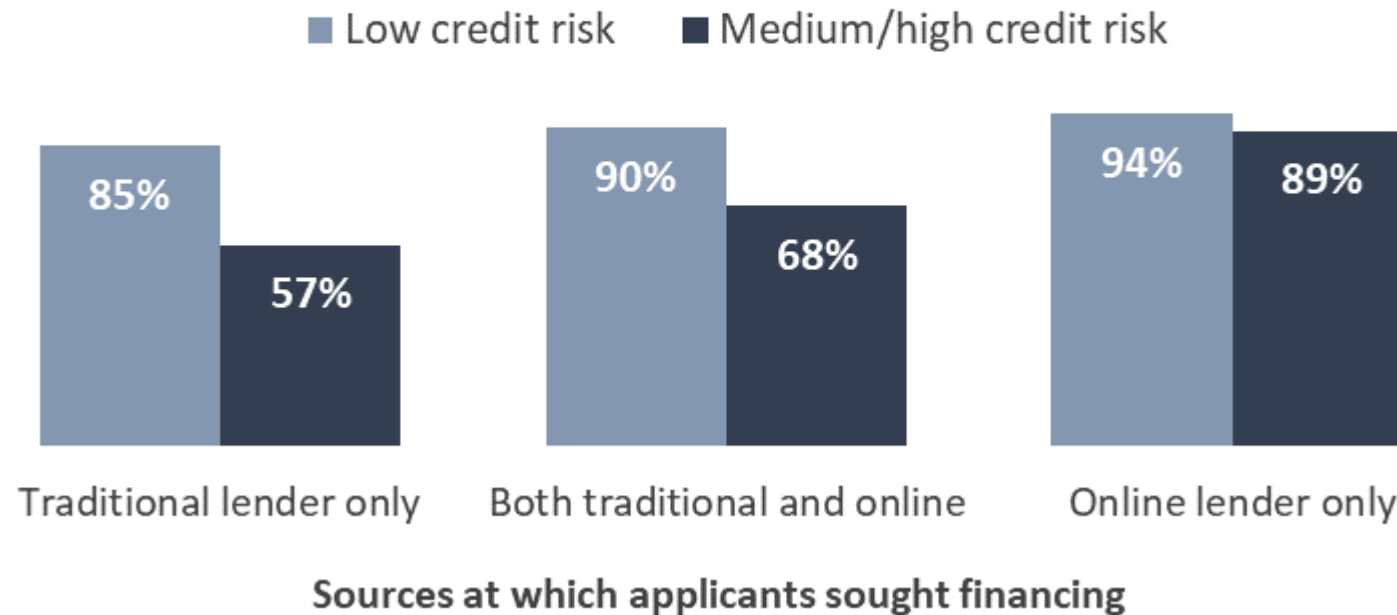
Source: Small Business Credit Survey, 2019 Report on Employer Firms

Note: Approval rate is the share of loan, line of credit, and cash advance applications that were partially or fully approved

Even higher-risk firms have high rates of success obtaining funding from online lenders

Financing received, by credit risk

Share that received at least some financing

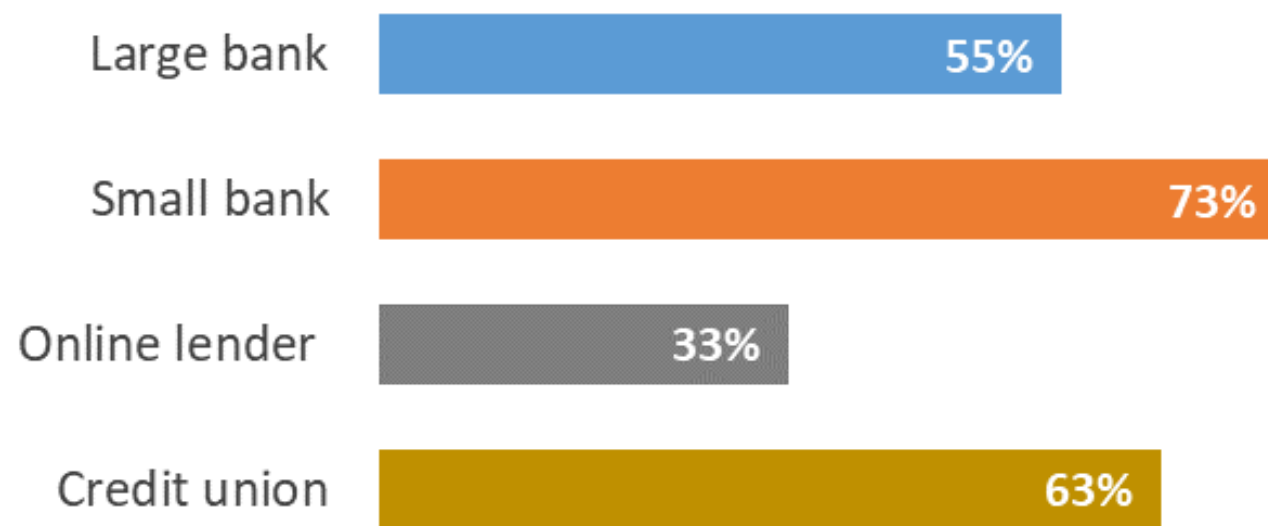


Source: Click, Submit 2.0

Note: Credit risk categories are based on self-reported credit scores. See report for more details.

Though they are more often approved, customers of online lenders are less satisfied

Net satisfaction with source

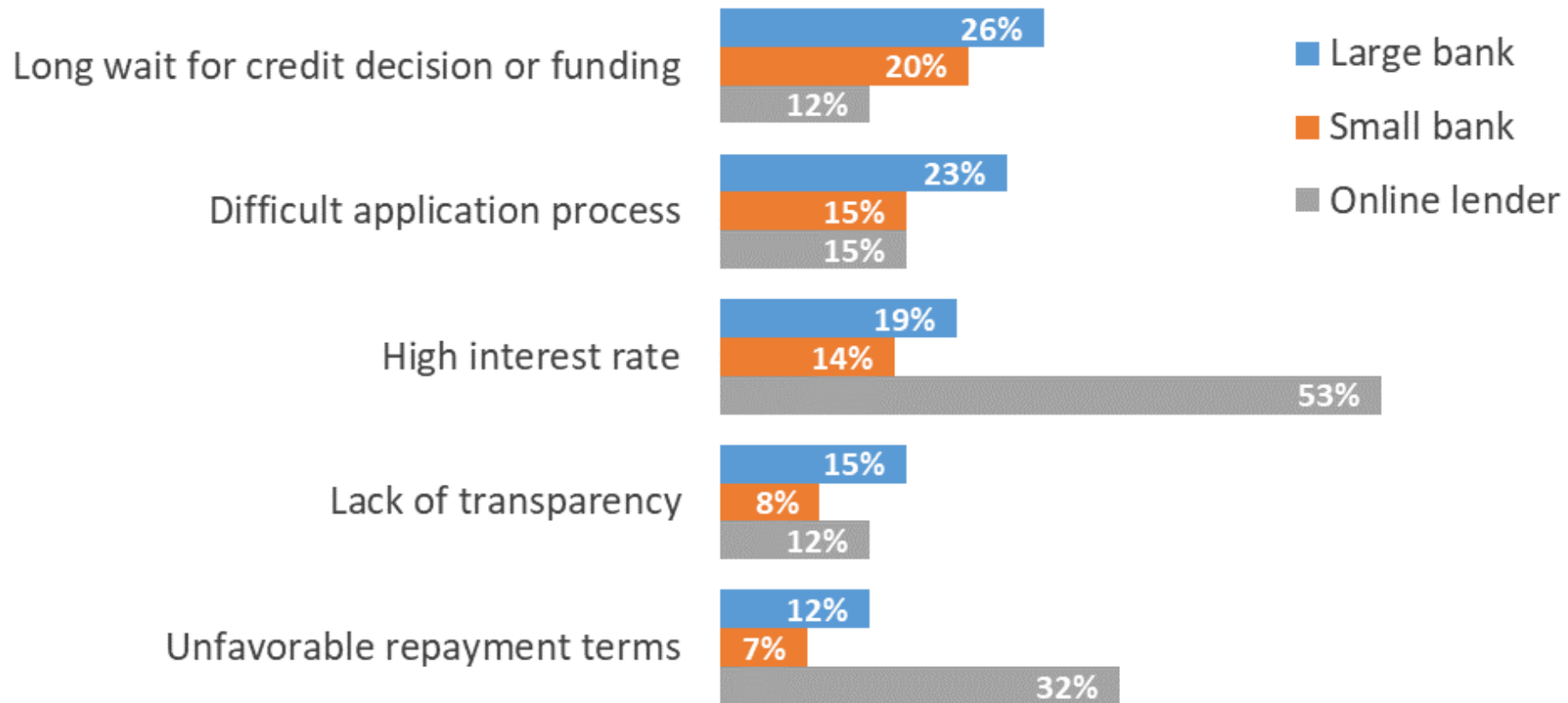


Source: Small Business Credit Survey, 2019 Report on Employer Firms

Note: Net satisfaction is share satisfied minus share dissatisfied, for approved applicants only.

Online lender applicants report challenges with high interest rates and unfavorable repayment terms

Challenges with lenders



Focus groups with small business owners shed light on dissatisfaction and other issues

In online focus groups, small business owners raised several concerns after browsing online lender websites and comparing products:



Product descriptions were confusing and used unfamiliar terminology



Key information was not disclosed or found only in footnotes



Product cost comparisons were challenging because of the varied ways lenders describe rates and terms

A review of online lender websites reveals wide variation in cost information disclosed

- Several lenders provided no information on product rates
- Other lenders provided at least some rate information using varied terminology:
 - “**fee rate**”
 - “**simple interest**”
 - “**factor rate**”
 - “**total annualized rate**”
- APR was rarely used when describing costs



“It is difficult [to compare when] they are using different models and different terminology to try to get our business”

Varied product rate descriptions make apples-to-apples cost comparisons a challenge

Sample scenario: \$50,000 borrowed; repaid in six months

	Lenders' rate description	Total amount owed*	Estimated APR equivalent*
<i>Lender A</i>	1.15 factor rate	\$59,000	~70% APR
<i>Lender B</i>	4% fee rate	\$56,500	~45% APR
<i>Lender C</i>	9% simple interest	\$54,500	~46% APR

* Calculated using product information (including repayment terms and fees) provided on three of the online lenders' websites. See *Uncertain Terms* report for details.

Online lenders emphasize speed, simplicity, and service...

We are different - and fast

Get a quote in minutes.

High Approvals

✓ All credit scores are considered

Experienced Lenders

Minimal Paperwork

Simple Process

Simple & Fast

We support all great businesses

Flexible Financing Options

81,000+ Small Businesses Served

Service Excellence

GROW YOUR BUSINESS

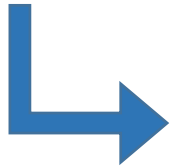
...but are short on details like products' costs & features



"I hoped to see rates, terms and what I qualified for. [The lender] wouldn't provide any information without an email or contact info."

Lenders collect business and personal data from prospective borrowers

Get your personalized rate



Legal business name

Majority business owner's **first** name

Majority business owner's **last** name

Email

Business phone number

Mobile phone number



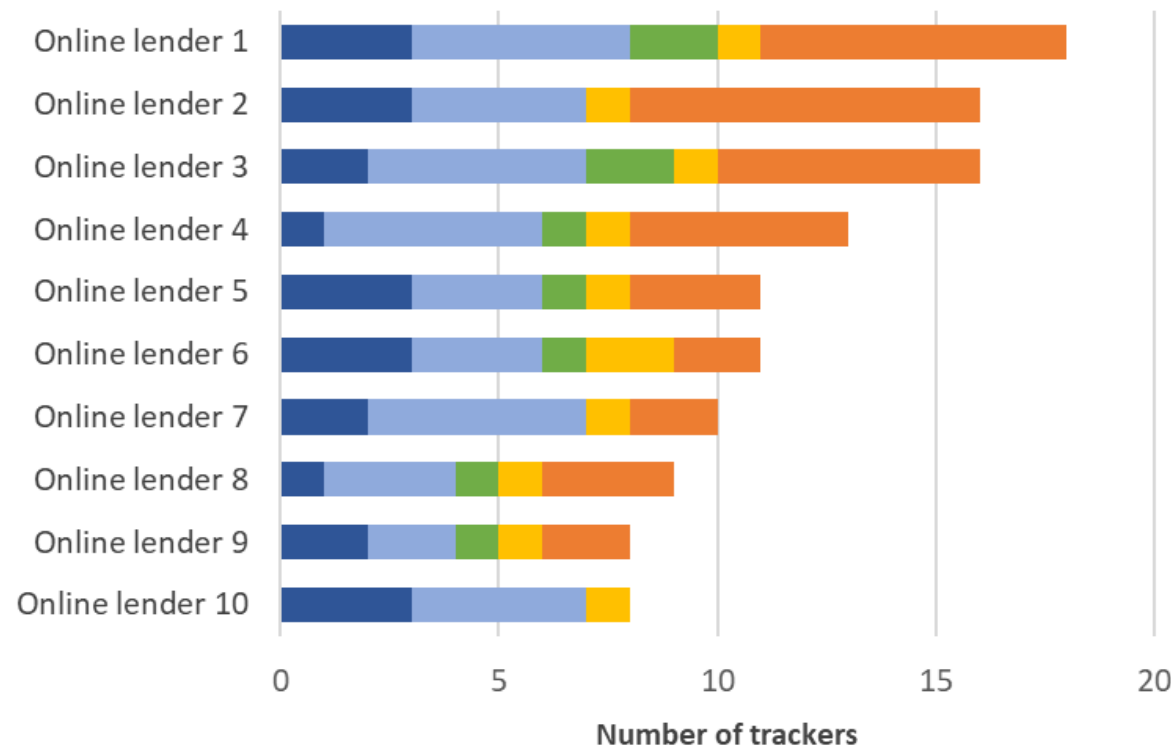
"I don't want to be solicited for the rest of my life just because I was looking for some information."

- * Note: All of the lender websites reviewed had provisions permitting lenders and affiliates to contact the business owner

Lenders collect user data through trackers

Privacy experts have raised concerns about whether data collected through trackers may be used by lenders for underwriting and pricing offers of credit.

Use of trackers on select online lender websites



- **Essential** includes tag managers, privacy notices, and technologies that are critical to the functionality of a website
- **Site analytics** collects and analyzes data related to site usage and performance
- **Customer interaction** includes chat, email messaging, customer support, and other interaction tools
- **Social media** integrates features related to social media sites
- **Advertising** provides advertising or advertising-related services such as data collection, behavioral analysis, or retargeting

Among the policy questions...

- Would standardized disclosures lead to more informed borrowing decisions?
 - State legislation (passed in CA, proposals in NJ, NY) and voluntary disclosures proposed by the industry (SMART Box); APR remains a sticking point
- How are online lenders using and sharing customer data?
- Do connections between fintech lenders and traditional banks have implications for industry risk?

There are many open questions because reliable data are lacking

For more information

- Small Business Credit Survey (SBCS) findings: www.fedsmallbusiness.org
- SBCS online lender analysis: [*Click, Submit*](#) (2016) and [*Click, Submit 2.0: An Update on Online Lender Applicants from the Small Business Credit Survey*](#) (2019)
- Focus group studies: [*Alternative Lending through the Eyes of “Mom & Pop” Small Business Owners*](#) (2015) and [*Browsing to Borrow: “Mom & Pop” Small Business Perspectives on Online Lenders*](#) (2018)
- Online lender website analysis: [*Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites*](#) (2019)

Contacts:

Barbara Lipman, Federal Reserve Board – barbara.j.lipman@frb.gov

Ann Marie Wiersch, Federal Reserve Bank of Cleveland – annmarie.wiersch@clev.frb.org