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An Update on Online Lender Applicants from the Small Business Credit Survey

A Publication of the Federal Reserve Bank of Cleveland

December 2019

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The authors appreciate the thoughtful comments, managerial support, and guidance from the following colleagues: Lisa Nelson from the Federal Reserve Bank of Cleveland, Jessica Battisto and Claire Kramer-Mills from the Federal Reserve Bank of New York, and Angelyque Campbell from the Federal Reserve Board's Division of Consumer and Community Affairs. Valuable assistance with this publication also was provided by Heather Ann and Natalie Bashkin of the Federal Reserve Bank of Cleveland.

OVERVIEW

Nonbank online lenders provide small-dollar credit for small businesses. These lenders, also referred to as "fintech" lenders, utilize data-driven processes and technology for underwriting, pricing, servicing, and delivering funds to borrowers. They offer various small-dollar credit products to their small-business customers such as short- and fixed-term loans, lines of credit, and merchant cash advances. While they represent a small share of total small-business lending, these fintech lenders are a growing source of financing for small firms. The Federal Reserve Small Business Credit Survey indicates that the share of applicants that sought funding at an online lender increased from 19 percent in 2016 to 24 percent in 2017 and to 32 percent in 2018.

Online lending to small businesses is still a nascent industry. Few studies have explored 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. In addressing this gap, this report examines the characteristics, financing experiences, and credit outcomes for three groups of small businesses that sought funding in the prior year: those that applied at only online lenders; those that applied at only traditional lenders (that is, banks and credit unions); and those that applied at both online and traditional lenders. To distinguish the third category from firms that applied at only online lenders or at only traditional lenders, this group is referred to as the "both" category throughout this report.

Furthermore, this report describes experiences of online-lender applicants in contrast with experiences of traditional-lender-only applicants. Unless specified, references to online-lender applicants include all applicants that sought financing at an online lender, whether they applied at online lenders only or at both traditional and online lenders.

SUMMARY OF FINDINGS

This study presents an analysis of data from the 2018 Small Business Credit Survey, an annual survey conducted by the 12 Federal Reserve Banks. The following were among the findings.

Types of Firms Using Online Lenders

- Compared to firms that apply at only traditional lenders, firms that apply at online lenders are more likely to be smaller, have lower credit scores, report more financial challenges, and be less profitable.
- Black-owned and Hispanic-owned firms are more likely than white-owned and Asian-owned firms to report they applied at an online lender.

Application Experiences

- Online-lender applicants are more likely than traditional-lender applicants to apply for smaller amounts of financing and to seek funding to cover operating expenses.
- Firms in the "both" category more frequently cited multiple reasons for pursuing financing.
- Nearly half of firms (49 percent) that applied to both traditional and online lenders reported they submitted at least four applications in the prior 12 months. Among firms that applied at either traditional or online lenders only, just 13 percent submitted four or more applications.

Credit Outcomes

- Online-lender applicants reported greater success obtaining credit than traditional-lender-only applicants, despite having lower credit scores.
- Among firms approved for financing, satisfaction levels were lower at online lenders as compared to levels at both large and small banks. Moreover, firms in the both category reported lower approval rates and lower satisfaction with their banks and online lenders than applicants that sought funding at only traditional lenders or at only online lenders.
- The most frequently cited challenges with bank lenders were the application process and long wait times for credit decisions. The most common challenges at online lenders were high interest rates and unfavorable repayment terms.

ABOUT THE SMALL BUSINESS CREDIT SURVEY

The analysis in this report is based on data from the Small Business Credit Survey (SBCS), an annual survey of firms with fewer than 500 employees, administered by the 12 Reserve Banks of the Federal Reserve System. Survey respondents are asked to report information about their business performance, financing needs and decisions, and borrowing experiences. The SBCS is conducted using a convenience sample of small firms in the 50 states and the District of Columbia. Because the sample is not selected randomly, the survey may be subject to biases. To control for potential biases, the sample data are weighted so that the weighted distribution of firms in the SBCS matches the census distribution of small firms in the United States.[1]

ABOUT THIS REPORT

The Federal Reserve has an interest in the availability of financing to small firms. These firms' ability to borrow, and to do so affordably, is essential to their financial health and future growth prospects. Small businesses play an important role in local economies as employers and as providers of goods and services. Collectively, they contribute significantly to the national economy; firms with fewer than 500 employees account for 47.5 percent of the private-sector workforce and 43.5 percent of private-sector output.[2]

This analysis builds on previously published findings from the SBCS on firms that use online lenders, and it provides updated insights on the small-business credit market and the experiences of borrowers.[3] As the small-business credit market evolves, particularly with the growing presence of nonbank online lenders, the Federal Reserve continues to monitor changes and the impact of those changes on small firms. This report contributes to those efforts.

This analysis draws on a subset of the data from the 2018 SBCS, utilizing the weighted dataset for employer firms—those small businesses with at least one employee other than the owner(s). Of the 6,614 employer firms in the 2018 SBCS, 43 percent applied for financing in the prior 12 months.[4] For purposes of this report, the applicant firms are grouped based on where they sought financing—at traditional lenders, online lenders, or both. The report outlines characteristics of firms in these three categories, as well as the similarities and differences in the application experiences and outcomes for firms across categories.

1 Responses are weighted on the dimensions of firm age, industry, number of employees, geographic location (census division and urban or rural location), gender of owner(s), and race or ethnicity of owner(s). For more information on the Small Business Credit Survey, including background and reports, see fedsmallbusiness.org.

2 US Small Business Administration. 2018. *2018 Small Business Profile*. sba.gov/sites/default/files/advocacy/2018-Small-Business-Profiles-US.pdf; and Kobe, Kathryn and Richard Schwinn. 2018. *Small Business GDP*, 1998–2014. advocacy.sba.gov/2018/12/19/advocacy-releases-small-business-gdp-1998-2014/.

3 Wiersch, Ann Marie, Barbara J. Lipman, and Brett Barkley. 2016. *Click, Submit: New Insights on Online Lender Applicants from the Small Business Credit Survey*. Federal Reserve Bank of Cleveland. October. clevelandfed.org/newsroom-and-events/publications/special-reports/sr-20161012-click-submit.aspx; and Schweitzer, Mark E. and Brett Barkley. 2017. "Is 'Fintech' Good for Small Business Borrowers? Impacts on Firm Growth and Customer Satisfaction." Federal Reserve Bank of Cleveland. Working Paper No.17-01. clevelandfed.org/newsroom-and-events/publications/working-papers/2017-working-papers/wp-1701-is-fintech-good-for-small-businessborrowers.

4 The Federal Reserve Banks. 2019. *Small Business Credit Survey 2019 Report on Employer Firms*. fedsmallbusiness.org/survey/2019/report-on-employer-firms.

SURVEY FINDINGS

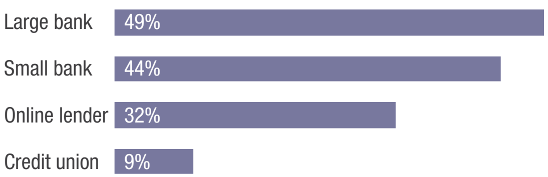
Where Small Businesses Apply for Credit

Nearly a third of small-business credit applicants sought financing at an online lender.

As described in the *2019 Report on Employer Firms*, applicants that sought a loan, line of credit, or merchant cash advance[5] in the prior 12 months most often reported they applied at a traditional lender—defined here as either a bank or credit union.[6] That said, applications at online lenders are becoming increasingly common; the online lender application rate rose from 24 percent in 2017 to 32 percent in 2018.

Credit sources applied to

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



N=2,379

Note: Loan, line of credit, and merchant cash advance applications for employer firms. Select answers shown. Respondents could select multiple sources.

Respondents were provided a list of large banks (those with at least $10B in total deposits) operating in their state. The questionnaire specifies that online lenders are nonbank lenders and provided examples including Lending Club, OnDeck, CAN Capital, PayPal Working Capital, and Kabbage.

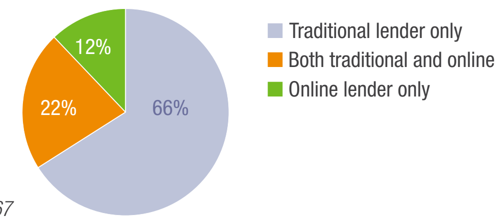
For purposes of this report, applicants are divided into three categories:

Traditional lender only	firms that applied for financing at only traditional sources (banks and credit unions);
Online lender only	firms that applied for financing at only online lenders; and
Both traditional and online	firms that applied at both traditional and online sources.

Applicants that applied at ***only*** Community Development Financial Institutions (CDFIs) or other sources—approximately 4 percent of employer firm applicants—are excluded from the analysis. Further, the analysis considers the responses of employer firms only—those small businesses with at least one employee aside from the owner(s).

Sources at which applicants sought funding

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



N=2,267

Note: This figure, and those that follow, exclude applicants that sought funding at ***only*** CDFIs or "other" sources (such as auto/equipment dealers, farm-lending institutions, friends/family, private investors). These applicants account for approximately 4 percent of employer firm applicants in the SBCS; therefore, these percentages do not correspond to those in the previous figure, which represents the share of all applicants.

5 Merchant cash advance products entail the sale of future receivables for a fixed dollar amount, repaid with a set percentage of the business's daily sales receipts. For example, a business may be advanced $50,000 and repay $60,000 through 10 percent automatic draws from its daily credit card receipts.

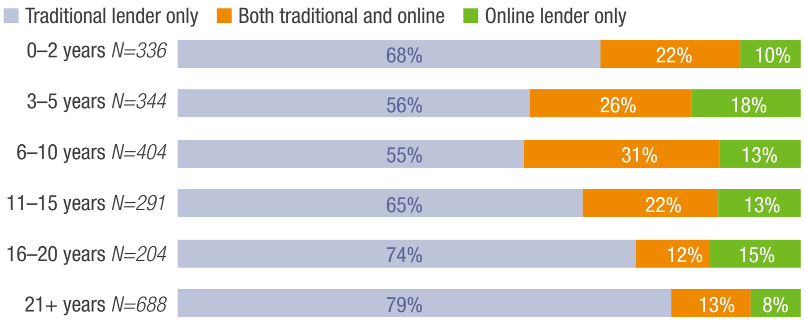
6 For more detail on findings from the 2018 Small Business Credit Survey, see *2019 Report on Employer Firms*, fedsmallbusiness.org/survey/2019/report-on-employer-firms.

Firm Demographics and Applications By Source Type

Newer firms, with the exception of startups, are more likely to submit an application to an online lender.

Employer firms in business from 3 to 10 years are more likely than established firms and startups to turn to online lenders. Notably, new firms typically do not meet online lenders' requirements for time in business, as most lenders require borrowers to have been in business at least one year.

Application rate at source type, by firm age

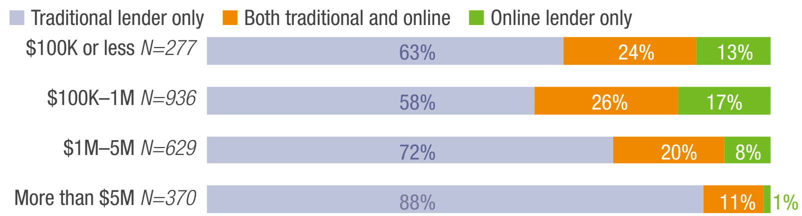


Note: Percentages may not sum to 100 because of rounding

Smaller firms have higher application rates at online lenders.

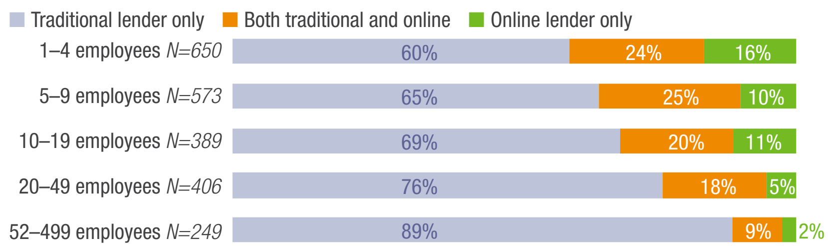
Small businesses with annual revenues of $1M or less are more likely than larger small firms to apply at online lenders. Among those firms with $1M or less in revenues, the smallest firms ($100K or less) were somewhat more likely to apply at only traditional lenders. This difference appears to be driven, at least in part, by the higher application rate at credit unions for these small firms (18 percent versus 9 percent for all applicants).[7] Similarly, businesses with fewer employees are more likely to use online lenders. Conversely, nearly 90 percent of larger small firms—those with more than $5M in annual revenues or at least 50 employees—sought funding from only traditional sources.

Application rate at source type, by firm revenue size



Note: Self-reported annual revenue in 2017. Percentages may not sum to 100 because of rounding.

Application rate at source type, by number of employees



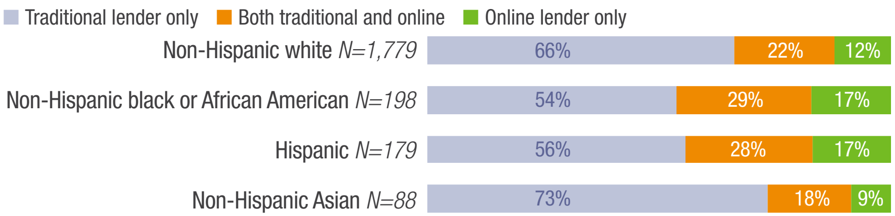
Note: Percentages may not sum to 100 because of rounding.

[7] The Federal Reserve Banks. 2019. *Small Business Credit Survey 2019 Report on Employer Firms*. fedsmallbusiness.org/survey/2019/report-on-employer-firms.

Application rates at online lenders were highest among black-owned and Hispanic-owned firms.

Almost half of black-owned and Hispanic-owned small businesses that sought funding in the prior 12 months turned to an online lender. White-owned and Asian-owned firms were considerably less likely to use online lenders.[8]

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

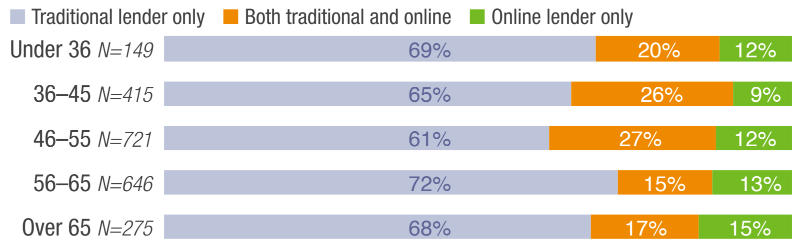


Note: Percentages may not sum to 100 because of rounding.

Application rates at online lenders were highest among firms with decisionmakers from the ages of 46 to 55.

Compared to other age groups, firms with a primary financial decisionmaker from the ages of 46 to 55 were most likely to apply at an online lender—that is, they applied at only online lenders or at both traditional and online lenders. Despite the conventional thinking that online lenders appeal to younger users, SBCS findings do not show higher online lender application rates among the youngest decisionmakers.

Application rate at source type, by age of financial decisionmaker



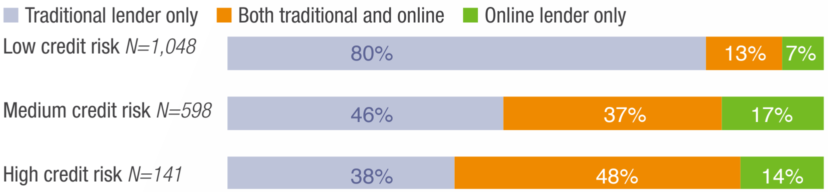
Note: Percentages may not sum to 100 because of rounding.

[8] For more details from the SBCS on financing applications and outcomes for minority-owned firms, see the Federal Reserve Banks. 2019. *Small Business Credit Survey: 2019 Report on Minority-Owned Firms*. fedsmallbusiness.org.

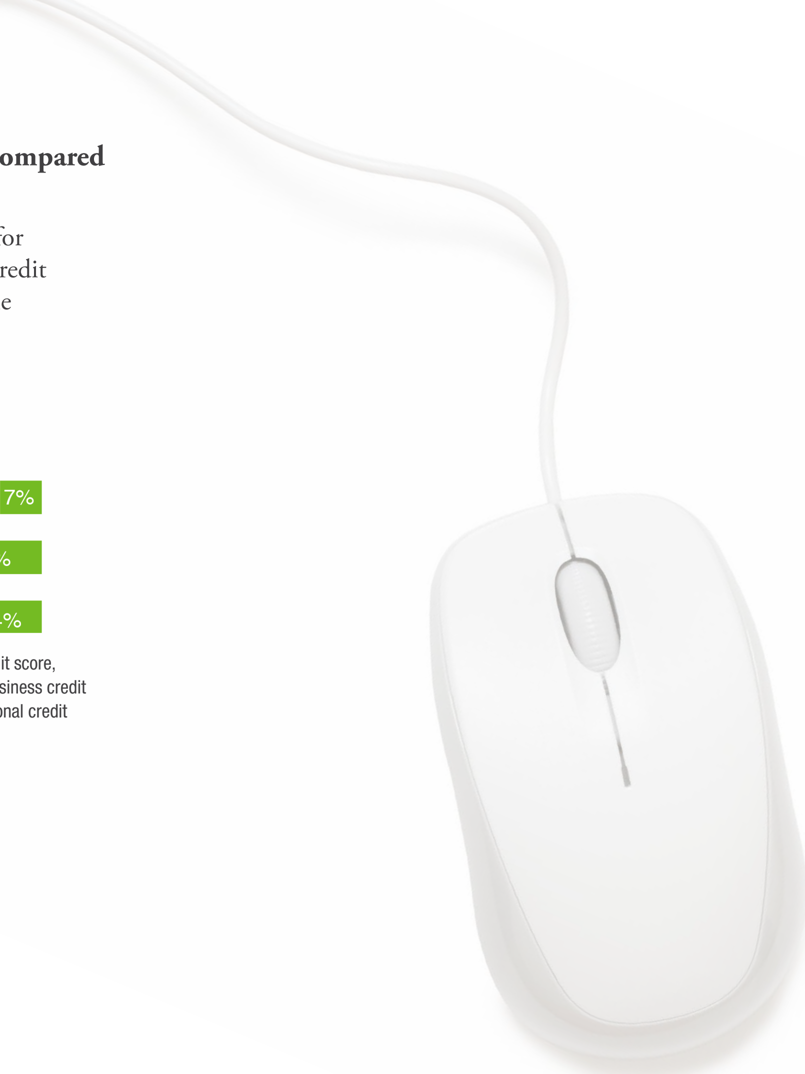
High-credit-risk firms are more likely to apply at online lenders compared to low-credit-risk firms.

Small firms with good credit scores (low-credit-risk firms) typically applied for financing at traditional sources, while more than half of firms with weaker credit scores (medium- and high-credit-risk firms) sought funding from at least one online lender.

Application rate at source type, by credit risk



Note: Percentages may not sum to 100 because of rounding. Self-reported business credit score or personal credit score, depending on which is used. If the firm uses both, the higher risk rating is used. “Low credit risk” is a 80–100 business credit score or a 720+ personal credit score. “Medium credit risk” is a 50–79 business credit score or a 620–719 personal credit score. “High credit risk” is a 1–49 business credit score or a <620 personal credit score.



Characteristics of Small Businesses that Apply to Traditional and Online Sources

The remainder of this report focuses on the experiences and outcomes of applicant firms, grouped according to the sources at which they sought financing. Such a grouping of firms is instructive for two reasons. First, the differences observed between groups provide insights into the types of firms that seek funding at traditional and online lenders. Understanding the characteristics of firms in each group provides perspective on their reported outcomes. Second, the grouping offers insights into the composition of the customer bases of traditional and online lenders. These data enable a better understanding of the market, including which lenders are reaching which borrowers and where risks may be concentrated. The following table describes the collective financial attributes of the firms in each of the three categories.

Financial Characteristics of Applicant Firms in Each Source Category

	Firms that sought funding		
Share of firms in each source category that…	at only Traditional Lenders	at both Traditional and Online Lenders	at only Online Lenders
have less than $1M in annual revenues	58%	73%	82%
are low credit risk	69%	29%	35%
operate at a profit	60%	44%	44%
report they experienced financial challenges in prior year	71%	96%	86%
took out additional debt to deal with financial challenges*	56%	75%	75%
N**	1,207–1,578	397–450	183–239

*As a share of firms with financial challenges
**Observation count varies by question
Note: Select financial metrics shown. See Appendix for more details.

When considering the application experiences and the outcomes of firms in each of the categories, it is important to take into account their collective financial condition. Applicants in the traditional-lender-only group were more likely to report greater financial strength, as measured by conventional metrics, relative to the other two categories. As a group, the traditional-only applicant firms reported higher annual revenues and credit scores and were more likely to be profitable. They were less likely to report financial challenges, and those that did report challenges were less likely to say they took on additional debt as a remedy.[9]

Conversely, online lender applicants (in the online-only and the both categories) are more likely to report financial challenges and lower credit scores. Some online lenders advertise their ability to work with borrowers that have lower credit scores, and many focus on applicants' cash flow as a more important determinant of creditworthiness.[10] Because these borrowers may be riskier, online lenders' products are typically higher cost and are designed to be repaid more quickly than traditional lenders' products.[11] That said, the survey does not gather details on the specific costs and terms of the products pursued by applicants.

9 Respondents selected from the following list: paying operating expenses, credit availability, making debt payments, purchasing inventory or supplies, "other" challenges, or no financial challenges.

10 FinRegLab. 2019. *The Use of Cash-Flow Data in Underwriting Credit: Small Business Spotlight.* September. finreglab.org/the-use-of-cash-flow-data-in-underwriting-credit-small-business-spotlight/.

11 According to Fundera, a small-business financial services firm that provides a platform to match prospective borrowers with lenders, the average repayment time frame for a merchant cash advance is 8 or 9 months. fundera.com/business-loans/merchant-cash-advance.

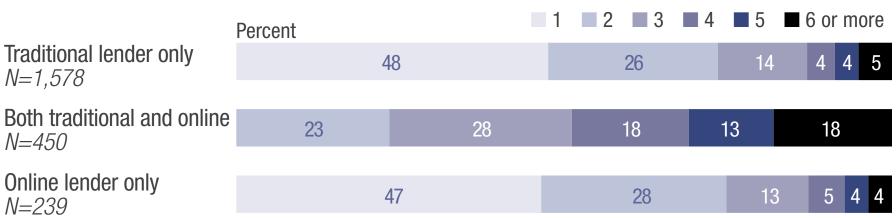
Application Experiences

Nearly half of firms that applied at both traditional and online lenders submitted at least four applications.

Applicants in the both category—those that applied to both traditional and online lenders—submitted far more applications than did other firms. Though by definition, all of these firms applied at least two times, 49 percent submitted four or more applications in the prior 12 months, compared to 13 percent in the online-only group and 13 percent in the traditional-only group.

Number of loan, line of credit, or cash advance applications submitted

% of applicants, by category



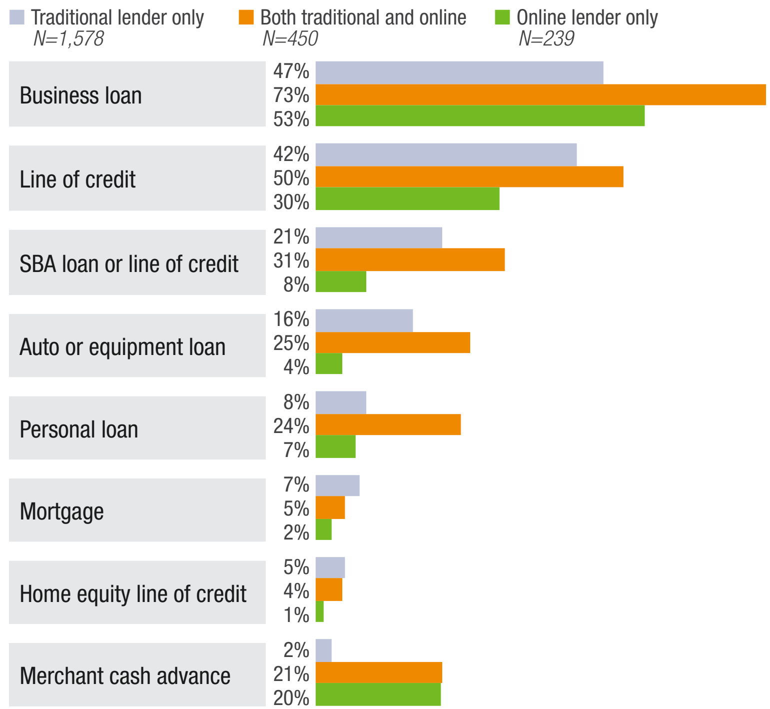
Note: Number of applications in the prior 12 months. Percentages may not sum to 100 because of rounding.

Applicants that sought financing from both traditional and online lenders more often applied for several different products than firms that sought funding at only traditional or only online lenders.

Applicants in the both category had higher application rates for most loan, line of credit, and cash advance products than applicants in the online-only and traditional-only categories. These higher application rates indicate that these respondents often reported applications for numerous different products.

Products sought

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



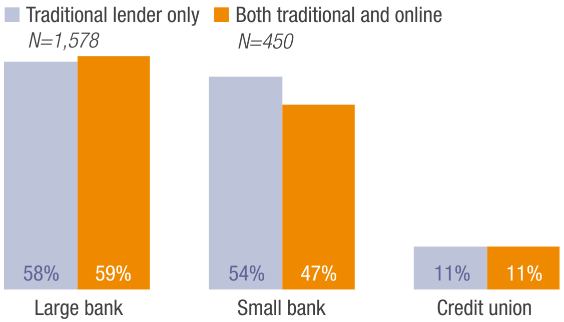
Note: Respondents could select multiple product options. Select response options shown.

The types of traditional and online lenders at which applicants sought funding did not vary significantly by applicant category.

Among applicants that sought funding at traditional lenders, large banks were the most common source, followed by small banks and then credit unions. The shares of firms applying to these lending sources was similar for both applicant categories.

Traditional lender sources

% of firms in each applicant category that applied at traditional lenders

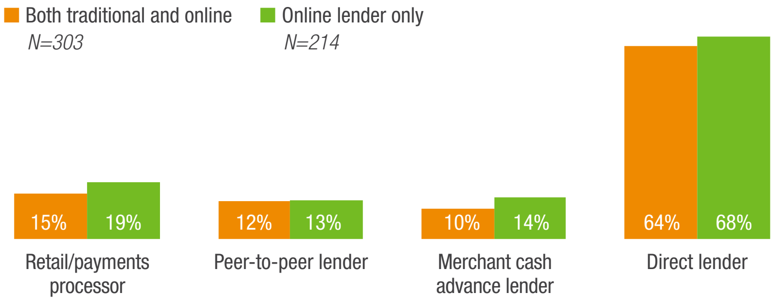


Note: Respondents could select multiple sources.

Direct lenders, such as Kabbage, OnDeck, and Blue Vine were, by a large margin, the most common type of online lender at which applicants sought funding.[12] Note that for each of the different types of online lenders, survey respondents were shown examples of a few of the more prominent lenders, but they did not provide the name of any specific lender.

Types of online lenders

% of firms in each applicant category that applied at online lenders



Note: Question was presented for the two most recent applications, if online lender was the source. Examples were provided for the types of online lenders: Retail/payments processor (e.g., Paypal Working Capital, Square Capital, Amazon Capital Services); Peer-to-peer lender (e.g., Lending Club, Prosper, Funding Circle); Merchant cash advance lender (e.g., RapidAdvance, CAN Capital, BizFi); Direct lender (e.g., OnDeck, Kabbage, Fundation, Blue Vine).

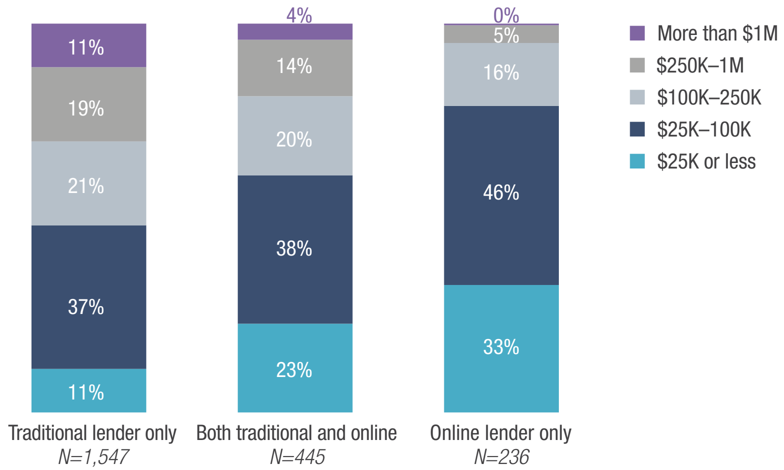
[12] For more details about the types of online lenders, see Lipman, Barbara J. and Ann Marie Wiersch. 2015. *Alternative Lending Through the Eyes of "Mom & Pop" Small Business Owners: Findings from Online Focus Groups.* Federal Reserve Bank of Cleveland. clevelandfed.org/newsroom-and-events/publications/special-reports/sr-20150825-alternative-lending-through-the-eyes-of-mom-and-pop-small-business-owners.aspx.

Online-lender applicants sought funding in smaller amounts than those sought by traditional-lender applicants.

Firms that applied at only traditional lenders sought larger amounts of financing than firms that applied at online lenders. The smaller amounts sought by firms that turned to online lenders are consistent with amounts offered by such lenders. The online lending industry has positioned itself as a funding source for small-dollar credit, with maximum amounts typically between $250,000 and $500,000. However, according to one industry analysis, the average loan size at most online lenders is less than $100,000, and the average line of credit is typically no more than $25,000.[13]

Total amount of financing sought

% of applicants, by category



Note: Total amount sought in the prior 12 months. Percentages may not sum to 100 because of rounding.

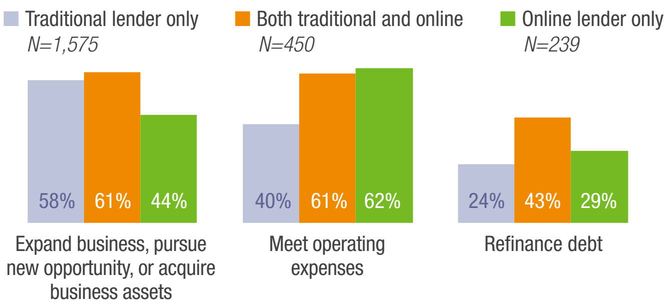
More than 60 percent of online-lender applicants sought funding for operating expenses.

Firms that sought funding at online lenders—in the online-only and both categories—were considerably more likely than firms that applied at only traditional lenders to report they sought funds to meet operating expenses. Firms in need of such funding may be drawn to online lenders for their faster funding times, because of the working capital financing products such lenders offer, or in response to advertising that borrowed funds may be used for any purpose.[14]

Firms that applied at both traditional and online lenders more frequently cited multiple reasons for pursuing financing than firms in the other two categories. Because the questionnaire did not link responders' reasons to specific applications, it is not clear whether these firms more typically sought to address multiple funding needs and purposes with each of the applications submitted or if they submitted separate applications for each of the reasons selected.

Reasons for applying for financing

% of applicants, by category



Note: Respondents could select multiple reasons. Top three responses shown.

[13] Shepherd, Maddie. 2019. *Average Small Business Loan Amounts, Broken Down and Explained*. Fundera. September 20. fundera.com/business-loans/guides/average-small-business-loan-amount.

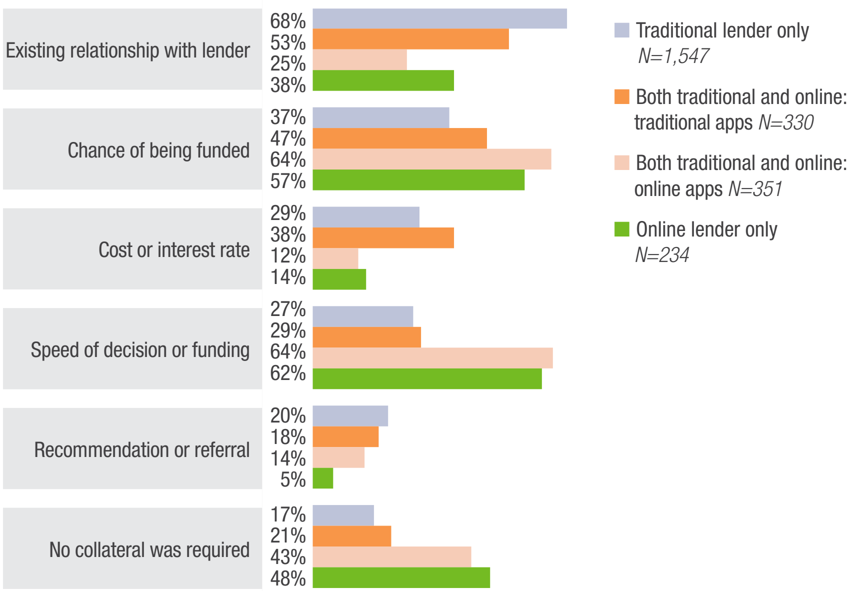
[14] For examples, see credibly.com, nationalfunding.com, and cancapital.com.

Existing lender relationships were important to firms that applied at only traditional lenders, while online-lender applicants selected their sources for quicker financing.

Traditional-lender-only applicants most often said they applied at the source(s) they did because they had an existing relationship with their lender. Online-lender-only applicants prioritized the expected speed at which they would receive a decision and funding, as well as their perceived chance of being funded. For firms in the both category, the reasons they chose their traditional sources differed from the reasons they chose their online sources.

Reasons for applying at source(s)

% of applicants, by category

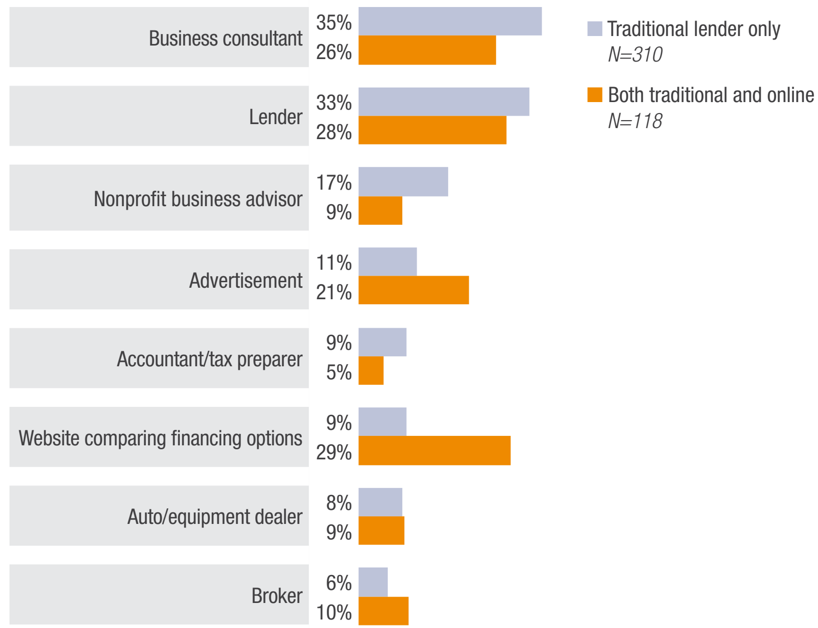


Note: Respondents could select multiple reasons. Select response options shown. The both category is divided to distinguish responses related to traditional lenders from responses related to online lenders.

The SBCS presents a follow-up question to respondents that select "recommendation or referral" as a reason for applying at the source(s) they did. The traditional-lender-only applicants were more likely than firms in the both category to cite referrals from professionals in advisory roles, including business consultants, business advisors, and accountants. On the other hand, firms in the both category were more likely to cite referrals from impersonal sources, including advertisements and websites that compare financing options.

Referral sources

% of applicants that chose source based on referral, by category



Note: Respondents could select multiple referral sources. Online-lender-only category omitted because of insufficient sample size. Select response options shown.

Overall Financing Received and Funding Shortfalls

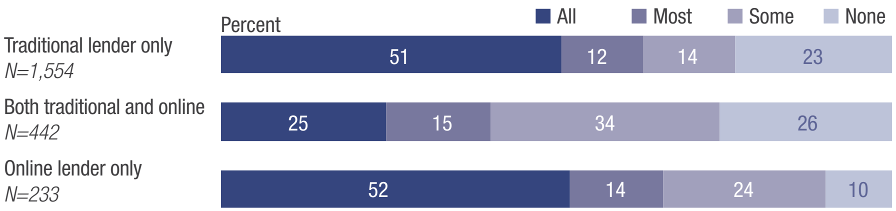
Firms in the both category were less likely than other firms to report they received all the funding they sought.

Each SBCS respondent that applied for financing was asked about the share of the ***total*** financing sought in the prior 12 months that the business obtained. This question covers all types of financing—including credit cards, trade credit, leases, and others, in addition to the loans, lines of credit, and cash advances that the survey explores in greater depth—and measures the share of funding actually obtained rather than approvals for specific applications.

Only a quarter of firms that applied at both traditional and online lenders said they received all of the funding they sought, while more than half of firms that applied at only traditional or only online lenders said they received all of the funding they sought. Firms that applied at only online lenders reported the best overall outcomes, with 90 percent indicating they secured at least some funding.

Total financing received

% of applicants, by category



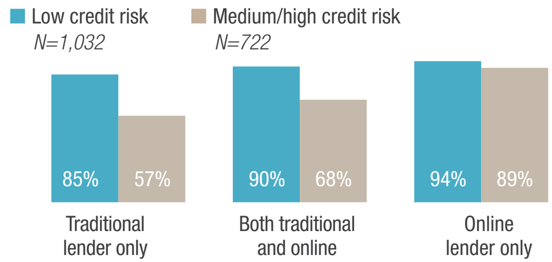
Note: As a share of the total amount sought, across all types of financing. Response option “unsure” is omitted. Percentages may not sum to 100 because of rounding.

Medium- and high-credit-risk firms that applied at online lenders reported greater success obtaining funding than medium- and high-credit-risk firms that applied at traditional lenders.

While most low-credit-risk firms (that is, those with stronger credit scores) were able to obtain at least some financing, medium- and high-credit-risk firms that applied at only online lenders were nearly as likely as their low-credit-risk counterparts to receive funds. More precisely, in the online-only category, 89 percent of medium- and high-credit-risk firms reported they were able to obtain at least some financing, compared to 94 percent of low-credit-risk firms.

Financing received, by credit risk

% of applicants, by category



Note: Share of firms receiving at least some financing. Financing received is a measure of overall funding, not specific to any product or lender. Self-reported business credit score or personal credit score, depending on which is used. If the firm uses both, the higher risk rating is used. “Low credit risk” is a 80–100 business credit score or a 720+ personal credit score. “Medium credit risk” is a 50–79 business credit score or a 620–719 personal credit score. “High credit risk” is a 1–49 business credit score or a <620 personal credit score.

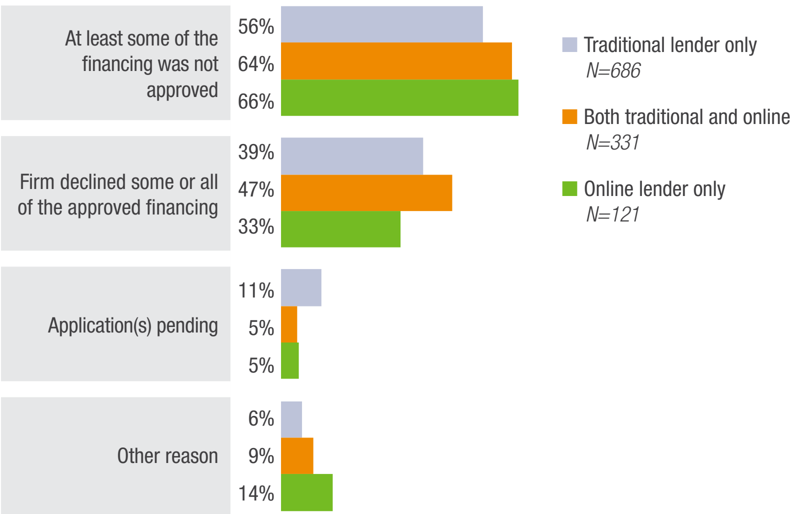
A majority of applicants with a financing shortfall said their applications were not approved in full, though a significant share declined to accept approved financing.

As described in the *Report on Employer Firms*, 53 percent of applicant firms reported a financing shortfall—that is to say, they did not secure the full amount of funding they sought. A majority of these firms (57 percent) reported that their applications were denied either in full or in part; however, 40 percent of applicants indicated that their firm declined to accept all or some funding that was approved.[15]

Firms in the both category were more likely than other firms to say they turned down approved funds. It is not clear the extent to which this finding contributes to the lower overall share of financing received among firms in this category.

Reasons applicants did not receive full amount of financing

% of applicants with financing shortfall, by category



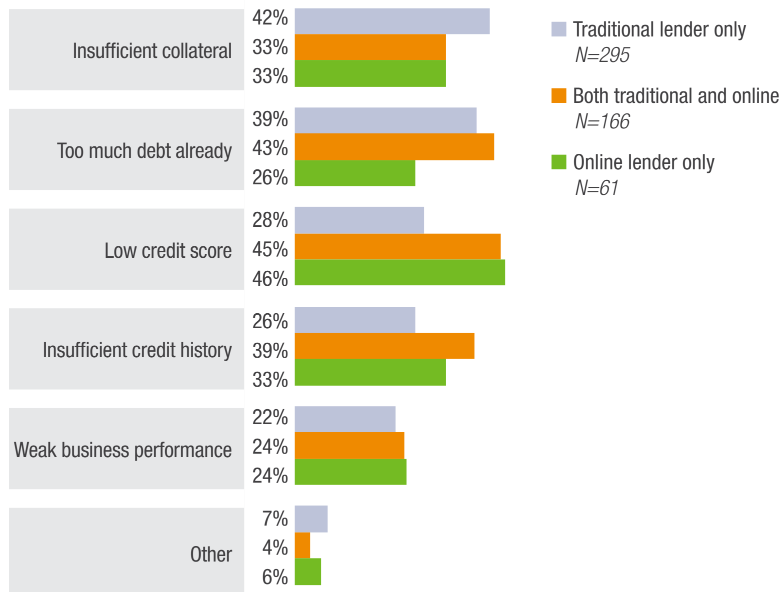
Note: Respondents could select multiple reasons.

Traditional-lender-only applicants most often cited insufficient collateral as a reason their applications were denied, while online-lender applicants reported that a low credit score was a primary factor.

Applicants that were not approved for financing often cited multiple reasons their applications were denied by the lenders at which they sought funding. Among traditional-lender-only applicants, insufficient collateral was the most-often cited reason. Conversely, a low credit score was the most frequently reported factor in credit denials among firms that applied at only online lenders and among firms that applied at both traditional and online lenders.

Reasons for credit denial

% of firms denied financing



Note: Respondents could select multiple reasons.

[15] The Federal Reserve Banks. 2019. *Small Business Credit Survey 2019 Report on Employer Firms*. fedsmallbusiness.org/survey/2019/report-on-employer-firms.

Outcomes for Loan, Line of Credit, and Cash Advance Applications

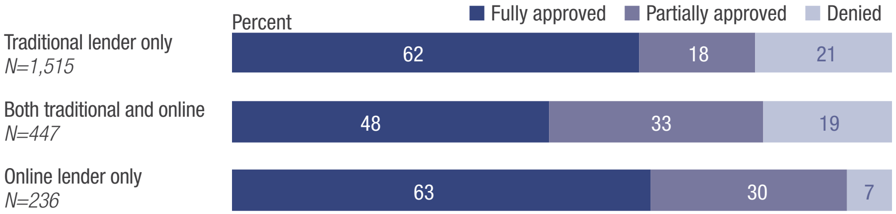
The survey explores in greater depth the experiences of those firms that applied for loans, lines of credit, and merchant cash advances. This section of the report describes outcomes for these applications, as well as applicant satisfaction and challenges with lenders.

Applicants in the both category were least likely to report their applications were fully approved.

Considering the best application outcome for each applicant, 93 percent of online-lender-only applicants were approved for at least some funding, compared to 79 percent of traditional-lender-only applicants and 81 percent of applicants that sought funding at both traditional and online lenders. Only 48 percent of firms in the latter category reported that one or more of their applications were approved in full, compared to 62 percent of the traditional-only category and 63 percent of online-only.

Best outcome of loan, line of credit, or cash advance applications

% of applicants, by category



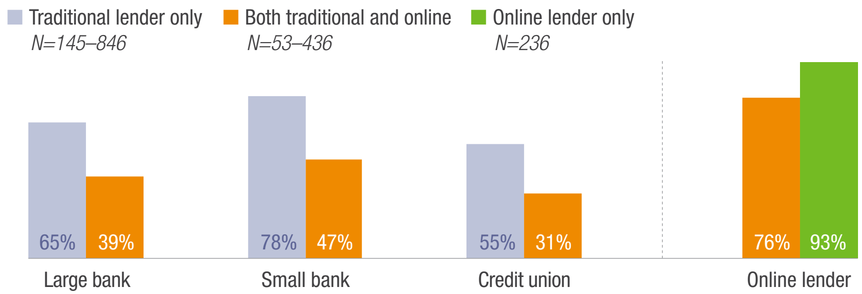
Note: For respondents with multiple loan, line of credit, and cash advance applications, the best outcome is used.

Application approvals were highest at online lenders.

Traditional-lender-only applicants were most often approved at small banks. Applicants that sought funding at both traditional and online sources had greatest success at online lenders. Overall, though, firms in the both category reported lower approval rates at all sources than firms that applied at only traditional lenders or at only online lenders.

Approval rate at source

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



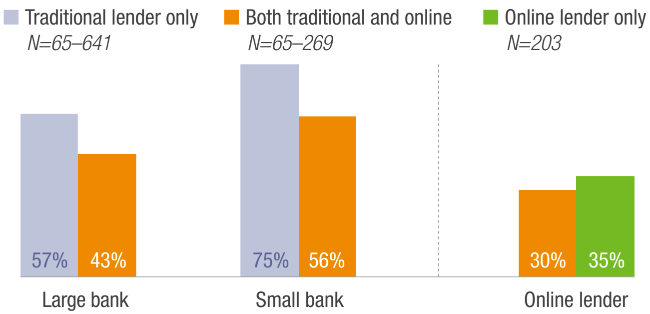
Note: Approval rate is the share approved for at least some financing. Observation counts vary by source. Only applicants' best outcomes at source are included.

Among firms that were approved for financing, satisfaction at banks exceeds satisfaction at online lenders.

Traditional-lender-only applicants reported higher overall net satisfaction at banks than did applicants that sought funding at both traditional and online lenders. For both categories, net satisfaction at small banks was higher than at large banks. Finally, net satisfaction levels at online lenders were lower than satisfaction levels reported at banks.

Net satisfaction of successful applicants at source

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



Note: Net satisfaction is the share of satisfied minus the share of dissatisfied. Includes only applicants approved for at least some financing. The higher satisfaction level is used if a respondent reports two successful applications at the same source type. Credit union not shown because of insufficient sample size for the both category. Observation counts vary by source.

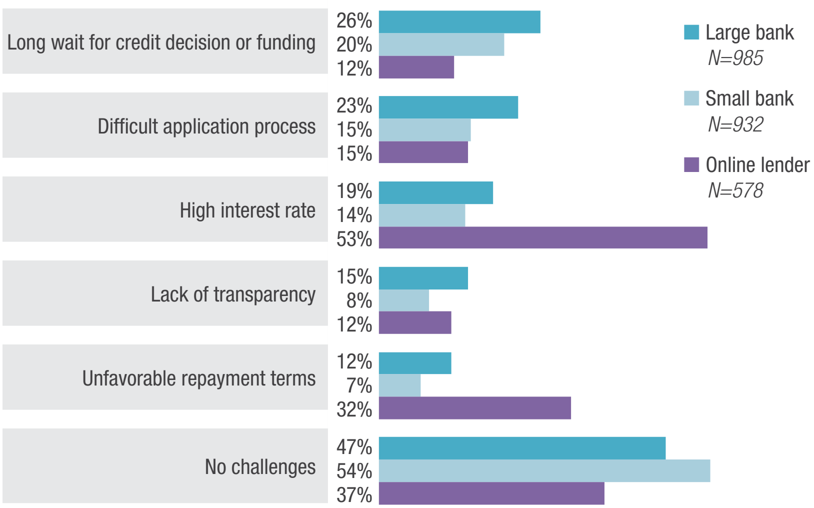
Applicants were more likely to report challenges with online lenders than with large and small banks.

Bank applicants' challenges were centered on the process for obtaining credit, specifically, difficulties with the application process and long wait times for credit decisions. Online lender applicants' top challenges were associated with product terms, namely, high interest rates and unfavorable repayment terms.

Note that relatively few online lender applicants report challenges with the application process or a long wait for a decision or funding. The share of online lender applicants reporting these particular challenges is consistent, in large part, with the manner in which online lenders present their advantages in the market, emphasizing fast processes and simple applications, with little focus on product costs and terms.[16] Furthermore, applicants' responses are consistent with the reasons they give for choosing their lenders, as speed ranked highest among factors in their decisions to apply to an online lender.

Challenges with lenders

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



Note: Select sources shown. Respondents could select multiple challenges.

[16] See Lipman, Barbara J. and Ann Marie Wiersch. Forthcoming. *Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites*. Board of Governors of the Federal Reserve System.

IMPLICATIONS AND ISSUES FOR FURTHER CONSIDERATION

This report builds on previously published findings and uses data from the 2018 Small Business Credit Survey administered by the 12 Federal Reserve Banks.[17] It also expands the previous analysis by separately considering three groups of applicants that sought financing in the prior year: those that applied for credit at only traditional lenders, those that applied at only online lenders, and those that applied at both online and traditional lenders (the both category).

The Conundrum of the "Both" Applicants

Across these three categories, small-business credit applicants exhibit both similarities and differences. As noted in the report, applicants that submit at least one application to an online lender (that is, those in the both and online-only groups) are newer, are smaller in terms of revenues and employees, have lower credit scores, report more financial challenges, are less profitable, and are more likely to be minority-owned as compared to applicants that sought funds at traditional institutions only.

Beyond these characteristics, other credit-seeking behaviors distinguish applicants in the both group. Since, by definition, they applied to at least two lenders, including one traditional and one online, firms in this group may be more active credit seekers than some in the traditional- and online-only groups. The SBCS reveals that firms in this category more frequently cited multiple reasons for pursuing financing (for example, for meeting operating expenses, expanding their businesses, and refinancing debt). They also more often applied for several different products, including business and personal loans, lines of credit, and equipment loans. Notably, nearly half of the both group submitted at least four applications in the prior year as compared with only 13 percent in each of the other two groups. Outcomes for the both category also differed, with 48 percent reporting that at least one of their applications for a loan, line of credit, or cash advance was approved ***in full***, as compared to more than 60 percent in each of the other two groups. If denied credit, firms were more likely to attribute denial to existing debt levels and an insufficient credit history.

In other words, applicants in the both category report more reasons to apply, more applications, and more denials of the full funding amounts requested. These findings are open to interpretation. They simply may reflect the fact that these firms have more varied needs for financing. Certainly, for some applicants, multiple applications may indicate that their businesses are financially precarious, a concern bolstered by their lower credit scores and greater reliance on debt. That said, a firm with numerous applications may be a prospering business with varying credit products needed to take advantage of growth opportunities.

Whatever firms' financial situations, the ease of the online application process also may influence their decisions to apply for credit. As this report notes, online lender applicants prioritize decision and funding speed, and their perceived chance of being approved, as important factors in their lender choice. Indeed, approval rates at online lenders are higher than those at traditional lenders. Moreover, when deciding where to apply, firms in the both category reported they rely on advertisements and websites comparing financing options. These findings raise the question of whether the lenders themselves may have a role in driving this active pursuit of credit. More research is needed to disentangle these factors. It would be useful to obtain more details about the relationship between firms' financial health and their sources of financing as well as the extent to which outcomes of applications at one type of source affect decisions to seek funding at other types of sources.

[17] Wiersch, Ann Marie, Barbara J. Lipman, and Brett Barkley. 2016. *Click, Submit: New Insights on Online Lender Applicants from the Small Business Credit Survey*. Federal Reserve Bank of Cleveland. October. clevelandfed.org/newsroom-and-events/publications/special-reports/sr-20161012-click-submit.aspx.

Online lenders' higher approval rates for less creditworthy borrowers

Now that online lending has become more mainstream, with nearly one-third of small-business applicants turning to them, the firms served are a mix of prime, mid-prime, and subprime borrowers. Though they may have access to lower-cost financing options, some prime borrowers may be drawn to the expediency offered by online lenders, preferring the faster, simpler processes to those they see as cumbersome at traditional lenders. Generally, though, online lenders market themselves to smaller firms that are less likely to be served by traditional lenders—firms that have small-dollar funding needs or lower credit scores. Indeed, 54 percent and 62 percent of medium- and high-credit-risk applicants, respectively, sought financing at an online lender. Moreover, a striking finding in this report is that 89 percent of medium- and high-risk firms that applied at only online lenders were approved for at least some of the funds requested—a rate nearly as high as the 94 percent approval rate for their low-risk counterparts.

Many online lenders underwrite on the basis of a business's cash flow rather than traditional business metrics, and their high approval rates may signal that these lenders are increasing credit availability for small firms. However, higher approval rates are not without risks. 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 subprime customers. Moreover, though limited data are available on loan performance, data from lenders that disclose such information suggest that delinquency and default rates are higher for online credit products than for traditional ones.[18] If loans do not perform as expected, investors may become wary, depriving online lenders of the capital they need to continue funding new loans. Risks are elevated in light of the fact that most of these credit products are unsecured.

These developments bear monitoring to ascertain whether some lenders' practices might negatively impact both the online lending industry and borrowers. A data collection effort, required but not yet implemented under the Equal Credit Opportunity Act, could enhance understanding of the online lending industry by requiring creditors to collect and report information on applications and loans extended to small businesses, including data on businesses owned by women and minorities.[19]

[18] For example, OnDeck reported a 15-day delinquency ratio of 8.5 percent in third quarter of 2019, while commercial banks reported a commercial and industrial (C&I) loan delinquency rate of just more than 1 percent in the second quarter of 2019. According to Federal Reserve analysis, C&I delinquency rates at small-business-lending-intensive banks run somewhat higher, but below 3 percent.

[19] Section 1071 of the Dodd–Frank Act amended the Equal Credit Opportunity Act to require that lenders gather information on credit applications made by small businesses and women- or minority-owned businesses. As of this writing, this requirement has not yet been implemented by the Consumer Financial Protection Bureau.

Lower Satisfaction Rates with Online Lenders

As the SBCS consistently has shown, satisfaction rates at online lenders are considerably lower than those at large and small banks. When asked about the specific challenges they faced, applicants at online lenders most often cite high interest rates and unfavorable repayment terms. That these concerns are prevalent even among successful applicants raises the troubling prospect that some prospective borrowers may not fully understand the cost of credit products they are considering. Qualitative research conducted by the Federal Reserve has underscored this concern.[20] During focus groups with more than 80 small business owners, participants were asked to complete a virtual shopping exercise and compare mock products based on real online product offerings. These studies found that small-business owners struggle to understand the features of many of the products offered by online lenders and the unfamiliar terminology that some lenders use in their product descriptions.[21] In response to these concerns, virtually all participants said they would like to see clearly stated features and costs and an easier way to compare product offerings.

The need for uniform disclosures for small-business credit products is a topic of discussion among small-business advocates, online lenders, and government policymakers alike. 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. In practice, then, online small-business lenders have more flexibility in their disclosures of product costs and features.[22] California recently passed legislation that would require standard disclosure forms for small-business credit products offered by online lenders, and other states are considering similar action.[23] More study is needed to determine how best to present information and whether such disclosures would prompt borrowers to comparison shop and help them make borrowing decisions that are most suitable for their businesses.

[20] See Lipman, Barbara J. and Ann Marie Wiersch. 2015. *Alternative Lending Through the Eyes of "Mom & Pop" Small Business Owners: Findings from Online Focus Groups*. Federal Reserve Bank of Cleveland. clevelandfed.org/newsroom-and-events/publications/special-reports/sr-20150825-alternative-lending-through-the-eyes-of-mom-and-pop-small-business-owners.aspx; and 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. federalreserve.gov/publications/files/2018-small-business-lending.pdf.

[21] It is important to note that focus groups are designed to gather insights, not to measure incidence. Findings are not necessarily reflective of a wider population of small businesses.

[22] The Truth in Lending Act is implemented through Regulation Z. Regulation Z does impose certain substantive protections applicable to credit card holders, including where the card is issued for business use. Alternative small-business lenders, however, do not typically issue credit cards.

[23] California SB-1235, "Commercial Financing Disclosures," was signed into law on September 30, 2018. As of this writing, it has not yet been implemented, as the California Department of Business Oversight is adopting regulations. The New York and New Jersey legislatures are considering similar bills.

APPENDIX

Supplemental details on characteristics of applicant firms in each source category

		Firms that sought funding		
		at only **Traditional Lenders**	at both **Traditional and Online Lenders**	at only **Online Lenders**
Revenue size of firm	Less than $100K	15%	16%	16%
	$100K–1M	44%	57%	66%
	$1M–10M	35%	25%	18%
	More than $10M	7%	2%	0%
Number of employees	1–4 employees	42%	50%	63%
	5–9 employees	20%	23%	17%
	10–49 employees	29%	24%	19%
	50–499 employees	9%	3%	1%
Credit risk	Low credit risk	69%	29%	35%
	Medium credit risk	26%	54%	54%
	High credit risk	5%	17%	11%
Profitability, end of 2017	At a profit	59%	44%	44%
	Broke even	16%	19%	29%
	At a loss	24%	37%	27%
Business stage of firm	Growing	39%	36%	27%
	Not growing	61%	64%	73%
Number of survey participants		*1,578*	*450*	*239*

		Firms that sought funding		
		at only **Traditional Lenders**	at both **Traditional and Online Lenders**	at only **Online Lenders**
Financial challenges	Experienced financial challenges	71%	96%	86%
	No financial challenges	29%	4%	14%
Types of financial challenges*	Credit availability	44%	75%	53%
	Paying operating expenses (including wages)	40%	66%	61%
	Making payments on debt	31%	51%	51%
Actions to resolve financial challenges*	Made a late payment or did not pay	28%	39%	33%
	Took out additional debt	56%	75%	75%
Outstanding debt	No outstanding debt	13%	8%	8%
	Have outstanding debt	87%	92%	92%
Number of survey participants		*1,578*	*450*	*239*

* Select response options shown

Source:
The Federal Reserve Banks. 2018. 2018 Small Business Credit Survey. fedsmallbusiness.org.

Note:
Percentages may not sum to 100 because of rounding.

Credit risk is based on self-reported business credit score or personal credit score, depending on which is used. If the firm uses both, the higher risk rating is used. “Low credit risk” is a 80–100 business credit score or a 720+ personal credit score. “Medium credit risk” is a 50–79 business credit score or a 620–719 personal credit score. “High credit risk” is a 1–49 business credit score or a <620 personal credit score.

Growing firms are defined as those that reported year-over-year growth in revenues and number of employees and expect to add employees in the next 12 months.

Financial challenges are those experienced in the prior 12 months (approximately the second half of 2017 through the second half of 2018).

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