Fed Releases Study on Online Lending to Small Businesses

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The Federal Reserve Board and the Federal Reserve Bank of Cleveland recently released the results of a study on alternative funding to small businesses in a report titled, “Browsing to Borrower: ‘Mom & Pop’ Small Business Perspectives on Online Lenders,” available here. The study results provided an informative look at the concerns of small-business owners about online funders, owners’ preferred funding sources, and what owners looked for in a funder.

The small businesses participating in the study had at least one, but no more than 20 employees, and less than $2 million in annual revenues. All participants had shopped for credit for their businesses in the prior 12 months. Two separate focus groups were conducted with a total of 42 small business participants.

Business owners responded that they preferred traditional lenders, although many expressed frustration with lengthy approval processes and difficult underwriting standards. Additionally, when choosing between online funders, owners strongly preferred those who provided more information about their products and pricing upfront, before owners begin the application process. Owners uniformly expressed frustration with repeated and unsolicited direct marketing by online funders-but some nonetheless retained information for future use.

Transparency about pricing also concerned owners, including some who perceived funders as attempting to conceal the true costs of their products by excluding basic information, or through use of unfamiliar terms such as “simple interest” or “factor rate.” The study’s authors drew on this concern, concluding, “Confusion Prevails,” when discussing the owner’s comparisons of a fixed-fee business loan, a short-term loan, and a split-processing merchant cash advance. The owners found it challenging to identify interest rates or estimate costs of the products; found descriptions of the products and terminology confusing; expressed “annoyance” with important terms appearing in fine print; and made faulty assumptions about products, based on their experience with more traditional products.

The study additionally presented sample disclosure boxes to owners. Owners generally responded favorably, and were “nearly unanimous” in their desire to receive the disclosed information, which included the loan amount, repayment amount, term, total cost of capital, APR, average weekly payment, cents on the dollar, and prepayment terms. Owners also recommended including clearer disclosures and standardizing terminology.

Overall, the study results suggest that how a funder presents information to owners affects the owners’ product and funder selection-and therefore affects the funder’s business and bottom line.

Although frequently funders focus on looming compliance risks when reviewing disclosures and product structure, the study provides a reminder that funders can differentiate themselves in the increasingly crowded marketplace by providing clear disclosures.

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