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OFFICE OF ADVOCACY
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ALTERNATIVE FINANCE SERIES

The Alternative Finance Series, launched in September 2016, focuses on the significance of the increasing relevance of alternative finance mechanisms. The series consists of white papers, issue briefs, and fact sheets on emerging alternative finance topics such as changing securities regulations, interest rate outcomes, and the value of crowdfunding to small businesses. The intended audience of this series includes policymakers, researchers, and small business owners.

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WHAT IS ALTERNATIVE FINANCE?

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ABSTRACT

This document provides an introduction to some new and existing forms of alternative finance.

While there is no single authoritative technical definition of "alternative finance," it can be identified as financing from external sources other than banks or stock and bond markets. [1] In addition, some definitions emphasize the direct connection of fundraisers with funders, often via online platforms.[2]

In order to understand alternative financing, it is helpful to consider the more traditional mix of small business financing. Figure 1 shows the most commonly used sources of small business expansion capital in 2007 and 2012. Aside from personal assets and reinvested business profits, the other financing sources listed originate in banks. In contrast, alternative finance draws from other sources and generally over internet platforms. Lenders range from individual investors to non-bank lending companies. Online lending platforms frequently rely on new methods of evaluating credit, require different criteria for funding (relying less on collateral), and they may consider new metrics or indicators of creditworthiness.

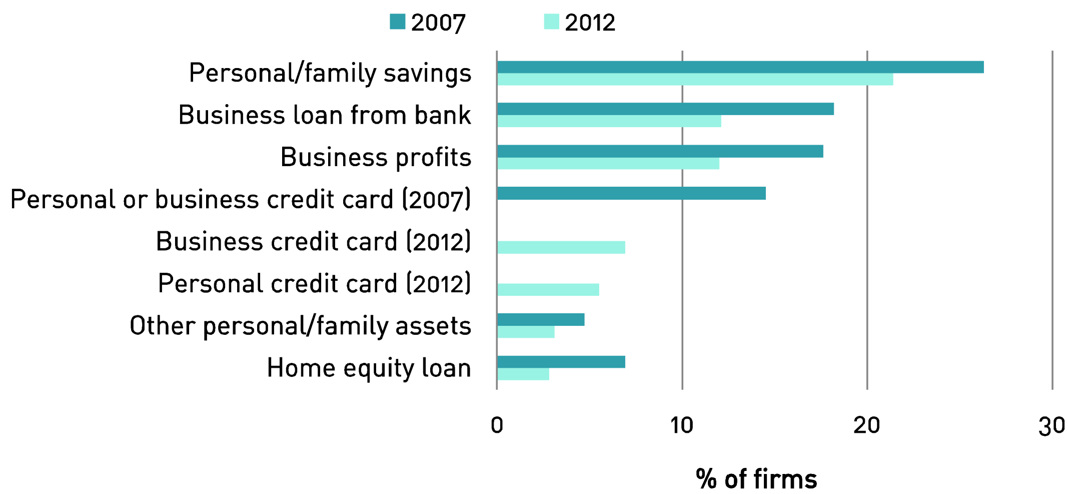
Figure 1 also shows the change in financing sources between 2007 and 2012.[3] The decrease in owners' self-reported usage of bank loans is notable. Research from the Office of Advocacy and other organizations has documented this post-Recession decline in banks' lending to small business, which has prompted these firms to seek finance elsewhere.[4] Although their use of alternative finance is still relatively uncommon, limited recent data suggests potential for growth, providing an impetus to identify defining characteristics of alternative finance.

The various forms of alternative finance that exist in practice do not fit into discrete, mutually exclusive categories. These evolving tools overlap at times and may combine aspects of each other. For example, the form of alternative financing known as "peer-to-peer lending" can be considered both crowdfunding and marketplace lending.

Crowdfunding and online marketplace lending are anecdotally the most prevalent alternative finance tools in the United States, and carry the most significant policy implications at present. Some newer alternative finance models are in use in other countries.

Figure 1. Sources of Expansion Financing, Employer Firms

Source: Survey of Business Owners, U.S. Census Bureau



Note: Unlike the 2007 SBO, the 2012 SBO specifically asks about credit cards on which a balance was carried. Additionally, the 2012 SBO asks about personal and business credit cards separately.

Crowdfunding

Crowdfunding, the pooling of small amounts of money from many investors through internet platforms, is one of the better-known forms of alternative finance. In the United States, the three most common forms of crowdfunding are:

- Donation- and rewards-based crowdfunding: In this fundraising model, investors give money without expecting financial compensation (i.e., donations), but, in the case of rewards-based crowdfunding, they receive benefits such as early access to a new product.

- Peer-to-peer and peer-to-business lending: These lending approaches are similar in concept to microfinance platforms such as Kiva. They anonymously connect borrowers (individuals or businesses) with multiple lenders; lenders receive interest in return, which distinguishes them from traditional microfinance. Peer-to-peer lending is covered in an issue brief from the Office of Advocacy.

- Equity crowdfunding: This form of crowdfunding was authorized in the United States beginning in May 2016. In this model, investors receive an equity stake in the company, similar to purchasing stocks. The Office of Advocacy released an issue brief on equity crowdfunding's potential for U.S. small businesses in 2015.

Some sources[5] distinguish between debt-based securities and peer-based lending. However, in the United States, lenders on peer-to-peer and peer-to-business platforms are technically buying debt-based securities, similar to bonds—meaning that these platforms are subject to certain federal regulations.

Two other models of crowdfunding that have emerged recently are:

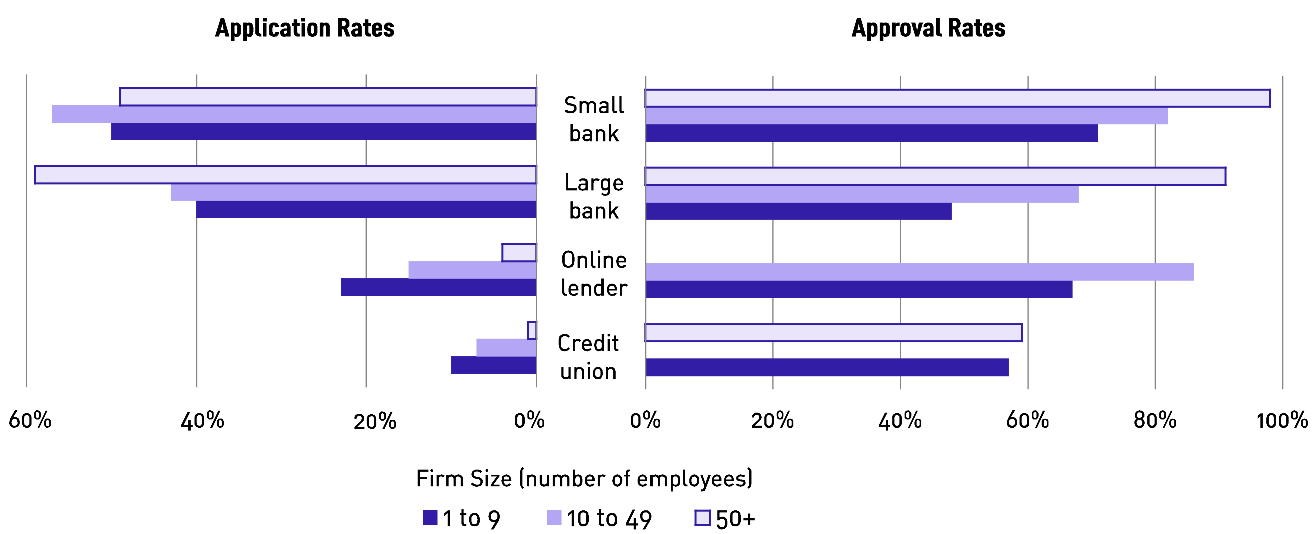
- Revenue and profit sharing crowdfunding: In this model, a business receives a loan funded by multiple investors and pays back the full amount based on future receivables, similar to a merchant cash advance.
- Invoice trading: With invoice trading, also a form of receivables-based financing, a business sells its invoices at a discount to a pool of individual or institutional investors for cash. This is similar to factoring, except that multiple parties instead of one lender purchase the invoice. Although some sources[6] consider invoice trading to be distinct from crowdfunding, it is included here because multiple investors participate.

Online Marketplace Lending

Marketplace lending refers to online platforms that allow one or more investors to make loans directly or indirectly to small businesses. These platforms rely on data-driven algorithms to evaluate the creditworthiness of borrowers, as distinct from traditional banking practices. Installment loans similar to traditional bank loans are available through marketplace lending platforms.[7]

Online marketplace lenders appear particularly significant to smaller businesses. In 2015, the smallest firms were more likely than other firms to apply for financing from an online lender. And the smallest firms were more likely to be approved at online lenders than at large banks or credit unions (Figure 2).[8]

Figure 2. Credit Applications by Firm Size *Source: Small Business Credit Survey, Federal Reserve System*



Note: Data is not available for certain categories due to small sample size.

Emerging Forms of Alternative Financing

Some newer forms of alternative finance are more established beyond the United States, particularly in the United Kingdom and Australia. Community shares, in use in the United Kingdom, have been described as "a way for co-operatives and community benefit societies to raise capital from individuals, who in return receive a direct equity stake in the enterprise."[9] Pension-led funding allows a business to borrow money from the owner's pension fund. Intellectual property is often used as collateral.[10]

What's next in the series?

Future products in the Alternative Finance Series include:

- An overview of the regulatory landscape,
- Fact sheets on crowdfunding and on interest rates at non-bank lenders,
- An empirical investigation of trends in capital raised under Regulation A+ (an update to federal securities law included in the JOBS Act of 2012),
- An issue brief on innovations in venture capital markets, and
- A fact sheet on small businesses' use of "Reg D" exemptions (i.e., exemptions included in Regulation D of the Securities Act of 1933) to exempt themselves from registration requirements.

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[1] Franklin Allen, Elena Carletti, Jun "QJ" Qian, and Patricio Valenzuela, *Handbook of the Economics of Finance,* Chapter 11: Financial Intermediation, Markets, and Alternative Financial Sectors, last updated March 25, 2012. http://apps.eui.eu/Personal/Carletti/Handbook_ACQV_25March2012.pdf. "Alternative finance" as discussed in the current report is distinct from the Federal Deposit Insurance Corporation's definition of "alternative financial services" as a sector that includes check-cashing outlets, title lenders, payday loans, etc.

[2] Peter Baeck, Liam Collins and Bryan Zhang, *Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014*. Cambridge University and Nesta. www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2014-uk-alternative-finance-benchmarking-report.pdf.

[3] Although the Survey of Business Owners does not ask specifically about alternative finance or any specific form thereof, it does include an "other" category that is used by less than 1% of reporting firms.

[4] *Small Business Lending in the United States 2013,* U.S. Small Business Administration, Office of Advocacy, 2014. https://www.sba.gov/advocacy/small-business-lending-united-states-2013.

[5] *The UK Alternative Finance Industry Report 2014.*

[6] *The UK Alternative Finance Industry Report 2014.*

[7] *Opportunities and Challenges in Online Marketplace Lending*, U.S. Department of the Treasury, 2016. www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf

[8] There may be selection bias with regard to firms that choose to apply to online lenders and not banks.

[9] Adam Palin, "Q&A: Community shares," *Financial Times*, July 3, 2015. http://www.ft.com/cms/s/0/44240144-1c04-11e5-8201-cbdb03d71480.html#axzz455WZmLN2

[10] Adam Uren, "As bank lending drought drags on, should entrepreneurs consider using their pension pot to invest in their business?" *This Is Money,* July 3, 2013. http://www.thisismoney.co.uk/money/pensions/article-2352476/Pension-led-funding-entrepreneurs-consider-using-pension-fund-raise-finance.html; James Hurley, "Directors turn to their pensions to fund growth," *The Telegraph*, Nov. 6, 2012. http://www.telegraph.co.uk/finance/businessclub/9656704/Directors-turn-to-their-pensions-to-fund-growth.html.