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The Alternative Finance Series focuses on the significance of alternative and emerging finance to small businesses. This series covers topics such as securities regulations, interest rates, and crowdfunding, and informs policymakers, researchers, and small business owners on key finance-related issues. The previous report in this series provides an introduction to alternative finance.

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INTEREST RATES AND NON-BANK LENDING TO SMALL BUSINESSES

By Office of Economic Research Staff

Non-Bank Lenders

Obtaining access to capital is an ongoing challenge for small businesses. Multiple sources document a long-term decline in bank lending to small businesses in the aftermath of the 2008 economic recession.[1] In light of this trend, borrowing from non-bank lenders may be increasingly appealing to small business owners in search of capital.

Despite its relatively recent emergence in policy discussions post-recession, non-banking lending is not a new trend. The dollar volume of small business loans originated by non-depository financial institutions has been increasing since the 1980s.[2] "Non-bank lender" is a non-technical term that is exactly what it sounds like: a non-bank financial institution (i.e., in which one cannot deposit cash) that lends money. Non-bank lenders provide a range of products and services, such as merchant cash advances, business lines of credit, and installment loans, the latter two of which may mimic similar products offered by banks. Compared to bank loans, products at non-bank lenders tend to feature higher interest rates. However, non-bank lenders often offer easier and/or faster application processes, and may be less likely to require collateral such as equipment or real estate to secure the loan (particularly for smaller loans).

Although these lenders may lend to businesses with lower credit scores, they still maintain minimum requirements for borrowers, such as credit score, cash flow, sales or revenue, and/or years in business. In summary, higher interest rates at non-bank lenders tend to reflect transactional conveniences or risk levels not typically found in traditional loan offerings. It is important to understand the implications of interest rates when assessing the financing options available to small businesses. Because some small business loans from non-bank lenders are available online, this paper addresses online small business lending as well.

Interest Rates

Non-bank lending products offer benefits to businesses for which a traditional bank loan is either not feasible or not desirable. That being said, these benefits come at a price, generally in the form of fees and higher interest. (Some non-bank lenders also require daily or weekly as opposed to monthly payments.) In order to compare loan products with different interest rates or terms, the "annual percentage rate," or APR, is calculated. The APR, which includes fees as well, can be thought of as the answer to, "What rate would I pay over the course of a year to borrow a given amount of money?" Generally, shorter term loans have higher APRs. Beyond this, online small business loans may present limited public information about average loan sizes, terms, and interest rates.[3]

Implications of Non-Bank Lending for Small Businesses

When borrowing money, business owners face tradeoffs between explicit costs (i.e., interest and fees), managing their time and resources as business leaders, and the need to obtain capital quickly. With a shorter-term loan, a business owner gets the benefit of not having to worry about making monthly (or daily) payments for multiple years. Additionally, if a business owner only needs to borrow money for a one-time last-minute expense (e.g., broken equipment); the annual rate may be less relevant than total interest paid. This is particularly notable in situations where time is a priority, as non-bank lenders tend to process credit applications faster than banks. For example, if a small business wins a large contract and needs to borrow money to purchase inventory, fulfilling the contract and growing the business could have better long-run financial outcomes than taking the time to find the lowest possible APR but running out of inventory. In one survey, the majority (70%) of small firms that applied for credit sought less than $100,000, meaning that online lenders can serve these borrowers' needs.[4]

However, some businesses may use high-cost short-term loans due to an inability to access longer-term loans with lower interest rates. Small firms are more than twice as likely as large firms to apply for cash advances (11 percent vs. 5 percent), which are known to carry high fees.[5] It is important for small business owners to understand the financial implications of the loan products they do choose.
Business owners may find it difficult to compare credit products, and despite being self-identified "financial decision makers" for their businesses; they may have difficulty calculating the actual costs of specific loan products.[6] A number of variables—such as frequency of payments, service and/or origination fees, and early payment penalties—ultimately affect the cost of a loan. Calculating the actual cost can be complicated for even the most informed business owners. As mentioned previously, cost in the quantitative sense is not the only important consideration for small business owners. In order to understand some of these comparative tradeoffs, the below examples illustrate the effects of changing terms for borrowing $10,000 as a loan and as a merchant cash advance.

With an installment loan, a business borrows a fixed sum at a given interest rate, and makes regular payments until the loan is "amortized," or fully paid off. A 12-month loan with a 10% stated interest rate will have a 10% APR. One might expect that the total interest on a $10,000 loan with a 10% APR would be $1,000. However, interest is only paid on the remaining balance each month, so as the amount owned decreases each month, so does the interest. This results in total interest of $550 for a $10,000 loan with a 10% APR.[7]

For many borrowers, the lowest annual percentage rate, or APR, is preferable. However, the needs of small business owners vary, and in some cases, a shorter-term loan may make more sense in spite of the higher rate, the same way it might make more sense for a family of two to purchase a small box of cereal at a grocery store for a higher unit price, but lower total price, than to purchase a larger amount in bulk at a wholesale club for a lower unit price but higher total price.

With a merchant cash advance, a business receives a sum of money, and pays the lender back based on a "factor rate," which is a multiple of the amount borrowed. Although the "factor rate" might seem identical to the concept of an interest rate on a loan, the two are distinct. In contrast to loans, merchant cash advances apply the factor rate to the whole amount borrowed at the beginning of the advance, and do not reflect the decreasing amount owed as a business owner pays back what was borrowed. The periodic payment for a merchant cash advance is frequently calculated as a predetermined share of periodic sales (often daily or weekly), meaning that sales volume affects the time it takes to repay the advance. Some online small business loans function like merchant cash advances rather than installment loans.

Conclusion

For informed small business owners, non-bank loans and online loans present an opportunity to procure capital more quickly and more easily. In turn, small businesses may be able to better manage financial emergencies or take advantage of unanticipated growth opportunities. According to one survey, dissatisfied small business applicants at online lenders were much more likely to identify high interest rates and unfavorable repayment terms as the source of their dissatisfaction, than those who applied at banks.[8] (However, approved borrowers at online lenders were much *less* likely to cite "long wait for credit decision" or "difficult application process" as the reason for their dissatisfaction.) In spite of the complaints described above, all else equal, online borrowers were more satisfied than businesses who were denied credit altogether.[9] With this in mind, it is important for policymakers to take a pragmatic approach and consider the preferences of small businesses.

Related Research

- **What is Alternative Finance?**, September 2016
  www.sba.gov/sites/default/files/advocacy/What-Is-Alt-Fi.pdf**Equity-based Crowdfunding: Potential Implications for Small Business Capital,** April 2015
  www.sba.gov/sites/default/files/advocacy/Issue-Brief-5-Equity-Based-Crowdfunding_2.pdf
- **Peer-to-Peer Lending: A Financing Alternative for Small Businesses,** September 2015
  www.sba.gov/sites/default/files/advocacy/Issue-Brief-10-P2P-Lending_0.pdf

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[1] Williams, Victoria. Small Business Lending in the United States, www.sba.gov/sites/default/files/2013-Small-Business-Lending-Study.pdf

[2] *(Jagtiani, Julapa and Lemieux, Catharine, Small Business Lending: Challenges and Opportunities for Community Banks (2016-03-21). FRB of Philadelphia Working Paper No. 16-8. Available at SSRN: https://ssrn.com/abstract=2752863)*

[3] *(http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf)*

[4] *Small Business Credit Survey report: https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf*

[5] *Small Business Credit Survey report: https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf*

[6] Federal Reserve Bank of Cleveland, "Alternative Lending through the Eyes of 'Mom & Pop' Small Business Owners." Aug. 25, 2015

[7] Some online loans do not offer prepayment options, meaning that if the principal is repaid early, any interest calculated initially must still be paid.

[8] According to the 2016 Small Business Credit Survey from the Federal Reserve System, at either large banks or small banks. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2926964.

[9] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2926964 (see note 6).

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