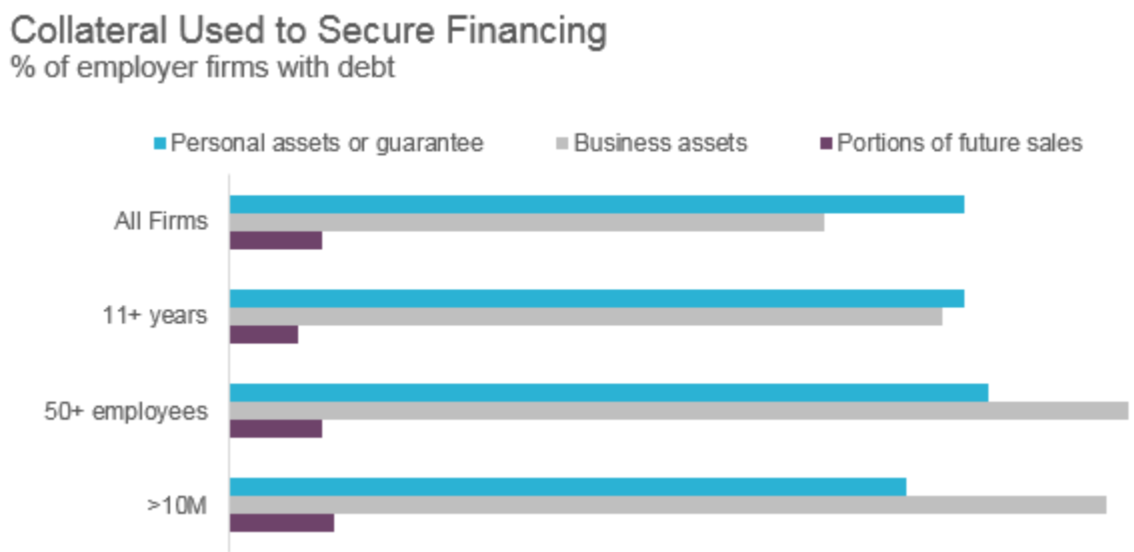
March 15, 2016

Collateral Requirements and Nonbank Online Lenders: Evidence from the 2015 Small Business Credit Survey

Businesses can secure a bank loan by offering collateral—typically a business asset such as equipment or real estate. However, the recently released 2015 Small Business Credit Survey (SBCS) Report on Employer Firms,conducted by seven regional Reserve Banks, found that 63 percent of business owners who had borrowed also used their personal assets or guarantee to secure financing. Surprisingly, the use of personal collateral was common not only among startups. Older and relatively larger small firms (see the following chart) also relied heavily on personal assets.



Source: 2015 Small Business Credit Survey

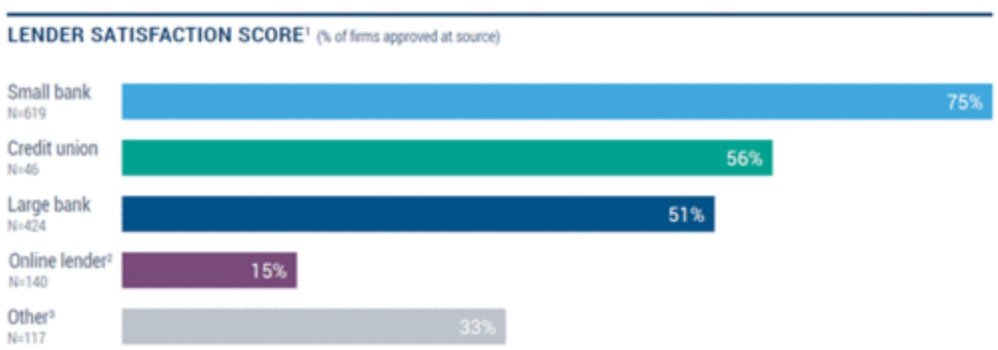
Note: "Unsure", "None", and "Other" were also options but are not shown on the chart.

(enlarge)

Alternative lending options also exercised

Not every small business owner has sufficient hard assets, such as real estate or equipment, that can be used as collateral to secure a traditional bank loan or line of credit. For these circumstances, there are options such as credit cards and products offered by nonbank lenders (mostly operating online) that have less stringent underwriting requirements than banks. Many online nonbank lenders advertise unsecured loans or require only a general lien on business assets, without valuing those business assets.

In the 2015 SBCS, 20 percent of small firms seeking loans or lines of credit applied at nonbank online lenders. These lenders have a good reputation for quick application turnaround, and the collateral requirements can be looser than those applied by traditional lenders. But when borrowers were asked about their overall experience, only a net 15 percent of businesses approved at nonbank online lenders were satisfied (40.6 percent were satisfied and 25.3 percent were dissatisfied). In contrast, small banks received a relatively high net satisfaction score of 75 percent (see the chart).



Source: 2015 Small Business Credit Survey Report on Employer Firms

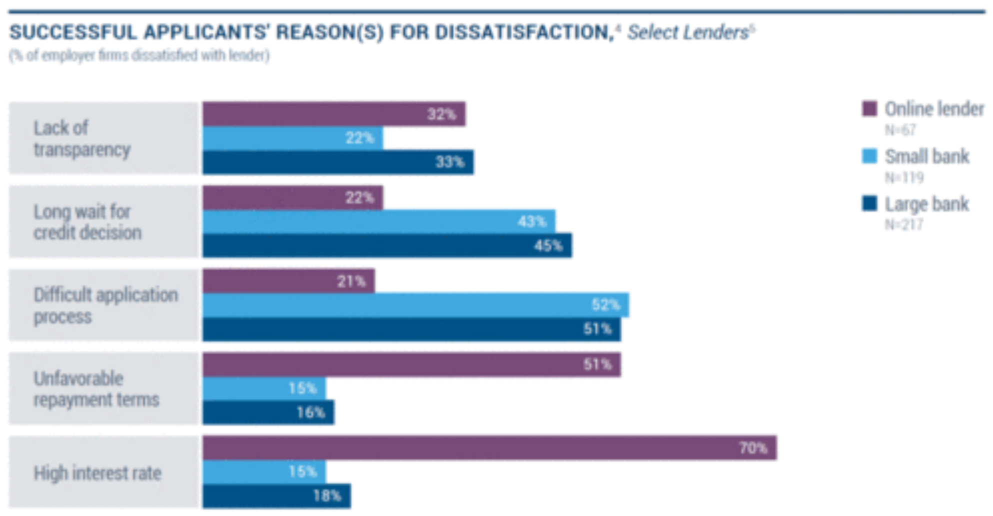
1 Satisfaction score is the share satisfied with lender minus the share dissatisfied.

2 "Online lenders" are defined as alternative and marketplace lenders, including Lending Club, OnDeck, CAN Capital, and PayPal Working Capital.

3 "Other" includes government loan funds and community development financial institutions.

(enlarge)

The survey also showed that high interest rates were the primary reason for dissatisfaction at nonbank online lenders (see the chart).



Source: 2015 Small Business Credit Survey Report on Employer Firms

Note: Respondents could select multiple options. Select responses shown due to low observation count.

(enlarge)

Merchant cash advances make advances

Most applicants to nonbank online lenders were seeking loans and lines of credit, but some were seeking a product that tends to be particularly expensive relative to other finance options: merchant cash advances (MCA). MCAs have been around for decades, but their popularity has risen in the wake of the financial crisis. Typically a lump-sum payment in exchange for a portion of future credit card sales, the terms of MCAs can be enticing because repayment seems easier than paying off a structured business loan that requires a fixed monthly payment. Instead, the lender is paid back as the business generates revenue, in theory making cash flow easier to manage.

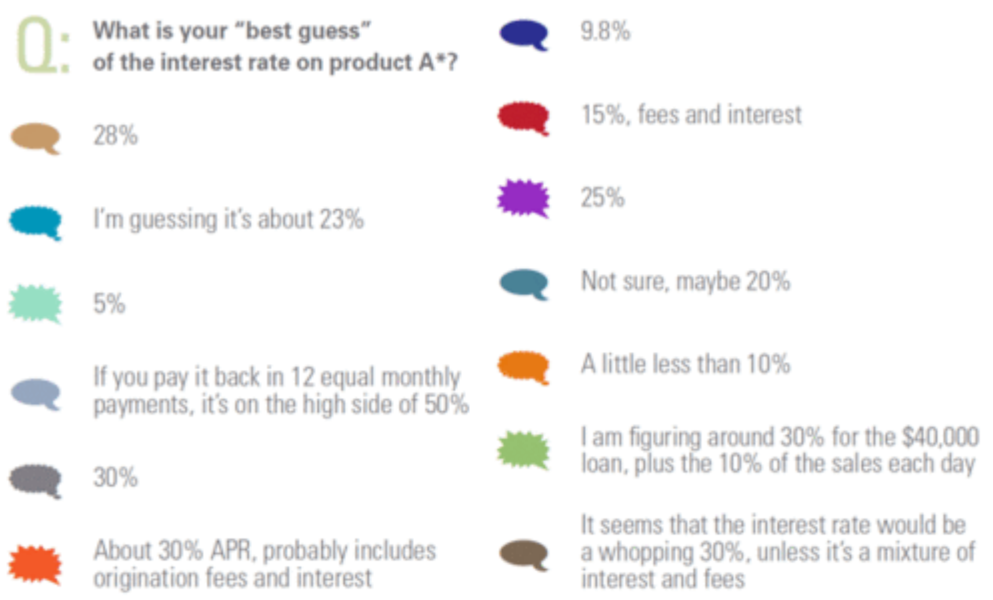
One potential challenge for users of MCA products is interpreting the repayment terms. Instead of displaying an annual percentage rate (APR), MCAs are usually advertised with a "buy rate" (typically 1.2 to 1.4). For example, a buy rate of 1.3 on $100,000 would require the borrower to pay back $130,000. However, a percentage of the principal is not the same as an APR. The table below compares total interest payments made on a 1.3 MCA versus a 30 percent APR business loan repaid over 12 months and over six months. With a 12-month business loan, a 30 percent APR would equal total interest payments of roughly $17,000. With a six-month business loan, repayment would include about $9,000 in interest.

	12-Month Term		6-Month Term	
	MCA: 1.3 Buy Rate	30% APR Business Loan	MCA: 1.3 Buy Rate	30% APR Business Loan
Total interest payments made	$30,000	$16,985	$30,000	$8,929.98

Source: http://www.bankrate.com/calculators/mortgages/loan-calculator.aspx

Because an MCA is structured as a commercial transaction instead of a loan, it is regulated by the Uniform Commercial Code in each state instead of by banking laws such as the Truth in Lending Act. Consequently, the provider does not have to follow all of the regulations and documentation requirements (such as displaying an APR) associated with making loans.

Converting a buy rate into an APR is not straightforward for many potential users, as was made clear in a recent online lending focus group study with small business owners conducted by the Cleveland Fed. When asked what the APR was on a $40,000 MCA that required a repayment of $52,000 (the same as a 1.3 buy rate), their answers were the following: (Product A is the MCA type of product; see the study for exactly how it was presented to respondents.)



Source: Federal Reserve Bank of Cleveland

(enlarge)

The correct answer is that "it depends on how long it takes to pay back." For example, if the debt is repaid over six months, the APR would be 110 percent (as this calculator shows).

Nonbank online lenders can fill gaps in the borrowing needs of small business. But there may also be a role for greater clarity to ensure borrowers understand the terms they are signing up for. In a September 2015 speech, Federal Reserve Governor Lael Brainard highlights one self-policing movement already well under way:

Some have raised concerns about the high APRs associated with some online alternative lending products. Others have raised concerns about the risk that some small business borrowers may have difficulty fully understanding the terms of the various loan products or the risk of becoming trapped in layered debt that poses risks to the survival of their businesses. Some industry participants have recently proposed that online lenders follow a voluntary set of guidelines designed to standardize best practices and mitigate these risks. It is too soon to determine whether such efforts of industry participants to self-police will be sufficient. Even with these efforts, some have suggested a need for regulators to take a more active role in defining and enforcing standards that apply more broadly in this sector.

Many, but not all, nonbank online lenders have already signed the Small Business Borrower Bill of Rights. Results from the 2015 Small Business Credit Survey Report on Employer Firms can be found on our website.

By Ellyn Terry, an economic policy analysis specialist in the Atlanta Fed's research department

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