Small Businesses’ Perceptions and Understanding of Online Alternative Loan Products: Findings from Online Focus Groups

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Organized by the Federal Reserve Bank of Cleveland and the Board of Governors

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- **Convening stakeholders**, including practitioners, financial institutions, nonprofits, governmental agencies, and the philanthropic and private sectors,

- **Conducting and sharing research** to examine economic challenges facing low- and moderate-income communities and attendant policy implications; and,

- **Identifying emerging issues**.

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Today’s Presenters

• Barbara Lipman, *Project Manager, Division of Consumer & Community Affairs*, Federal Reserve Board of Governors

• Ann Marie Wiersch, *Senior Policy Analyst, Community Development*, Federal Reserve Bank of Cleveland
The Online Alternative Lending Industry: Players and Products

• Online alternative lenders are nonbank credit providers
  – Merchant cash advance providers
  – Marketplace platforms (peer-to-peer)
  – Other direct lenders

• Small business credit products
  – Loans
  – Cash advances
A Small but Growing Industry

• Growth driven by borrowers’ unmet demand for credit

- Investors demand for notes
- Venture capital investment
- New partnerships

Source: 2014 Joint Small Business Credit Survey (Federal Reserve Banks of Atlanta, Cleveland, New York, and Philadelphia)
Focus Group Study Initiated to Explore Borrowers’ Perspectives

• Gauge small business owners’ perceptions about alternative lending
  – Their approach to credit decisions
  – Their impressions of online alternative lenders
  – Their understanding of the products offered

• Surface issues to inform future research
About the Online Focus Groups

• Two focus groups, 44 business owners
• Online discussion format, three days of questions, professionally moderated
• Participants’ businesses varied in size and across industries, geography
• Discussion topics
  – Day one: Managing business and financial challenges
  – Day two: Process for seeking short-term credit, virtual “shopping”
  – Day three: Evaluation of mock credit products, recommendations
Business Challenges and Financial Decision Making

• Challenges managing business finances

“Managing cash flow is the hardest thing I face. The second hardest thing, as well as the third, are managing cash flow.”

- Business owner from Texas

• Participants would consult a variety of sources for advice, including their banks, but some did not view banks as a likely credit source
Participants’ Initial Impressions of Online Lenders

- The wild west
- Seems shady to me, a scam
- Identity theft
- High APRs
- Pay day lenders
- I do not trust them

- Wants to do business quickly
- Place I would trust
- Less overhead, better rates
- More variety of products
“Shopping” Appears to Change Participants’ Impressions

• Participants found websites to be appealing.
• Some participants that held unfavorable initial impressions shared very positive impressions after shopping.
• Others shared concerns about data security, high rates, and loss of control over their merchant accounts.
Mock Product Comparisons

Scenario: Suppose you needed $40,000...

**Product A**
- Need FICO 500+
- You provide sales history and bank account info
- Decision and funding within 3 to 5 days

**Repayment:**
- You owe $52,000. The lender takes 10% of your credit card sales receipts each day until paid off

**Product B**
- Need FICO 650+
- Sales history and account info pulled electronically
- Decision and funding within 1 day

**Repayment:**
- You owe the original $40,000 plus 28 cents for every dollar you borrow; repaid in one year

**Product C**
- Need FICO 700+
- You provide three years of tax returns and financial statements
- Decision and funding within 4 weeks

**Repayment:**
- You owe monthly payments of $3,440. Your effective APR is 6%; loan is repaid in one year
Confusion about Product Costs

**Product A:** $40,000 borrowed, $52,000 repaid with 10% of sales receipts, assuming one-year repayment.

*What is your best guess of the interest rate?*

- 28%
- About 23%
- 9.8%
- 30%
- A little less than 10%
- On the high side of 50%
- 5%
- Not sure, maybe 20%
- 25%
More Confusion about Costs

Suppose you repay Product A in 4 months. How would paying back more quickly affect your rate?

- I assume the rate would be lower
- It would not affect the rate
- The effective interest rate would be higher
- I really don’t know
- The interest rate is irrelevant since I still have to pay $12K on $40K
Challenges Comparing Products

- Respondents self-identified as financial decision maker
- Said it was “Easy” to compare products

- Qualified answers with “I think” or “I’m not sure but ...”
- Admitted difficulty on some specific questions or ...
- ... Did not answer correctly

- Almost to a person ... recommended making products easier to understand and compare
Participant Recommendations

- They want information about loan products – especially costs – to be clear.
- They don’t want to feel they can be taken advantage of.
- They want ironclad protections for their business data.
- They want to do business with firms they are sure are reputable.
Key Findings Summary

• Online alternative lender websites are alluring, but trigger concerns about data security and privacy.
• Small businesses find it difficult to compare credit products using information typically provided on online alternative lenders’ websites.
• Virtually all the focus group participants said they want clearly stated product features and costs and an easier way to compare product offerings.
Policy Questions

• How would standardized disclosures affect borrowing decisions?
• How will concerns about data and privacy affect borrowers and the industry?
• How will online alternative lending change the nature of small business banking?
Closing Thoughts

• The online alternative lending industry is growing and evolving.
• With greater market penetration will come greater experience, more competition, and changes in borrower expectations.
• Future research should track industry developments from the borrowers’ perspective.
• Please visit the Federal Reserve Bank of Cleveland website for the complete report.

• For more information, please contact Barbara.J.Lipman@frb.gov or AnnMarie.Wiersch@clev.frb.org.
Questions?
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