

# ALTERNATIVE **LENDING**

through the Eyes of “Mom & Pop”  
Small-Business Owners:

*Findings from Online Focus Groups*

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## through the Eyes of “Mom & Pop” Small-Business Owners: Findings from Online Focus Groups

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## EXECUTIVE SUMMARY

Online alternative lenders are reporting rapid growth and recent surveys suggest more small businesses are turning to them as potential sources of credit. These nonbank lenders offer small-dollar credit products including cash advances, lines of credit, and various types of loans. Many provide the funds in days or even hours, expedience made possible with data-driven technologies and new approaches to underwriting, pricing, loan delivery, and servicing. While the industry holds promise for expanding access to credit, it also raises potential risks for small-business borrowers as these products can be considerably more expensive than traditional credit.

Few studies have examined the emergence of online lenders and the impact to the small-business credit environment, especially from the perspective of borrowers. In light of this, the authors set out to gauge small-business owners' perceptions and understanding of online alternative lenders and the small-dollar credit products these lenders offer. The study was conducted using online focus groups, a method of gathering participants' perceptions through online discussions—and in this case, an effective way to convene a group of geographically dispersed and busy small-business owners. The online format allowed for the collection of detailed responses as well as insights into the complex decision processes of potential borrowers. As part of the study, participants evaluated mock loan products and visited the websites of actual online lenders and shared their impressions.

The participants recruited for this study operate small businesses ("Mom & Pops") with two to 20 employees and less than \$2 million in annual revenues, from across the US, and in a wide range of industries. In total, 44 small-business owners participated in two separate online focus groups. Given the relatively small sample size, this study was not designed to derive conclusions about a representative sample of borrowers; rather, the intent was to surface key issues that could guide future research, data collection, and policy analysis.

# EXECUTIVE SUMMARY

## Key Findings

The focus group findings reveal that as small-business owners navigate financial challenges, they turn to a number of sources for financial advice, including their banks. However, they did not necessarily perceive banks as a likely credit source. Some participants cited concerns about their ability to meet banks' lending criteria, while others were skeptical about their banks' willingness to lend to businesses of their size. The study also found that some participants did not readily recognize online alternative lenders as a distinct lender category. Rather, they view "online" as a place where they can shop for or obtain credit from both traditional and alternative sources.

While the focus group participants demonstrated an openness to online alternative lenders, their responses suggest areas of concern.

- **Online alternative lender websites are alluring, but trigger concerns about data security and privacy.**

When asked for their initial top-of-mind impressions of online lenders, a majority of participants relayed negative to neutral reactions. Interestingly, attitudes shifted positively after participants visited actual lender websites. However, the lenders' collection of businesses' financial information raised data-security and privacy concerns, recurring themes in the discussions about online lenders.

- **Using information typically provided on online alternative lenders' websites, small businesses find it difficult to compare credit products.**

Although participants initially said it was "easy" to evaluate credit products when presented with several options, many expressed uncertainty or answered questions incorrectly when making specific product comparisons, particularly on cost.

- **Virtually all the focus group participants said they want clearly stated product features and costs and an easier way to compare product offerings.**

Among their suggestions were interest rates expressed as APRs, straightforward explanation of all fees, and required statements about payment policies, including late fees and prepayment penalties.

# ONLINE ALTERNATIVE SMALL-BUSINESS LENDING IN BRIEF

## Online alternative players and products

Small-business lending in 2015 looks very different from the lending environment in the years prior to the Great Recession. Bank lending to small businesses declined considerably in the post-recession period and credit remains tight, especially for small-dollar loans, or those under \$250,000.<sup>1</sup> At the same time, alternative online lenders have become increasingly active, although they account for a small share of the total small business credit market.<sup>2</sup>

In this study, online alternative lenders are defined as nonbank credit providers operating online to serve small-business borrowers. The players include merchant cash advance companies that allow businesses to borrow against future sales and repay with a fixed percentage of daily credit card sales receipts. Some online lenders are marketplace lending platforms (also known as peer-to-peer lenders) that do not lend directly, but price the risk of loan applications and connect small-business borrowers with investors who have capital to lend. Other providers lend directly to small businesses and keep the loans on their balance sheets. Still others are payment processing firms that have made forays into the cash advance business by lending to their small-business account holders. Online alternative lenders often pull borrower data electronically, including non-traditional measures of creditworthiness such as customer ratings on social media.

The credit products offered by online alternative lenders go by a variety of names: *business loans*, *peer-to-peer loans*, *lines of credit*, *funding programs*, *capital advances*, *business cash advances*, or simply "*funds*." Payment amounts may be fixed installments or based on a percentage of sales, and may be due daily, weekly, bi-monthly, or monthly. They also have varying repayment arrangements, for example, daily swipes of credit card receivables, payment accounts, or automated clearinghouse payments (ACH). Despite the differences, the products generally come in two varieties—loans and cash advances.

*Loans*: Typically, these are short-term loans underwritten by the online lender. Those with a fixed term usually are originated with an FDIC-insured bank that immediately assigns the loan back to the online lender. These loans are serviced by the online lender, who may package and sell the notes to investors.

*Cash advances*: Advances allow businesses to convert future credit card or payment account receivables into capital. While the distinction may be unclear to the borrower, these products differ from term loans in that they are the sale of a set percentage of the borrower's future sales for a specified dollar amount. For example, \$50,000 in capital is provided in exchange for \$65,000 in future receipts, repaid with daily swipes of 10 percent of credit card sales.

In practice, both of these credit products are unsecured and often carry effective interest rates that exceed those of traditional bank products.<sup>3</sup>

## Drivers of online lending to small businesses

Online alternative small-business lending appears to be gaining traction, although the overall size of the industry is unclear due to a lack of independent data. Online alternative lenders are not subject to the same reporting requirements as banks, making it difficult to accurately assess the volume of lending taking place. Estimates come from industry sources and suggest rapid growth in the past several years.<sup>4</sup> Whatever its precise magnitude, the growth appears to be fueled, to some extent, by both small-business borrowers and investors.

Among borrowers, there is evidence of unmet credit demand. For example, a recent small-business survey conducted by several Federal Reserve Banks indicates that 44 percent of credit applicants reported they received none of the funding they were seeking. The survey also suggests that small-business borrowers are increasingly turning to alternatives, with nearly one in five (18%) of those who applied for credit saying they applied to an online lender.<sup>5</sup>

# ONLINE ALTERNATIVE SMALL-BUSINESS LENDING IN BRIEF

On the supply side, curtailed lending to small businesses by traditional banks may also be a factor driving the growth in alternative lending.<sup>6</sup> Small-business lending has reportedly become less profitable relative to other types of lending, reducing banks' interest in making small-dollar loans to small business. At the same time, while small businesses' financial position (collectively) has improved, it is not yet as strong as reported prior to the recession.<sup>7</sup> This makes it all the more challenging for small businesses to meet traditional banks' credit standards.<sup>8</sup>

Online alternative lenders assert their business models can more effectively meet small businesses' small-dollar credit needs. Among their innovations are proprietary underwriting algorithms that the lenders say can identify borrowers most likely to repay, despite their inability to meet traditional lender criteria or collateral requirements. Also, online alternative lenders purport to underwrite, originate, and service credit more cheaply than traditional banks. They cite cost savings from not having a branch network (the biggest savings), as well as efficiencies from automated originations and online back office support.<sup>9</sup>

Meanwhile, investors pursuing better returns in the current low-interest-rate environment are actively investing in the alternative lending industry. Interest is reportedly robust from investors looking to purchase the loans originated by the alternative lenders.<sup>10</sup> Securitization activity is rising, and a few recent securitization transactions have earned investment-grade ratings.<sup>11</sup> In addition, venture capital firms are backing many of the new entrants, as well as existing industry players, in developing their underlying platforms and technologies.

To keep pace with investor demand, online alternative lenders are seeking new borrowers to boost their lending volumes. They've been active in forming new partnerships with other corporations and non-profit organizations that serve small-business customers, as well as with traditional banks.<sup>12</sup> These partnerships drive new customers to the lending platforms and supplement the flow of customers reached not only through brokers, but also through the online lending industry's growing investment in marketing. Online alternative lenders have increased their television, radio, internet, and direct-mail advertising markedly in the

past two years.<sup>13</sup> Furthermore, some online alternative lenders continue to broaden their customer bases and the menu of products they offer to small-business borrowers. For example, a number of the lenders formerly focused on the consumer market are branching into small-business lending. Similarly, some of those that had offered only cash advances are now extending loans as well.

## Implications for potential small-business borrowers

In short, online alternative lending is an emerging industry that its leaders say holds promise for increasing access to credit for small businesses. It is also a rapidly growing, crowded, and potentially confusing marketplace for prospective borrowers. From their perspective, a number of concerns arise.<sup>14</sup> Small-business advocates note the prevalence of subprime lending in the industry as some firms, especially merchant cash advance companies, offer high-cost credit to borrowers with FICO scores in the low 500s. They also have raised concerns about questionable industry practices that result in "stacking" (i.e., the practice of providing cash advances to borrowers who already have outstanding cash advances).

Disclosure is another issue raised by advocates. Credit extended for a business or commercial purpose is not covered by the disclosure requirements of the federal Truth in Lending Act. In practice then, online alternative small-business lenders have had considerable leeway when it comes to the content and format of disclosures about their products' features and costs.<sup>15</sup> On this issue of disclosure, some online lenders and small-business advocates have proposed a "borrower bill of rights" to clarify the obligations of both borrowers and lenders.<sup>16</sup> Finally, researchers have called for more data collection from industry participants and for statistics on the various loan products and how borrowers fare during and after repayment.

## ABOUT THE STUDY

The Federal Reserve has an interest in online alternative lending from several perspectives. For one, small businesses need adequate credit to succeed and grow; otherwise they may underperform, slowing economic growth and employment. For another, these online products and delivery methods are still relatively new and pose opportunities as well as potential risks to borrowers. The smallest businesses (those with 2 to 20 employees) are of particular concern as they lack the financing options of larger businesses and may be less likely to recover from a poor credit decision.

Also, traditional banks may view online alternative lenders as competitors or as partners. As a bank regulator, it is important for the Federal Reserve to understand changes in the competitive landscape for financial institutions. Finally, this study can help set the stage for more in-depth qualitative or quantitative research on the topic of alternative lending. While one study cannot address all the issues noted earlier, this project attempts to further our understanding of how a segment of small-business potential borrowers views this important emerging industry.

### Why online focus groups?

For this study, the Federal Reserve Board and the Federal Reserve Bank of Cleveland conducted online focus groups

to better understand small businesses' perceptions of online alternative lenders and the short-term, small-dollar credit products they offer. Typical quantitative surveys of small businesses do not probe respondents' motivations for considering online lenders or their decision-making processes for evaluating these alternatives. Focus groups provide deeper insights into these topics. Furthermore, the type of focus group employed here, an online bulletin-board focus group, is an especially effective way to convene a group of geographically dispersed and busy "Mom & Pop" small-business participants—a demographic that is particularly hard to reach with a face-to-face focus group.<sup>17</sup>

The online focus group format proved to be well suited for studying products marketed and delivered online. It also yielded insights that may be useful to policymakers and that can inform the design of follow-up research using other qualitative or quantitative methods. It should be underscored, however, that focus groups, whether online or in-person, are not designed to measure incidence or quantitative trends. Due to their small sample size and the non-random selection of participants, the results of these focus groups should not be interpreted numerically or otherwise generalized to the wider population of small businesses. Key facts about the logistics for the online focus groups are summarized in Figure 1.

Figure 1 Overview of the small-business online focus groups



- Two separate online focus groups were conducted: the first from November 11-14, 2014, and the second from March 23-27, 2015.
- Both focus groups had 22 small-business participants for a total of 44.
- Both focus groups were professionally moderated by the Nielsen Company.
- The online bulletin boards ran day and night; participants responded at their convenience.
- New questions were posted daily for three days. The boards remained opened a fourth day for closing comments and follow-up questions.
- Participants committed to spending 30-45 minutes each day answering questions.

# ABOUT THE STUDY

## Recruitment of small-business participants

The focus groups convened small businesses likely to be in the pool of potential borrowers for online sources of credit. To qualify for the study, a business was required to have 2 to 20 employees and annual revenues under \$2 million (a minimum threshold of \$200,000 was set for the second focus group).<sup>18</sup> Participants had to be the financial decision makers, or share that responsibility, for their businesses. Excluded were self-employed individuals, “larger” firms with more than 20 employees, and new businesses—this last category because many online alternative lenders require at least a two-year sales history.

Professional recruiting firms contacted small businesses and screened for these criteria. The recruiters were charged with identifying at least 22 qualified small-business participants for each group<sup>19</sup> that were diverse in geography and industry and with varying levels of knowledge of and experience with online alternative lenders. The Federal Reserve was identified as the sponsor of the study.

Within the established criteria, the 44 small businesses that participated in the focus groups were quite diverse. They were fairly balanced across the ranges for number of employees and annual revenue. While two years was the minimum threshold for participation, many firms had been in business a decade or even two. The businesses came from a wide variety of sectors and services and were located across five US time zones in more than 20 states. Participants were roughly balanced between males and females, and about a quarter self-identified as African-American, Hispanic, or Asian. Their ages ranged from early 30s to late 60s. See Appendices A and B for more detail on the demographics of the focus group participants and the screening process.

## The online focus-group discussion

The question set for the focus groups (or “topic guide”) was developed by Federal Reserve System staff in collaboration with the Nielsen Company (Nielsen). Leveraging the flexibility of the online focus-group format, loan-product descriptions and other items were posted on a virtual whiteboard for participants’ consideration. Participants also were asked to visit the websites of online lenders and then return to the focus group discussion to share their impressions. Using these capabilities, the topic guide staged three days of questions, each focused on a different theme.

- **Day 1 topics:** Stresses and joys of running a small business, their biggest financial concerns, where they go for advice.
- **Day 2 topics:** Process for seeking short-term credit, perceptions of online lenders, online “shopping” exercise that prompted participants to visit web pages of online lenders.
- **Day 3 topics:** Evaluation of mock credit products, participant recommendations.

During the online focus group, participants logged onto a secure internet site each day over a period of three days to respond to questions. The site remained accessible a fourth day for participants to review, add final thoughts, or respond to any last follow-up questions. Participants were able to go in and out of the site at their convenience since it did not occur in “real time.” Participants could view questions one at a time and were able to see others’ responses only after posting their own. The groups were professionally moderated by Nielsen, with Federal Reserve staff observing and conferring with the moderator on follow-up questions for participants, when needed.<sup>20</sup>

## KEY FINDINGS

The focus groups provided documentation for some existing assumptions about small-business borrowers and also provided fresh insights on these and on new issues. The findings outlined here summarize the common perceptions and notable themes raised by the participants themselves. The detailed observations that support these findings are discussed in the next section of this report.

### **1. Online alternative lender websites are alluring, but trigger concerns about data security and privacy.**

About one-quarter of all participants in the focus groups had direct experience with an online alternative lender. Most of the others reported they were at least vaguely familiar with online lenders or had heard the names of some of the larger firms, though a few indicated they were not at all familiar. All participants were asked for their initial, top-of-mind impressions of the term “online lender.” The overall impressions of those not experienced or unfamiliar with online lenders were quite negative. Conversely, those who had applied to or actually borrowed from an online lender were generally more positive.

Interestingly, the negative attitudes of participants less familiar with online lenders turned somewhat positive after they visited actual lender websites. Some participants said they were pleasantly surprised by the user-friendliness and professionalism of the websites. However, the websites’ collection of businesses’ information for marketing and underwriting raised data-security and privacy concerns and was a turn-off for participants across the board.

### **2. Using information typically provided on online alternative lenders’ websites, small businesses find it difficult to compare credit products.**

Although participants initially said it was easy to evaluate loan products, many expressed uncertainty or answered questions incorrectly when making specific product comparisons, particularly on cost.

Participants in the focus group self-identified as a financial decision maker for their businesses. This may have been one of the reasons that, when asked whether it was easy or difficult to compare several mock loan products, participants overwhelmingly answered that it was “easy.” However, during the course of the focus group, many participants said they were “not sure” about the actual costs and specific features of some of the products. Moreover, when asked for recommendations to ensure online loans are safe, stable, and flexible, most said they wanted more information to make products easier to compare.

### **3. Virtually all the focus group participants want clearly stated product features and costs and an easier way to compare product offerings.**

The lack of standardization in how online lenders present their products was problematic for many focus group participants. During the product comparison exercises, some noted missing information about specific features and costs, while others did not.

A majority of participants said they want clearly stated product features and an easier way to compare product offerings. Among their suggestions were using a standard annual percentage rate (APR) and explicitly listing all fees as well as requiring statements about payment policies, including late fees and prepayment penalties. In addition, participants stressed they want assurances about the security of their business data and information to help them determine whether the companies they might borrow from are reputable or not.

## DETAILED OBSERVATIONS

This section both summarizes key elements of the discussion among the focus-group participants and presents their views in their own words.<sup>21</sup> Tracking the flow of the topics covered during the focus group (see Appendix C), the section begins with insights on business owners' financial challenges as well as their sources of advice and short-term credit. Next, detailed observations are presented on participants' perceptions of online alternative lenders and their comparisons of mock online credit products. The section closes with participants' recommendations to ensure online loans are safe, stable, and flexible.

### Business challenges and financial decision making

At the outset of the focus group, participants were asked about the challenges of running a small business today. They described a wide range of challenges, many of them financial and stemming from uneven cash flow. Were they to consider short-term financing, most said they would proceed cautiously, doing research on the Internet but also seeking out trusted sources of advice, including personal contacts and their banks. However, they did not necessarily view banks as a likely source of funding.

### CHALLENGES MANAGING BUSINESS FINANCES

The business challenges participants face are as varied as their products, services, and customers. Participants relayed concerns about generating new business, meeting the evolving needs of their clients, and managing employees. The foremost and nearly ubiquitous financial concern they voiced, however, was managing cash flow. This sentiment was expressed directly and also emerged at the top of a priority-ranking exercise on the focus group whiteboard. Uneven cash flow was a source of worry for dealing with matters ranging from the immediate—such as paying creditors or meeting payroll—to the longer-term, including business promotion, expansion, and related challenges they described.

### Cash flow and cash-related problems are what keep many of the participants up at night.



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

*Part-owner of an engineering firm, Texas*



Short term: I want to make sure that the lights stay on. Long term: I want to make sure that the lights stay on. Seriously though, getting clients to pay what they owe in a timely fashion, and make sure that my employees are properly compensated.

*Part-owner of a professional staffing firm, California*



The one concern that keeps me up at night in regards to the growth in my business is the ability to have the funds to pay for product on demand. There are times where my client might ask for a substantial amount of inventory, and if I don't have the capital to produce the demand requested [it] will cause my client to lose faith in my company's integrity.

*Owner of a manufacturing business, Illinois*



My biggest financial headache is the uncertainty of my tax burden combined with fluctuating cash flow.

*Part-owner of a media production company, Utah*



My biggest concern is keeping a good bank balance so when we are slow in the winter months and do not have very many payments coming in we can keep afloat. So we have to be mindful during our busy season.

*Part-owner of a photography business, Georgia*

If they have sought, or were to seek, advice on options for short-term credit to cover business expenses, participants turned to a variety of sources and approaches. Perhaps not surprisingly, many reported the Internet as a useful resource. In addition, participants said they would turn to business colleagues, family, and friends as important sources of advice. Also, quite a few participants—from businesses as varied as architecture, event planning, and healthcare staffing—said they would consult their bankers for guidance, citing their existing banking relationships and the banks' familiarity with and interest in their businesses. That said, a number of participants reported they would avoid banks altogether.

## DETAILED OBSERVATIONS

### Participants would consult a variety of sources, including their banks, for advice on short-term credit.



I would talk to a trusted business person who is a friend and ask their advice. I would seek out short-term funding from the bank institution that is familiar with our cash flow.

*Part-owner of a funeral services business, North Carolina*



I would do my research on the Internet. For advice, I would most likely go to a friend or financial advisor.

*Owner of a remodeling business, North Carolina*



We have a great relationship with our local bank and I would probably go to them first.

*Manager of a law firm, Illinois*



First I would call my local bank [with] whom I have had a long-term relationship. Next I would go online to see what offers are available from online lending sources.

*Manager of a management consulting firm, Virginia*



I would go to my attorney, not a bank.

*Probe: Why not a bank?*

Banks are very inflexible and limiting. Like the classic Bob Hope line, A bank is a place that will loan you money if you don't need it.

*Owner of an automotive business, New Jersey*

Interestingly, while banks were a source of advice for some, they were not necessarily viewed by many participants as likely sources of loans for working capital. Quite a few business owners cited concerns about their ability to meet banks' lending criteria, while others were skeptical about their banks' willingness to lend to businesses of their size. This is consistent with findings from other small-business surveys and sources in which respondents raise concerns about lending standards, especially credit score and collateral requirements, as obstacles to obtaining a loan from a traditional financial institution.<sup>22</sup>

### Some participants did not view banks as a likely source of short-term credit for their businesses.



By the time you need the loan a lot of banks do not want to give it to you. Also, the interest rate and the payment on the loan are so high that it's not feasible.

*Owner of a home remodeling business, North Carolina*



Securing debt for a forklift is easy. It is operating money that is tough. Most of the time you don't need it. When you do, there is never enough time to get it.

*Part-owner of an engineering firm, Texas*



Lenders are so much more cautious these days. It has been very difficult to obtain funds simply for cash flow management in a small business. They are more willing to lend for things like capital improvement, but unsecured loans are very hard to get.

*Owner of a medical practice, New Jersey*



Biggest problem I have is lack of collateral to secure a loan with.

*Owner of an office supply business, Georgia*



[The biggest challenge is] the amount of information and records needed to secure a loan. Banks do not seem to want to take a chance on small firms.

*Manager of an environmental consulting business, Maryland*

### Perceptions of online alternative lenders

Probing participants about their business challenges and attitudes toward borrowing and short-term credit set the stage for in-depth discussions about online alternative lending during the next phase of the focus group. Those discussions began with questions about general top-of-mind impressions of online lenders, then moved to virtual shopping in which participants visited the websites of online lenders and reported back on their impressions. As noted in the Key Findings, while many participants shared initial neutral or unfavorable impressions of online lenders, a number of them reported more favorable views after "shopping."

## DETAILED OBSERVATIONS

### UNFAVORABLE INITIAL IMPRESSIONS

Top-of-mind impressions from participants who had not heard of online lenders—or had heard of but not used them—were generally unfavorable and skeptical. Some participants were quite wary, particularly about cash advance providers. That said, a number of the skeptics attributed their distrust to their limited knowledge of and experience with online lenders.

- The wild west 
- Seems shady to me, a scam 
- Lacks customer service 
- Identity theft 
- A little skeptical 
- High APRs 
- High interest - low brow. RUN! 
- Largely unregulated 
- Pay day lenders 
- I do not trust them 
- Not sure about it 
- Charge ridiculous interest rates 

Other participants, particularly those who reported experience with online lenders, were a bit more trusting and were more likely to see the lenders in a favorable light.

- Wants to do business quickly 
- Place I would trust 
- More relaxed, simple application 
- Less overhead, better rates 
- Willing to take a risk on a smaller company 
- More lenient in their lending practices 
- Feels like a modern bank 
- More variety of products 

### “SHOPPING” APPEARS TO CHANGE PARTICIPANTS’ IMPRESSIONS

During the course of the focus groups, participants were asked to visit some online lender websites and pretend to shop for a loan. Participants were instructed not to apply or provide any personal information. Although a list of online lenders was provided to participants, no hotlinks to lender websites were included. Rather, participants were encouraged to explore those and other lenders as they wished.

The online shopping experience created excitement and interest especially among those who were not particularly familiar with online alternative lenders. The number and variety of lenders was surprising to many participants. Although most participants reported knowledge of a few online lenders during the screening process, they became aware of many others through the shopping exercise. Some visited as many as a half-dozen websites and reported back in detail on their impressions. A number of participants were wooed by the sites’ positive testimonials, customer-friendly feel, advertised low rates, and quick turnaround for funds deposited in borrowers’ accounts.

## DETAILED OBSERVATIONS

**What comes to mind when you see or hear the phrase “online lender”? How about “cash advance” company?**



Online lender—I feel a little leery because I don’t know anything about them. Cash advance company—I think shady and high interest rate.



Online lender sounds better than cash advance but both make me nervous. I get the feeling of high rates and no personal connection. I feel like there would no working with them if things got tough.

*Following the virtual shopping exercise, these participants shared more favorable views.*

**Let’s talk about the online lending site(s) that you looked at. What was the most interesting thing that you learned?**



I am really so excited and impressed with the new online ways to get financing, which are based on your business history and not on your credit reports or on your other debt. [These lenders] are really fueling small businesses with micro-loans and banking on the businesses growing and prospering. That’s the kind of people I want to do business with.



Some of the websites are user friendly and provided a lot of information, which makes it easier to navigate through what could be a stressful time. I like that [one lender] gives personal stories of borrowers’ success with the lender. I like when I see an ad that [a major business publication] has given them a top rating. That puts me more at ease because I feel that a reputable company has put their name on the lender backing up their practice.

**Asked what they would tell a friend they learned after “shopping,” many participants cited the wide variety of options, quick funding, and reasonable advertised interest rates.**



You’d be surprised how much money you can get and how fast you can get it from some of these online lenders. There’s a ton of competition and it seems like everyone wants your business.

*Manager of an entertainment business, California*



Most of them advertised reasonable rates in the 6-9% range. They also supported loans from \$4,000 to \$200,000 and seemed to be willing to lend for cash-flow problems.

*Owner of a medical practice, New Jersey*



With banks there’s usually a standard set of loan offerings. While there are a lot of similarities, none of these companies seem to offer exactly the same things as each other.

*Part-owner of a technology business, Tennessee*



All of these companies seem to not only offer a high amount of money (up to \$2,000,000), [but also] a short time in which you could get access to the money (most ranging up to 5 days), and being able to show your cash flow as your main support to obtain the money.

*Owner of an accounting firm, Georgia*



There are solutions for almost any problem. To me, the idea of going to my bank and sitting down with a stranger and filling out piles of forms makes me nervous and is really unappealing. I liked how easy the online solution is and all the choices, especially if I could work with a company I trust.

*Owner of a retail business, Massachusetts*



They offer great deals to businesses with not-so-great credit scores. They seem to give small businesses hope. I feel like this would be a great alternative to a traditional bank loan.

*Owner of an event planning business, Pennsylvania*

However, even some of the participants who shared very positive reactions about their shopping experiences expressed apprehension about vague terms and conditions associated with borrowing. Indeed, privacy, security of information, and borrower protection emerged as primary concerns among participants. They were more comfortable with providers with which they have some familiarity, either through name recognition or a business relationship.<sup>23</sup>

# DETAILED OBSERVATIONS

## After “shopping,” many would tell a friend about data-security and privacy concerns, high interest rates, and loss of control over their merchant accounts.



Do NOT enter any personal info until you have decided which lender(s) to work with. Check the rate, fees, and terms very carefully as they vary dramatically.

*Owner of vacation rental business, Connecticut*



I would steer my people away from these types of lenders. Although their rates were not as high as I thought they would be, they are still too high to consider in a real world situation.

*Owner of a technology firm, California*



I would have to apply to several to see what the fine print really said. Sounds almost universally like you give up control over your merchant services account.

*Part-owner of an engineering firm, Texas*



Only one site out of the four I reviewed provided the exact fees you would pay for the loan. The other sites all required that I input my contact info before I could get further info about terms and conditions of the potential loan.

*Owner of a real estate company, California*



Overall, the fees were much higher than I thought they'd be.

*Owner of a financial planning firm, Washington*



There are so many more ways to borrow money than I realized. It just isn't that hard to do. But you have to be so careful because the interest rates provided will kill you if you aren't ready to pay back the loans on time or ahead of time.

*Manager of a management consulting firm, Virginia*

## Mock product comparisons

As a follow-up to the questions about impressions of online lenders, the focus group discussion turned to credit products. The following scenario was posed to participants: “Suppose you needed \$40,000 in funds above and beyond the limit on your personal or business credit cards.” Participants were then shown three mock credit products on the whiteboard (see Figure 2) and asked a series of questions, both general and product-specific.

Note that the features described in the table are based on advertised conditions and terms because, in many ways, this captures the initial filtering process a prospective borrower uses to decide whether to explore, if not pursue, a particular product. In practice, the actual terms and conditions specified in a borrower credit agreement may be similar to, or quite different from, the featured terms and “as low as” rates highlighted on the lender’s website. The terms offered may vary depending on borrower creditworthiness, or may change with the inclusion of additional costs and fees. Furthermore, the frequency of payments specified in a credit agreement—daily, bi-weekly, or monthly—may greatly affect the product’s effective rate.

While not identified to participants, Product A mimics the common features of merchant cash advance products,<sup>24</sup> while Product B is modeled after loan products offered by several online direct lenders (particularly those that rely heavily on automated processes). The third offer, Product C, reflects what a small business borrower might find either in-person or on the website of a traditional financial institution.

Figure 2	Product A	Product B	Product C
Amount borrowed	\$40,000	\$40,000	\$40,000
Information you provide	Your sales history and bank account information, tax returns, etc. You send the information directly to the lender through mail or email.	You give permission to have your records pulled electronically for your sales history, bank accounts, inventory, and online reviews of your business.	Your bank account information, tax returns, and three years of financial statements. You send the information directly to the lender through mail or email. You pledge collateral to secure the loan.
Credit score	You need at least a 500 FICO	You need at least a 650 FICO	You need at least a 700 FICO
Waiting period for decision	3 to 5 days	2 hours	7 days
How soon funds arrive in your account	3 to 5 business days after you are approved	The same day you are approved	4 weeks
Repayment information provided	You owe \$52,000. The company takes 10 percent of your debit/credit card sales receipts each day until it is paid off.	You owe the original \$40,000 plus 28 cents for every dollar you borrow. The loan is paid off in one year.	You owe monthly payments of \$3,440. Your effective APR is 6.0%. The loan is paid off in one year.

## DETAILED OBSERVATIONS

For purposes of comparing the three products, a one-year repayment schedule is presented. However, in practice, terms for many online products are shorter than one year. For this reason, follow-up questions were asked to gauge participants' understanding of the impact of earlier repayment on the total amount owed and on the effective interest rate. Though perhaps imperfect in their representation of "typical" credit products, the mock products do provide insights into participants' preferences, priorities, and understanding of product features.

### CHALLENGES COMPARING PRODUCTS

Participants were presented with the mock products and asked to comment on each individually before comparing the three. Overall, Product A was appreciated for its flexible approach to underwriting and Product B was attractive largely due to the ease of application and speedy delivery of funds. Product C was perceived to be the most affordable. The downsides cited by participants were the high costs associated with the first product, the potential data risks for the second product, and the length of time required for approval and funds disbursement for the third.

When comparing the products, participants initially reported the three were easy to compare and that they had all the information needed to make a borrowing decision. However, many participants subsequently found it difficult to answer specific questions about the products. For example, although many cited the importance of knowing an APR, participants often did not note until asked that a specific interest rate was not included in the table. Instead, a number of participants made assumptions based on the information provided. When attempting to answer questions about the total amount owed and interest rates, participants became notably less confident in their ability to make an informed borrowing decision, with many qualifying their answers or indicating they were "not sure." Interestingly, when asked later for recommendations to ensure online loans are safe and secure, the majority indicated that products should be easier to understand and compare. Their recommendations are described in greater detail later in this section.

#### Is there anything in these offers you find confusing?



Nothing confusing.



No, it's pretty straightforward.

#### What additional information would you like to see about these products to help you make a decision?



I can't think of anything more I would need to see, really.



This is enough info for me to make a decision.

#### How easy or difficult is it for you to compare the cost to you or the total amount you would pay for these loan products?



It was simply a matter of a little multiplication. Very easy to compare the 3 loans.



Very easy, just do the math.

*When asked specific questions about the interest rate or repayment amount, the first participant qualified answers with "I think...", "My best guess is...", and "Maybe..." and was unable to correctly answer the questions. The second answered somewhat more accurately but made some incorrect assumptions.*

#### What specific recommendations would you make to ensure that online loans are safe, stable, and flexible to use?



Just make the loan descriptions simple and easy to understand for the average person who might not have a CPA license.



They need to set guidelines for APR, length, and fees that these types of online lenders can charge. This would make what you end up owing much more clear to the average consumer.

## DETAILED OBSERVATIONS

### CONFUSION ABOUT PRODUCT COSTS

Though the questions were not designed to gauge participants' financial acumen, their answers to some questions suggest significant gaps in their understanding of the repayment repercussions of some online credit products and the true costs of borrowing.

As previously noted, the information provided was deliberately limited to replicate terms and features as presented by lenders on their websites. Using only this information, calculating a true effective interest rate would not have been possible without making some assumptions. With that proviso, participants were asked about interest rates for the products, initially using a one-year loan duration for simplicity. Participants also were asked about the directional change in their effective interest rates should the credit products be repaid sooner. The wide variation in responses may reflect both differences in their interpretation of product features when these features are not clearly specified as well as differences in participants' financial savvy.

The graphics that follow present a sampling of participant responses to questions about the interest rate for Product A. It is the product that participants appeared to have the greatest difficulty interpreting, conceptually. Typical of a merchant cash advance, Product A combines the interest payments with other fees in the total repayment amount and, generally speaking, there are no savings associated with early repayment for these types of products. The entire repayment amount is owed, even if paid off the next day. As this repayment obligation usually is not indicated up front in product advertising, it also was not mentioned in the chart. Perhaps not surprisingly, the lack of details about early repayment on this product was a source of confusion for many participants.

**Q:** What is your "best guess" of the interest rate on product A?

-  28%
-  I'm guessing it's about 23%
-  5%
-  If you pay it back in 12 equal monthly payments, it's on the high side of 50%
-  30%
-  About 30% APR, probably includes origination fees and interest
-  9.8%
-  15%, fees and interest
-  25%
-  Not sure, maybe 20%
-  A little less than 10%
-  I am figuring around 30% for the \$40,000 loan, plus the 10% of the sales each day
-  It seems that the interest rate would be a whopping 30%, unless it's a mixture of interest and fees

## DETAILED OBSERVATIONS

**Q:** Suppose sales are brisk and you pay this loan back in four months. How do you think that affects the total amount you pay? How would paying back the loan more quickly affect your interest rate? Is it higher, lower, or the same?

 I would 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



Well, it looks like I will owe \$52,000 no matter what. That would skyrocket the effective APR, to like 90%.

*Owner of a retail electronics business, Indiana*



The rate would stay the same but the amount would be less. If paid back in 4 months versus 12 months, it would be 25% of \$12,000 or \$3,000.

*Owner of a training/consulting firm, Washington DC*



You would end up paying less if you paid the loan off in 4 months rather than 6 or 8 months because you would not have that extra 10% going out every month. I would not consider this an interest rate hike as much as a fee.

*Owner of a technology business, California*



There is no information on what happens if this loan is paid early. I assume you would pay less in interest but not necessarily a lower interest rate.

*Manager of an environmental consulting business, Maryland*

While the quotes here are a sampling of responses to questions about Product A, it should be noted that participants reported confusion in understanding all three products. For example, in response to questions about Product B one noted, "Okay, after looking at a few replies, maybe I am confused. I thought for the first \$40K there was no interest, that it was only 28 cents on the dollar for anything borrowed above the \$40K?" Another remarked of Product C, "I am not sure what they mean by my 'effective APR.'"

### Participant recommendations

At the conclusion of the focus group, participants were asked about recommendations they would make to ensure online loans are safe, stable, and flexible. Virtually all participants cited the need for consistency, common terminology, and the use of plain English in describing online loan products and details about their features, terms, and costs.

### Potential borrowers want information about loan products—especially costs—to be clear.



Everything needs to be spelled out and easy to understand.

*Owner of a remodeling business, North Carolina*



Give the customer the most information available in the clearest terms possible.

*Owner of a retail business, Massachusetts*



They should have minimum requirements to clearly spell out the terms, fees, APR, prepayment scenarios, and borrower requirements.

*Owner of a vacation rental business, Connecticut*



APR and total repayment cost need to be easily available and displayed.

*Manager of a law firm, Illinois*

Furthermore, participants noted the possibility that potential borrowers could be confused or misled by advertised features, and recommended safeguards to reduce the likelihood that they would misunderstand actual product terms.

# DETAILED OBSERVATIONS

## Potential borrowers don't want to feel they can be taken advantage of.



Lenders will present these offers [in] as confusing [a way] as possible and provide bright colors and sweet logos and friendly people saying 'we are here to help,' but they don't give you all that you need.

*Owner of an automotive business, New Jersey*



Requiring certain figures (APR, total cost, etc.) is a really good idea because the American public is generally in the dark about simple math and calculations. It may be too easy for lenders to use that to their advantage and use tricky or unclear wording.

*Manager of an education services business, Illinois*



The loan business depends on the borrowers paying as much 'extra' as possible, I understand that. However, it should be ensured that disclosure is not intentionally deceptive or misleading.

*Owner of a retail electronics business, Indiana*

During the course of the focus group, participants repeatedly raised data-security and privacy concerns. Many recommended that steps be taken to ensure the protection of borrowers' personal and business information.

## Potential borrowers want ironclad protections for their business data.



Guarantee that personal information is safe by encrypting, and alert all customers of any security breaches.

*Owner of an event planning business, Pennsylvania*



Make sure all information provided is kept safe.

*Owner of a retail business, California*



Privacy should be protected when online permission is given to pull electronic records.

*Owner of a training/consulting firm, Washington DC*



Make sure my information is not sent to a third party.

*Part-owner of a real estate business, Alabama*

Finally, as potential borrowers, the small-business owners participating in this focus group want assurances that firms they would consider borrowing from are reputable. Several participants recommended some measure of regulatory oversight.

## Potential borrowers want to do business with firms they are sure are reputable.



Ensure that the lenders are scrutinized and are honest and reliable. Some of these loans seem very predatory.

*Owner of a real estate business, California*



Require minimum cash reserves for lenders so they don't do desperate things to stay in business if borrowers are slow in paying back.

*Owner of an entertainment business, California*



Regulating who can qualify to play/participate in both roles is crucial to preventing predatory lending [and protecting borrowers, but] don't over-regulate to a simple model that reduces who can access these loans.

*Manager of a construction company, Colorado*



Regulate all parts of the industry under Federal law.

*Part-owner of an engineering firm, Texas*

## CONSIDERATIONS FOR POLICY AND RESEARCH

This study used an online method of, and best practices for, focus-group research to better understand small-business owners' perceptions of online lenders and credit products. The findings are based on the responses of 44 business owners, and should not be considered representative of the nation's small business population. That said, the focus groups do provide insights into small-business owners' approach to financial decisions, as well as their interest in and concerns about online borrowing. This study raises key issues and questions that may help guide policy discussion and inform future research and data collection on small-business borrowing.

### Issues for future exploration

#### How would standardized product disclosures affect small-business owners' borrowing decisions?

As with any emerging product line, building understanding and educating borrowers are essential for the development of an efficient and equitable marketplace. Participants in the focus groups, for example, had varying levels of financial acumen and degrees of comfort with financial products and decisions. It is notable that even those participants who demonstrated a firm understanding of financial products, similar to those who did not, recommended that lenders be required to disclose specific product terms (i.e., APR, fees, and total cost) in straightforward and consistent language. While a number of participants said they preferred to know the total repayment amount over the effective interest rate, a majority wanted the interest rate or both. Total repayment amount alone, as typically presented by cash advance providers, is generally useful only in the context of assessing the affordability of an individual loan product. The effective interest rate expressed as an APR could make comparing products easier, especially alternative credit products with traditional ones.

For many small firms, borrowing working capital is a relatively high-stakes, complex, and infrequent transaction that can put them at a disadvantage in dealing with lenders. Recently, alternative lending industry leaders have advocated for best practices, concerned that "bad actors" could inflict reputational harm at a time when the online lending business is gaining greater acceptance.<sup>25</sup> Some lenders

promote and advocate for their own companies' approaches to explaining their products, rates, and costs. Therefore, it remains to be seen whether efforts on the part of the industry to gain consensus on and adopt best practices will be successful.

More study is needed to determine the impact that clear and consistent disclosures would have on potential borrowers' decisions. Would standard disclosures prompt borrowers to comparison shop and lead to better borrowing decisions? Would borrowers expect different disclosures from online alternative lenders versus traditional institutions? If disclosures were required for small-business credit products, what information should be included and in what format, and how should such rules be implemented?

#### How will concerns about data security and privacy affect both borrowers and the industry?

That participants reacted positively, in general, to their virtual shopping experience suggests that online lenders know their target audiences well and cater to their desire for ease and simplicity. Yet small businesses—like consumers—clearly are concerned about the safety and security of their business information, a theme that recurred throughout the focus groups. This raises an important question about the extent to which privacy concerns are affecting the rate of adoption of online credit products by borrowers.

Automated record pulling and algorithms for underwriting are key features of the online credit industry and have potential to drive down costs for providers, raise returns for investors, and increase access to credit for borrowers. Individual lenders tout their proprietary underwriting models and creative use of electronic data. This study's findings suggest that, should there be a significant data breach, potential borrowers might well become reluctant to share the type of information many online lenders depend on. An important issue for the industry going forward is how to balance the streamlined, customer-friendly experience they offer with an effective approach to data security. Policymakers may want to weigh in, as well, on how best to protect the interests of both borrowers and industry participants.

# CONSIDERATIONS FOR POLICY AND RESEARCH

## **How will online alternative lending change the nature of small-business banking?**

The value focus-group participants place on their relationships with their banks was highlighted during the discussions about trusted sources of information. It was notable that business owners indicated that they would be likely to turn to the bank where they have their accounts for advice or information, but would not necessarily expect to receive funding there. This finding is important because it speaks to the potential of, and concerns with, partnerships between traditional banks and online alternative lenders.

The rising prevalence of these partnerships increases the connectedness of online lenders to the broader financial industry and raises a number of questions. Do issues of disparate treatment arise if banks refer certain customers to their alternative lending partners, but offer traditional loan products to others? Does the use of automated underwriting raise or address fair lending concerns? If small-business borrowers become increasingly reliant on online alternative lenders, could small firms' access to credit suffer if the lenders' business models prove to be unsustainable, especially during an economic downturn?

## **Lessons for future research**

### **Potential borrowers appear to consider "online" a place, not a category of loan.**

In contrast to industry analysts and researchers, potential borrowers do not appear to distinguish between cash advances and loans, nor do they appear to make distinctions among the various types of online lenders providing them. The website of a traditional bank may prompt a potential borrower to view that bank as an online lender much the same as a nonbank online platform, since "online" is the place many go for information about both alternative and traditional lenders and products. This suggests that, in future quantitative and qualitative research, questions about online alternative lenders and their products be carefully phrased to ensure that respondents are truly distinguishing and not answering with other products and services in mind.

## **Self-reporting of ease or difficulty making judgments about loan products should be paired with more objective measures of comprehension.**

The fact that participants in the focus group self-identified as financial decision makers may have led them to respond that it was "easy" to compare the mock loan products. However, when asked specific questions, it became clear that the participants were unsure about the actual costs and features of some of the products. In future quantitative research, it may be useful to pair questions on self-reported perceptions of ease or difficulty with a series of questions developed to measure actual understanding of products and the obligations associated with them.

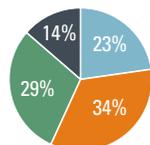
## **Perceptions of online lending will likely evolve along with the industry itself, and future research should track these changes.**

Online alternative lending is an industry still gaining traction. With greater market penetration will come greater experience among borrowers with online credit products. This experience, along with greater competition among lenders, may raise expectations among prospective borrowers about the features of products that are offered and how well the terms of these products are disclosed. Further study on borrowers' comprehension of credit products – both new and existing – and research to track changes in their attitudes and expectations will be important to understanding the online alternative lending industry going forward.

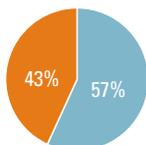
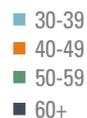
# APPENDICES

## Appendix A: ABOUT THE PARTICIPANTS AND THEIR BUSINESSES

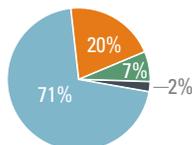
A total of 44 participants took part in the two national online focus groups. They were identified and recruited through a detailed screening process (see Appendix B). The pool of participants ranged across revenues, geography, and industry. Twenty-eight had annual revenues of \$500,000 or less. Participants came from 20 states across the US and operated in a variety of industries. As seen in the charts below, they were a diverse group reflecting various demographic and business characteristics.



**Age**



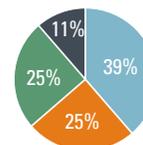
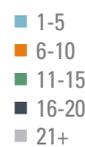
**Gender**



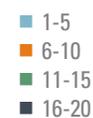
**Ethnicity**



**Years in business**



**Number of employees**



### Industries:

- Accounting
- Architecture
- Automotive
- Construction
- Craft supplies and design
- Digital production
- Electronics, retail
- Engineering, custom machine work
- Entertainment
- Environmental consulting
- Event planning
- Funeral services
- Hair grooming and stylist
- Healthcare
- IT services
- Law firm
- Literary management
- Management consulting
- Media production
- Medical practice
- Office equipment
- Pet grooming
- Photography
- Physical therapy
- Real estate
- Recruiting
- Remodeling
- Retail
- Software development
- Software sales
- Staffing
- Technology
- Telecommunications
- Training consulting
- Vacation rentals
- Wealth advisor
- Web and graphic design
- Women's apparel, wholesale and retail

## Appendix B: FOCUS GROUP SCREENER QUESTIONS

Besides yourself, how many employees, either full- or part-time, are in the company that you work for?

1. 1–20 employees
2. Greater than 21 [*Terminate.*]

Which one of the following statements best describes your involvement at your business?

1. I am the sole owner of the business
2. I am part owner of the business
3. I manage the business, but don't own it
4. Not an owner or manager of the business  
[*Ask to speak to; otherwise, terminate.*]

Which of the following best describes your role in financial decision-making for your business?

1. I am a final decision maker in all financial business decisions
2. I share the decision-making in all financial business decisions
3. I have no involvement in financial business decisions  
[*Ask for; otherwise, terminate.*]

Does your business fit into any of the following industries? [*Rotate list*]

1. Non-profit organization [*Thank and terminate.*]
2. Retail trade
3. Health-care
4. Technology
5. Marketing research [*Thank and terminate.*]
6. Lending industry, such as a bank, credit union, or loan firm  
[*Thank and terminate.*]
7. Other

# APPENDICES

Please describe your business: \_\_\_\_\_ [Categorize for purposes of obtaining a mixture of industries.]

How long has your company been in business? [If less than two years, terminate.]

So we can be sure to include a wide range of respondents, which of the following best describes the total annual revenue for your business before taxes? Your best estimate is fine.

1. Less than \$200,000 [Thank and terminate. \*]
2. \$200,000 to less than \$500,000
3. \$500,000 to less than \$1,000,000
4. \$1,000,000 to less than \$2,000,000
5. \$2,000,000 to less than \$5,000,000  
[Reserve for possible inclusion.]
6. \$5,000,000 or more, Don't Know, or Prefer  
Not to Say [Thank and terminate.]

\* For this study, recruiters sought businesses with annual revenues under \$2 million (a minimum threshold of \$200,000 was set for the second focus group). An upper bound for revenues was set at \$5 million in case recruitment proved difficult. In the end, virtually all the participants' businesses had revenues of approximately \$2 million or less.

We are interested in understanding your familiarity and experience with different lending sources and ways of obtaining funds. Have you ever applied to any of the following sources to obtain funds or loans for the purposes of operating or growing your business, debt consolidation, or refinancing? [Yes, applied; No, have not applied.]

- Traditional financial institutions such as a bank or credit union, either in person or online
- Online lenders such as merchant cash advance companies, peer-to-peer lenders, or online direct lenders, other than bank or credit union websites
- Credit cards, either business or personal
- Other [Specify.]

Which of the following online funding sources have you heard of? [Rotate list below.]

1. Lending Club
2. Prosper
3. CAN Capital
4. Rapid Advance
5. OnDeck
6. Kabbage
7. Live Oak Bank
8. CIT
9. Amazon Capital
10. PayPal Working Capital
11. Square Capital
12. Any other online direct lenders, merchant cash advance companies, or peer-to-peer lenders you have heard of? [Specify.]
13. None of the above [If answered Yes, applied to Online Lender but can't name, thank and terminate.]

Did you apply for a loan or other forms of credit at [list each company respondent heard of] for the purpose of operating or growing your business, debt consolidation, or growing your business? [Looking for a mixture of respondents who have applied/have not applied at online lenders.]

What age group do you fall into? \_\_\_\_\_ [Terminate if less than 18.]

What do you consider to be your ethnic background?

INVITATION FOR BULLETIN BOARD: Based on your responses, we would like to invite you to participate in an online bulletin board-style focus group sponsored by the Federal Reserve to discuss some topics regarding small business lending needs and lending practices. [Participants committed to spending 30-45 minutes each day answering questions and were provided with a \$150 incentive upon completion.]

# APPENDICES

## Appendix C: FOCUS GROUP TOPIC GUIDE

### Summary of day 1 questions – introductions, financial challenges, thoughts about short-term credit

Tell us a bit about your business and some interesting things about what you do, e.g.: What your business is all about; how long you've been doing this; your role and responsibilities; what you think makes your business special:

- What gives you the greatest satisfaction and joy?
- What's the toughest part about running your business?
- Imagine a friend was talking with you at a party and asked you, "What is it like running a small business in today's economic environment?" What would you tell them?

Think about all that's required to keep your business up and running and able to meet your financial obligations. What's your business's biggest short-term financial concern today? What's the one thing that's keeping you up at night and making you nervous?

Take a look at this list of some of the short-term financial challenges that your business may have faced or may be facing today. Please prioritize them. If you've had a business issue that's more important than the ones listed here, please write it below.

- A. Pay for inventory
- B. Meet payroll
- C. Pay creditors
- D. Marketing and sales
- E. Attend a special event like a trade show or sales event
- F. Purchase or lease new equipment
- G. Make needed repairs
- H. Offer a new product or service
- I. Smooth out cash flow

Have you ever been faced with an immediate business problem or opportunity where you didn't have the cash on hand to fund it? What did you do? How did you handle it?

Have you ever taken out a short-term business loan to secure funds for your business?

Let's assume that you are going to take out a short-term loan or cash advance for your business... Describe how you would shop for such a loan or get access to short-term funds.

- Where would you go to look for the loan or short term funding?
- What specific things would you want to know about the loan?
- What would you want to know about the lender?

### Summary of day 2 questions – impressions of online lenders and products

Imagine you need a \$40,000 loan to pre-pay for inventory or materials. You intend to repay the loan when you receive payment from your client—say, in about 6 months. You don't want to expense it over the long term. Who would you go to for advice? Where would you turn for information?

What comes to mind when you see or hear the phrase "online lender"? How about "cash advance" company?

Here are the logos of a number of online lenders.

- What's your reaction to seeing this list?
- Which of these online lenders had you heard of before this research?
- How familiar are you with what these companies have to offer?

AmeriMerchant®

CAN CAPITAL

OnDeck>



# APPENDICES

Thinking back, have you seen information or ads from any of these or other online lenders? What do you remember seeing? Where did you see them?

Have you ever been contacted online or by phone by a sales person or broker who wanted to present or talk about an online loan? *[Probe, if yes.]*

In your opinion, do you feel online lenders and online loans are safe? Are they secure? Why do you feel this way?

Is it important for you to know how online lending sources get their money or how they use your business information?

Have you looked for or applied for a loan with an online lender? *[If yes, probe: Which online lenders, steps taken, and if obtained the loan, thoughts about the experience.]*

Go online and “pretend to shop” for a loan. You may explore the websites shown on the whiteboard or the sites of other online lenders. PLEASE, don’t apply or provide any personal information.

- What do you notice that you find interesting or attractive?
- Do you see anything that turns you off or makes you nervous or concerned?
- Did you find anything confusing?
- How easy are the products to compare?
- What makes one [lender or product] more attractive than another?

## Summary of day 3 questions – mock product evaluations, recommendations

Let’s assume that you needed \$40,000 in funds above and beyond the limit on your business or personal credit card and you came across the following online loan. *[Participants are presented with one product at a time from Figure 2 of the report, and asked about each product.]*

- What do you like most about this loan?
- What concerns, if any, do you have with this loan?
- Is there anything that you find confusing?

What is your best guess of the interest rate on this loan if you pay the loan back in one year?

What do you think the [payment amount presented in chart] in this loan includes?

Suppose sales are brisk and you pay back this loan in four months. How do you think that affects the total amount you pay?

How would paying back the loan more quickly affect your interest rate? Is it higher, lower, or the same? Looking at all three loan options together:

- Which looks like the best business proposition for you and your business? Why?
- Is there any one of these three loan products that you would never take? If so, why?

When it comes to borrowing for the short term, are you more comfortable knowing the interest rate (APR) or total cost of repayment?

Is there anything else you would want to know in order to make a decision on which loan to take?

Based on what you have learned about online loans, what specific recommendations would you make to ensure that online loans are safe, stable, and flexible to use?

# ENDNOTES

- <sup>1</sup> Bank lending to small businesses was rising until the Great Recession, then declined significantly. [FDIC reporting](#) shows that, in 2015, total small-business loans outstanding are 16% below 2008 levels, in absolute terms. Even with recent recovery in small C&I lending (under \$250K), these loans remain almost 9% below 2008 levels. For more on the small-business lending environment, including the various factors contributing to the decline in bank lending, see Federal Reserve Bank of Cleveland [Economic Commentary](#), “Why Small Business Lending Isn’t What It Used to Be,” August 2013; and “Current State of Small Business Lending,” Traci Mach, Board of Governors of the Federal Reserve System, [presentation](#), May 15, 2014.
- <sup>2</sup> See Karen Mills and Brayden McCarthy, [Harvard Business School Working Paper 15-004](#), July 22, 2014, and updated figures in Mills’ September 23, 2014 [Forbes.com](#) post.
- <sup>3</sup> Traci L. Mach, Courtney M. Carter, and Cailin R. Slattery, Federal Reserve Board 2014 [Working Paper](#), “Peer-to-peer lending to small businesses.”
- <sup>4</sup> Industry estimates vary and this may be due to the inclusion of certain online products or lenders and to the specific metric being reported. For example, a [Morgan Stanley](#) study, “Global Marketplace Lending” (May 2015), estimates marketplace loans at just over \$4 billion in issuance in 2014. Peter Renton, Global Overview of Online Lending, [Lend Academy](#) (April 2015), estimates total industry loan volume at \$5 billion in 2014, rising to \$12 billion by the end of 2015. Karen Mills’ “[Alternative Online Lenders Fill Funding Needs for Small Business](#)” in [Forbes.com](#) (September 23, 2014) estimates outstanding capital in the market at \$10 billion by the end of 2014, excluding merchant cash advances. Lenders often report their own growth rates; for examples, see websites of [OnDeck](#) and [CAN Capital](#).
- <sup>5</sup> The 2014 [Joint Small Business Credit Survey](#) was conducted by the Federal Reserve Banks of New York, Atlanta, Cleveland, and Philadelphia. Other surveys from prior years, while not altogether comparable, have indicated very little activity with online alternative lenders. For example, a 2013 Federal Reserve Bank of New York survey asked small-business owners about their primary source of funding and almost none cited an online lender. For other indications of growth in online borrowing, see recent [Pepperdine Private Capital Access Survey](#) results.
- <sup>6</sup> Federal Reserve Bank of Cleveland [Economic Commentary](#), August 2013.
- <sup>7</sup> Federal Reserve Bank of Cleveland [Community Development Brief](#), “Good News and Bad News about Small Business Lending in 2014,” January 2015.
- <sup>8</sup> The October 2014 Federal Reserve [Senior Loan Officer Opinion Survey \(SLOOS\)](#) asked special questions about small-business-lending standards relative to the midpoint of standards in the previous 10 years; the responses point to relatively tight standards. The [July 2015 SLOOS](#) again included the special questions and these responses show that standards have now eased somewhat relative to their midpoint since 2005.
- <sup>9</sup> For an example of an industry analysis, see “A Trillion Dollar Market: By the People, For the People,” [Foundation Capital](#), May 2014.
- <sup>10</sup> See [2015 Marketplace Lending Survey](#), Richards Kibbe & Orbe LLP and Wharton FinTech.
- <sup>11</sup> See May 1, 2014 [Bloomberg report](#) on subprime online business loan securitization.
- <sup>12</sup> For examples, see the following [American Banker](#) reports: [May 8, 2014](#) (a bank partnership - OnDeck and BBVA Compass); [June 10, 2015](#) (a nonprofit partnership - Lending Club and Opportunity Fund); and [February 3, 2015](#) (a corporate partnership - Lending Club and Alibaba). See also a corporate partnership example in February 24, 2015 [USA Today](#) (Staples and Lendio). For an example of bank involvement with a cash advance and loan company, see April 2, 2015 [Market Watch](#) report.
- <sup>13</sup> [Mintel White Paper](#) (Q4 2014: Small Business Banking & Lending White Paper, Feb. 16, 2015).
- <sup>14</sup> Borrowers, collectively, can be affected by the overall health of the online lending industry and the continued flow of capital. These and other more “macro” issues are covered in a 2014 International Organization of Securities Commissions ([IOSCO](#)) [working paper](#).
- <sup>15</sup> Note that merchant cash advances involve the sale of future receivables, and, as such, industry proponents have argued that they should not be considered “loans.” For example, see First Data 2012 [White Paper](#), pg. 3: Because a merchant cash advance by a nonbank provider “is structured as a commercial transaction instead of a loan, it is regulated by the Uniform Commercial Code in each state—as opposed to banking laws like the Truth in Lending Act. Thus, the provider is able to avoid many of the regulations and documentation requirements associated with making loans.”
- <sup>16</sup> See Responsible Business Lending Coalition [Borrowers’ Bill of Rights](#), August 6, 2015.
- <sup>17</sup> An online bulletin board also is known as an “asynchronous” focus group because it does not occur in real time. This method is increasingly used by banks and financial services firms for conducting customer research.
- <sup>18</sup> An upper bound for revenues was set at \$5 million in case recruitment proved difficult. In the end, virtually all the participants’ businesses had revenues of approximately \$2 million or less.
- <sup>19</sup> Online focus groups can accommodate two to three times more participants than traditional face-to-face focus groups.
- <sup>20</sup> In addition, Nielsen provided independent observation reports on the focus groups, which informed the authors’ own analysis as they identified the key findings.
- <sup>21</sup> Verbatim quotes are presented as they were typed into the online focus group bulletin boards by the participants themselves, with only minimal editing for space and clarity, or to remove names of specific lenders.
- <sup>22</sup> Federal Reserve 2014 [Joint Small Business Credit Survey](#); [NSBA Access to Capital Survey](#), 2012.
- <sup>23</sup> For example, participants that use PayPal or Square for payments processing reported greater comfort with PayPal Working Capital and Square Capital.
- <sup>24</sup> Note that a typical daily remittance rate of 10% of credit card sales receipts was used for Product A. Even some merchant cash advance industry executives have observed that the remittance rate is sometimes mistaken by borrowers as the APR. Online lenders (especially merchant cash advance providers) often express repayment either as the total amount owed or as a factor of the original amount borrowed (say, 1.28). The more straightforward total amount is used here.
- <sup>25</sup> For example, see “Bridging the Small Business Capital Gap: Peer-to-Peer Lending,” Sam Hodges, Co-Founder and Managing Director, Funding Circle USA, [Testimony to US House of Representatives](#), Small Business Committee, May 13, 2015. See also, Responsible Business Lending Coalition [Borrowers’ Bill of Rights](#), August 6, 2015.



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