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What's the Big Idea With Alternative Lending?

By Rebekah Jensen

Peer-to-Peer Lending, Digital Financing, Alternative Lending...

All of these terms refer to the same financial phenomenon that has risen in the market in the last decade. The alternative lending industry is relatively small when compared to the nation's entire lending market, but it is evolving and growing quite quickly. By 2020, market analysts predict the industry to have a total loan origination volume of $90 billion.[1]

Alternative lending is a relatively new industry. While the first companies like Prosper and OnDeck Capital started in 2005[2] and 2007[3] respectively, the vast majority of the companies in the industry didn't get started until after the 2008 Financial Crisis, which played a key role in the emergence of this new market. One the main explanations is the effect of the downturn on small businesses.

Why Small Business?

America is the center of small business. Half of the jobs in the private sector are in small and medium sized businesses (SMBs), totaling approximately 62 million workers. Since 1995, 60% of the net new jobs created were in SMBs, and coincidentally (or perhaps not), 60% of the jobs lost during the Great Recession were among SMBs.[4]

During the Recession, banks tightened their credit boxes and small businesses increasingly struggled to find a provider for loans. Small businesses need these loans for a variety of reasons. Funding makes it possible to start or expand the business, purchase inventory, and "strengthen the firm's financial foundation."[5] Without loans, growing the business, financing future sales, and keeping adequate inventory are all more difficult for a small business.[6] Thus, credit access is a must for any SMB hoping to survive. In 2015, 73% of SMBs needed a loan to fund business operations at least once at some point during the year.[7]

How does alternative lending work?

Before alternative lending came into existence, when a business needed a loan, the typical process would look something like this: the business owner would approach a couple of different banks, fill out their loan applications (a process which could take several hours), and wait several weeks before hearing back whether their loan was to be approved.

Alternative lending on the other hand is not through a traditional bank or credit union, but through an online broker. One of the main advantages of obtaining a loan through an alternative lender is that the application process is much shorter and easier. Applications are usually completed online, take less than 30 minutes, and get approved within hours. Then, the applicant can have the money in their hands in just a few days. This is much easier than the traditional bank option, which entails applicants spending an average of 25 hours filling out applications at 3 different banks.[8]

The other main advantage of alternative lending is that approval ratings are often higher than at traditional banks. A recent study by OnDeck found that 82% of business owners are denied credit from their bank.[9] Another source similarly noted that for small businesses, approval ratings at big banks are between 13 and 20%, whereas among alternative lenders approval ratings are between 61 and 64%.[10]

Thus, the fact that SMBs can get a loan when they would otherwise be unable to makes alternative lending extremely attractive to small businesses.

Why do alternative lenders have higher approval ratings than banks?

There are two main explanations:

1. Different underwriting criteria
2. Different profit based on size of the loan

Underwriting is the process through which a loan officer evaluates a loan applicant's credentials and estimates how likely the applicant is to repay the loan. This process plays a heavy role in determining whether or not the application is denied.

When banks underwrite a loan applicant, they typically look at the business's monthly revenue, the business owner's personal credit score, and value of the business's collateral.[11] For a company that is just barely getting off the ground, qualifying for a loan can thus be extremely difficult, especially if the owner does not have a good personal credit score.

Alternative lenders on the other hand use different criteria to underwrite. The process is automated and uses algorithms to compute credit worthiness based on the financial data available. Using different criteria to underwrite broadens the scope of applicants that alternative lenders can approve.[12]

Another reason that alternative lenders have higher approval ratings is because banks have less incentive to fund smaller loans. Of SMBs applying for credit, 44% wanted loans less than $50k, and 76% wanted loans less than $250k.[13] Because the cost of underwriting is the same regardless of the loan size, banks have higher incentive to fund larger sized loans because they will turn a higher profit.

What's the Catch?

While there are several benefits of the services alternative lenders provide, one of the downsides is that there seems to be a trade-off between the convenient/speedy application process and the price of the loan. One of the most common complaints about online lenders is that the interest rates are higher than what you would find from a traditional bank. A survey of small businesses conducted by the Federal Reserve found that 53% of applicants to alternative lenders were dissatisfied with high interest rates.[14]

Another complaint that small business owners have voiced about alternative lenders is that they use aggressive marketing tactics in order to find clients. A survey of small businesses noted that many companies complained of being pestered by alternative lenders through emails and phone calls as salespeople try to solicit them for their business.[15]

To apply or not to apply?

Alternative lending is still a rather new phenomenon and is not a completely perfect system. There are benefits and disadvantages to both alternative lending and traditional lending. For a small business trying to decide where to go to source their funding, the best decision will always depend on the individual business and its needs, plans, and goals. As a small business tries to make such a decision, it should make sure to give alternative lending at least some consideration. With all the advantages of the alternative lending system, it could be just what the business needs.

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