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What's Really Happening in Small Business Lending

Setting straight a couple popular narratives

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The alternative lending industry is changing so quickly, and the story for the past three months has been one of universal tumult and caution in the wake of the Lending Club shake-up, downsizing at Prosper and Avant, and reported shrinking of institutional demand across the board through the first half of 2016. Lending Club and OnDeck, the two publicly-traded U.S. alt lenders, have both given up about half of their value since the start of the year, though mostly for different reasons. Meanwhile, two large institutions have recently entered the fray with their own products modeled after alternative lenders, and existing players have announced a few bank partnerships that appear to have flown under the radar.

Amidst all the noise, the small business alternative lending space seems to have been forgotten, or at least greatly distorted. Here are two of the top pieces of the narrative that I think have been reported sloppily in much of the print media:

Narrative #1: Small business lenders are subject to the same trends as those on the consumer side.

It seems like every time alternative lending hits the news, especially in a negative light, an author will throw in a mention of small biz lender OnDeck alongside consumer lenders Lending Club and Prosper. Even after OnDeck's stock dropped by 34% in one day in late April, it continued to give up ground as the Lending Club news was hitting a week later. The market was certainly processing new revelations about their business model—the gradual shift to an "On-Deck-as-a-Service" model for a greater percentage of loans, and the short-term decision to hold more loans on their balance sheet—but it definitely seemed like an overreaction to news items on the consumer lending side.

The truth is that small business lenders are not subject to the same forces in the credit market as consumer lenders. While increased consumer delinquency rates caused investor skittishness and demand for higher returns from the likes of Lending Club, Prosper, Avant, and So-Fi, small business lenders have not encountered similar difficulties. And the very nature of small business alternative lending is much shorter-term, with many alt lenders offering lines of credit rather than term loans as their primary product. This allows for lenders to constantly reevaluate customers' ability to borrow, and alter credit offers on the fly if need be.

Narrative #2: Alternative lenders are set to disrupt traditional bank loan revenues.

On the other side of the coin, we still see a lot of irrational exuberance on display. In fact, until recently this "$870B+" figure was scrolling on the front page of American Banker's Marketplace Lending + Investing Conference. It's derived from a 2014 report that identifies nearly one trillion dollars in annual lending revenues generated by consumer, real estate, small business, student, and other classes of lending at banks and other lenders. That figure aside, I continue to see reports suggesting there is a realistic chance that alternative lending companies will abscond with a large portion of bank loan revenues and leave bankers blinking through thick bifocals wondering what happened.

Now, I think alternative lenders are really onto something. In fact, I only use that term because they represent an alternative to traditional avenues of obtaining credit. In every other sense, these companies, the way they make credit decisions and interact with customers, are no longer "alternative".

But this "disruption" and "disintermediation" narrative has got to go. Alternative lenders do not present a substantial threat to banks simply through their effort to take a meaningful portion of lending revenues. They've combined innovations in credit decisioning (and resulting cost and time efficiencies) with higher tolerance for risk, and the result was opening of access to credit for a segment of less-than-prime consumer and business borrowers previously not considered creditworthy by banks. Where non-bank lenders trade on speed of decisioning and access to funds, bankers trade on relationship value and services auxiliary to the depository relationship.

In other words, today they're mostly providing different types of products.

The real threat to banks comes from rival banks—specifically those who are more agile in innovating or partnering to offer an alt-lending type product to their small business customers. That's because small business customers still value a relationship with their primary banker. In fact, as we found in our latest report on alternative lending, 63% of small businesses have only one banking relationship for all of their depository, merchant services, and credit needs, compared to 45% among consumers. The small business market has really resisted commoditization. So when a business owner or decision maker perceives the inability of their banker to extend credit at a time of need for the business, it's more than a matter of applying for a credit product at the next institution. It's a perceived failure of the FI to act as a financial partner in the growth and success of the business and threatens the relationship as a whole.

So while there is very little chance the non-bank lending industry will eat a significant portion of the supposed $1 trillion in lending revenues made annually by banks, that's not to say alt lenders aren't revolutionizing how bankers make credit decisions and offer loans to their customers and prospects.

The bottom line is that most of that type of lending will occur at banks, as they form further arrangements with fintechs and/or develop their own products to mimic what the alt lending industry has done. Either way, it's a case of disruption leading to a change in behavior by incumbents, not a wholesale dumping of those incumbents.

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