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Issue Brief

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ISSUE BRIEF NUMBER 10

Peer-to-Peer Lending: A Financing Alternative for Small Businesses

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Overview

Imagine that you own a small bakery and you need $15,000 to buy a new oven. There are 15 people across the country, each of whom has $1,000 that they want to invest in a small business. The only problem is that the likelihood of meeting all of these 15 investors is fairly low—unless you use an online peer-to-peer (P2P) lending platform. Peer-to-peer lending is a relatively recent development that uses the Internet to connect individual investors with other individuals, such as small business owners, seeking to borrow money. On peer-to-peer lending websites, potential borrowers apply for credit, receive a credit rating, and post to a listing that investors view. Investors can then choose to fund part of the loan, and are repaid periodically until the loan matures. Peer-to-peer lending, which has grown rapidly over the past decade, offers both benefits and downsides to small business owners who are seeking capital. For example, although the credit application process is less burdensome, interest rates can be higher than with traditional bank loans.

This issue brief focuses on the use of P2P loans by small businesses in the United States. Data suggest that peer-to-peer lending may be a viable financing alternative for small businesses, particularly given the post-recession credit market, although financial regulations have an impact on this potential; for example, peer-to-peer lending is only available to investors in certain states due to regulatory restrictions. This issue brief examines data on P2P lending to small businesses, offers an explanation of the peer-to-peer lending industry, compares it to traditional small business financing options, and discusses implications regarding its future.

Background

P2P lending is an option for raising capital made possible by the Internet. It is a hybrid of crowdfunding (the pooling of small amounts from many investors) and marketplace lending (**Figure 1**). "Marketplace lending" is a term used to describe the "online platforms that stand between borrowers and lenders."[1] Marketplace lending encompasses peer-to-peer lending, as well as online lending by large institutions. Prosper and Lending Club are two of the best-known peer-to-peer lending platforms in the United States.

Note: Regulatory economist Ryan Taylor provided helpful suggestions for this issue brief.

1. "Innovation of the year: marketplace lending," *American Banker,* December 17, 2014. www.americanbanker.com/news/bank-technology/innovation-of-the-year-online-marketplace-lending-1071693-1.html, accessed July 2015.

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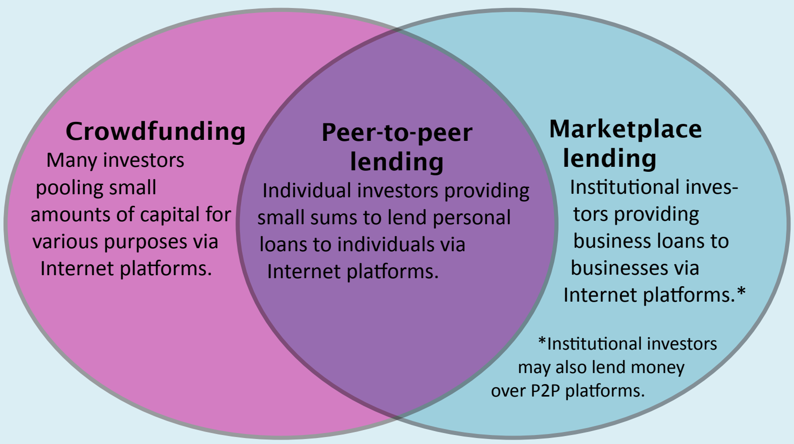
Examples of institutionally backed marketplace lenders include OnDeck Capital, Kabbage, and CAN Capital, all of which offer credit exclusively to businesses, rather than consumers.[2]

This issue brief treats “peer-to-peer lending” as synonymous with “lending-based crowdfunding” and “debt-based crowdfunding.”[3] Other types of crowdfunding are donation- or reward-based, pre-selling, and investment- or equity-based (**Figure 2**). Like P2P lending, other types of crowdfunding occur online on websites or platforms. Agrawal, Catalini, and Goldfarb note, “Crowdfunding systems enable users to make investments in various types of projects and ventures, often in small amounts, outside of a regulated exchange, using online social media platforms that facilitate direct interaction between investors as well as with the individual(s) raising funds.”[4] Crowdfunding has gained popularity in recent years as a viable alternative to traditional financing (such as bank loans or credit cards) for small businesses.

As of August 2015, in the United States, online loans funded by retail investors were only available as consumer loans (i.e., to individual borrowers), as opposed to commercial loans. However, small business

Figure 1. In the United States, peer-to-peer lending combines aspects of crowdfunding and marketplace lending



	Crowdfunding	Peer-to-peer lending	Marketplace lending
Borrowers	Businesses, individuals	Individuals (loans can be used for business purposes)	Businesses
Investors	Retail	Retail, accredited	Accredited and institutional only
Examples	Indiegogo, Kickstarter, EquityNet	Lending Club, Prosper	CAN Capital, Kabbage, OnDeck Capital

Figure 2. Types of crowdfunding

- **Donation/reward-based**, e.g., Indiegogo, Kickstarter
- **Pre-selling,** in which funders contribute in exchange to get a product first
- **Investment or equity-based,** where funders contribute or purchase an equity stake in the company
- **Lending- or debt-based,** in which multiple funders lend smaller sums of money through online platforms with the expectation of periodic repayment. Also known as “peer-to-peer lending” or “peer-to-business lending”

2. Use of the names of specific lending platforms should not be considered an endorsement from the Small Business Administration, the Office of Advocacy, or the author of this issue brief.
3. This issue brief defines peer-to-peer lending as interest-bearing, unlike some types of microfinance (e.g., Kiva) in which lenders are not paid interest.
4. *The Geography of Crowdfunding*, Ajay Agrawal, Christian Catalini, and Avi Goldfarb. NBER Working paper 16820, 2011. www.nber.org/papers/w16820.pdf, accessed July 2015.

owners can and do use these consumer loans to finance their businesses.[5] Online lenders that offer true commercial loans exist as well, but these are backed exclusively by institutional or accredited investors.[6] In order to examine small-scale P2P lending, this issue brief focuses on the market segment consisting of personal loans used for business purposes.

Implications of Peer-to-Peer Lending for Small Businesses

P2P lending offers several potential benefits and drawbacks to both borrowers and lenders. On the plus side, P2P loans can serve credit needs in markets where financial institutions would not traditionally lend.[7] This means that small businesses that might not otherwise have access to capital are able to finance growth, manage working capital, or handle sudden financial needs (**Figure 3**). On the negative side, P2P loans tend to carry higher interest rates than traditional bank loans, or even business credit cards in certain circumstances. And since most loans are unsecured and lenders bear all risks, if a small business cannot make its payments, lenders have no recourse. Lending platforms such as Lending Club and Prosper recommend that lenders diversify across loans.

Compared to traditional loan products, marketplace loans feature decreased search costs; this is a result of the proprietary credit scoring algorithms that the lending platforms use.[8] This decrease in costs makes it economical for lenders to provide smaller and/or shorter-term loans to firms on which less information is available. Such firms may include those that are younger, less established, have a shorter credit history, lack collateral, or may be in acute financial distress (e.g., imagine that you own a bakery and your only oven stops working). Borrowers also benefit from decreased search costs, as marketplace lenders offer simple online forms and rapid application processing. For example, Lending Club advertises that potential applicants can receive a quote in minutes, and that the approval and funding process typically take seven days; Kabbage boasts same-day approval for small business loans, and OnDeck can provide funding in a little as 24 hours. Searching for credit is time-consuming; small businesses in one survey spent an average of 26 hours searching for and applying to credit, contacted three financial institutions, and submitted three credit applications in the last quarter of 2013.[9] Decreasing application time

Figure 3. Who are small business borrowers?

A random sample of 31 business loan recipients at Lending Club revealed a variety of borrower needs. Some descriptions were vague, such as "business capital" or "We want to expand and need some cash to buy some things." Others were more specific, such as a young electrical engineering firm that wanted operating capital to maintain payroll and finance growth while waiting on accounts receivable. Some borrowers were wage-and-salary workers with industry experience who wanted to start their own firms. Some had been presented with time-sensitive, one-time-only opportunities to buy, join, or expand an existing business. More detail is available in Appendix A, Table 4.

5. The term "peer-to-business" may be used when retail investors fund true commercial loans. This funding model is currently unavailable in the United States as a result of securities regulations. Funding Circle in the United Kingdom is an example of a peer-to-business lending platform. Additionally, institutional investors can still invest through P2P platforms.

6. Accredited investors must meet financial requirements determined by the U.S. Securities and Exchange Commission.

7. "Peer pressure: how peer-to-peer lending platforms are transforming the consumer lending industry," PricewaterhouseCoopers, 2015. www.pwc.com/en_US/us/consumer-finance/publications/assets/peer-to-peer-lending.pdf, accessed July 2015.

8. *The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game,* Karen Gordon Mills and Brayden McCarthy. Harvard Business School working paper 15-004, 2014. www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf, accessed August 2015.

9. *Key Findings: Small Business Credit Survey, Q4 2013,* Federal Reserve Bank of New York, 2014. www.newyorkfed.org/smallbusiness/2013/pdf/full-report.pdf, accessed July 2015.

Table 1. Loan terms and amounts at select P2P and online marketplace lenders

Rates vary with term length and credit rating. On P2P lending platforms, loans used for business purposes tend to have higher rates than other loans since they are riskier.

	Lending Platform	Loan amounts	Loan terms
Peer-to-peer loans (consumer loans used for small business purposes, backed by retail investors)	Lending Club	$1,000–$35,000	36 or 60 months
	Prosper*	$2,000–$35,000	36 or 60 months
Online marketplace loans (commercial loans backed by institutional or accredited investors)	CAN Capital	$2,500 to $150,000 (single-location firms) Up to $250,00 (multi-location firms)	4–24 months
	Kabbage	$2,000–$100,000	Up to 6 months
	Lending Club	Up to $300,000	1–5 years
	OnDeck Capital	$5,000–$250,000	3–24 months

Source: All data were collected on company websites in August 2015.

removes a significant barrier to credit. The mutual reduction of information and search costs may be particularly significant for small business borrowers compared to their larger counterparts, who do not face so many hurdles to borrowing, such as limited credit history.

Table 2. Loan term and amount for small P2P business loans at Lending Club, 2007–2015 Q1

	36 months	60 months
Percent of loans	73.3%	26.7%
Average amount	$13,399	$20,047
Average interest rate	14.9%	19.0%
Weighted*	15.1%	19.4%

* Weighted by loan amount. Data source: publicly available Lending Club data, calculations by SBA Advocacy.

P2P business loans are typically fixed-rate term loans, and as mentioned, typically shorter-term and smaller than those offered by banks. Although business owners can obtain a P2P loan for small business purposes through Lending Club or Prosper, these loans are technically personal loans.[10] **Table 1** shows available loan amounts and terms for select marketplace lenders.

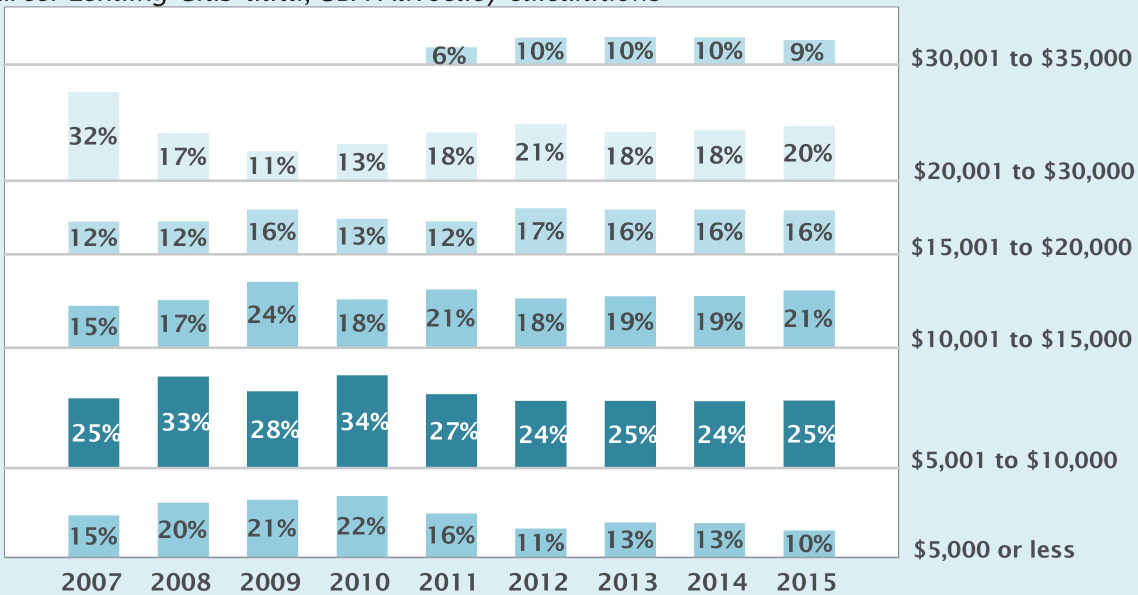
Although Lending Club offers P2P loans up to $35,000, the average small business loan is smaller than that, as shown in **Table 2**. Since 2007, roughly one-quarter of the loans funded on Lending Club have been between $5,000 and $10,000 (**Figure 4**).

P2P lending may fill a gap in small business lending for entrepreneurs seeking small amounts of capital when existing options are not suitable or available (e.g., bank loans, credit cards, and merchant cash advances). As the data in **Table 2** and **Figure 4** show, the majority of small business borrowers appear to be interested in relatively short-term loans in relatively small amounts. Since inception, only 2 percent of approved Lending Club small business borrowers received loans for less than the amount for which they applied.

P2P lending could additionally benefit business owners by making it difficult for lenders to discriminate, intentionally or otherwise, on the basis of personal characteristics. Anonymity between lenders and

10. Lending Club offers commercial loans, but these are backed by institutional investors, and as such, are outside the scope of this paper. Lending Club also offers 24-month loans for borrowers with the highest credit rating, but these loans are not included in the Lending Club data analyzed herein. All references to small business P2P loans refer to loans made to individuals for business purposes unless otherwise specified.

Figure 4. Percent of Lending Club P2P business loans by amount funded, 2007–2015 Q1
Source: Lending Club data, SBA Advocacy calculations



borrowers in peer-to-peer lending is typically greater than in other types of crowdfunding. Lenders do not have sufficient information to identify borrowers personally, and borrowers receive no information on lenders. This addresses ongoing concerns about discrimination in lending. Mijid and Bernasek found that three-quarters of the difference in loan denial rates between white and minority small businesses owners is due to discrimination.[11] And a recent paper by Marom, Robb, and Sade using donation-based crowdfunding data showed that that investors tended to give money to project leaders that were the same gender as themselves, and found evidence that taste-based discrimination explained some of men's decreased likelihood of investing in women-led projects.[12]

On the other hand, personal information may persuade investors to fund a particular project. Herzenstein, Sonenshein, and Dholakia found that borrowers who provided more narrative information about their identities received greater amounts of funding on Prosper.com.[13] And there is little opportunity for borrowers and lenders to build a business relationship with P2P lending.[14] Cole found that firms with lender relationships are less likely to be discouraged from applying for credit, and also noted the potential role of social capital in relationship lending for women- and minority-owned firms.[15] However, some online small business lenders report to the credit bureaus, meaning that small businesses can build and improve their credit histories through these platforms.

11. "Decomposing racial and ethnic differences in small business lending: evidence of discrimination," N. Mijid and A. Bernasek, 2013. *Review of Social Economy*, 71(4), 443-473.

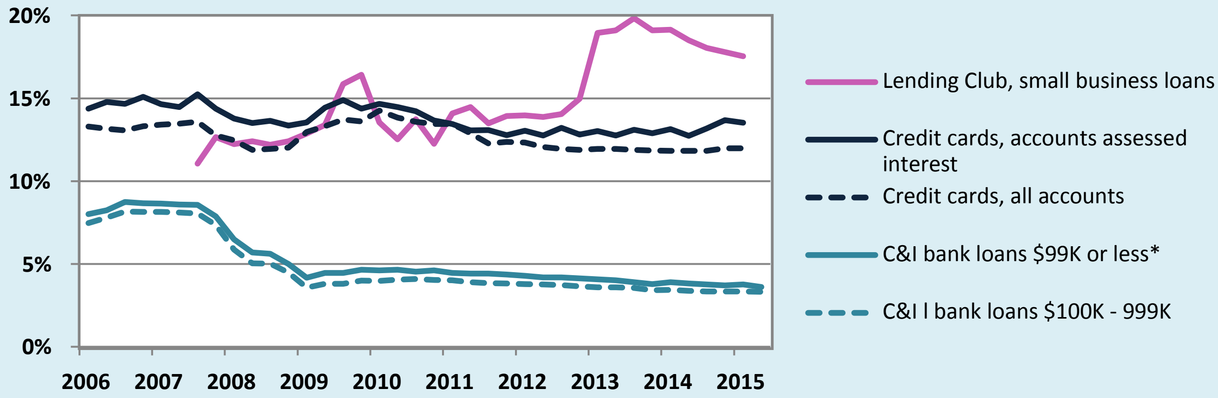
12. "Gender dynamics in crowdfunding (Kickstarter): evidence on entrepreneurs, investors, deals and taste based discrimination," D. Marom, A. Robb, and O. Sade, 2015. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2442954, accessed July 2015.

13. "Tell me a good story and I may lend you money: the role of narratives in peer-to-peer lending decisions," Michal Herzenstein, Scott Sonenshein, Utpal Dholakia. *Journal of Marketing Research.* November 2011, 48:SPL, pp. S138-49.

14. "Peer pressure," PwC, 2015.

15. *Credit Scores and Credit Market Outcomes,* Rebel Cole. U.S. Small Business Administration, Office of Advocacy, 2014. www.sba.gov/sites/default/files/files/rs419.pdf, accessed August 2015.

Figure 5. Quarterly interest rates on small business lending products, 2006–present



C&I loan data, Survey of Terms of Business Lending (FRB); credit card data, Federal Reserve Economic Database, St. Louis Fed; Lending Club data calculations by SBA Advocacy

The benefits of marketplace lending may also come at a price. Annual rates on marketplace loans range from 15 percent for a 36-month peer-to-peer loan, to 45 percent for a 4-month institutionally backed loan. **Figure 5** shows interest rates on commercial and industrial (C&I) loans, credit cards, and Lending Club small business loans. Mach, Carter, and Slattery noted that “relative to small business loans from traditional sources, [Lending Club] peer-to-peer small business borrowers paid an interest rate that was about two times higher.”[16] They also observed that even controlling for observable borrower characteristics, “loans for small businesses were more than 250 times more likely to perform poorly than loans for other purposes, which may give some insights into why such loans are charged a higher rate.”[17] Put simply, investors require a higher payoff in order to fund these riskier loans, and for some small businesses, an expensive loan may be better than no loan. And unlike merchant cash advances, P2P loans do not require businesses to pay a share of their sales until the loan is paid back. P2P small business loans—especially those with 36-month terms—offer rates roughly comparable to credit cards, a relatively common source of financing for small businesses. In 2007, 15 percent of firms with employees used credit cards to finance business growth, while 26 percent used personal savings, and 18 percent used business loans from banks.[18]

It is difficult to compare credit cards to P2P loans for several reasons. Most notably, credit cards offer revolving credit with variable interest rates, whereas P2P loans are generally fixed-rate term loans with a uniform monthly payment. Additionally, credit card charges are not subject to interest until the next accounting period, but if a balance remains, additional interest can be charged on top of existing interest charges as well as principal. Publicly available information on small business credit cards from select large U.S. bank websites shows interest rates (APRs) ranging from 9.24 percent to 19.24 percent for purchases, and around 24 percent for cash advances—and many banks charge additional fees for cash advances. Several banks may impose penalty rates for late payment or going over the credit limit, which are generally around an APR of 29 percent. (More data is available in **Table 5** in **Appendix A**.) On the plus side, small business credit cards may come with perks not offered by P2P loans, such as credit cards for each employee or rewards. In summary, although marketplace loans and credit cards are both relatively high-cost

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16. “Peer-to-peer lending to small businesses,” Traci L. Mach, Courtney M. Carter, and Cailin R. Slattery, 2014. Federal Reserve Board, FEDS Working Paper 2014-10.

17. Ibid.

18. “Credit card financing and small business,” fact sheet. U.S. Small Business Administration, Office of Advocacy, 2012. www.sba.gov/sites/default/files/advocacy/Credit-Card-Financing.pdf, accessed July 2015.

fast cash, they differ in many ways, suggesting that P2P loans may fill a need not currently addressed by business credit cards.

The vast availability of credit cards to small businesses also suggests that P2P loans serve a different purpose than credit cards. Using data from a survey of small businesses with 1 to 50 employees, the Board of Governors of the Federal Reserve System found that nearly four out of five applicants for credit cards were successful, compared to about half of applicants for bank loans and one-third of credit line applicants.[19] Additionally, nearly four out of five firms used either personal or business credit cards for businesses expenses.[20] But only 21.5 percent of these card-using firms actually borrowed money, that is, carried a balance after making monthly payments. And the majority of these borrowing firms typically had balances less than $5,000, further suggesting that P2P loans may not be a substitute for credit cards.

Given the variations in application process, interest rate, loan amount, and term length across loan products, it is apparent that each option presents a unique set of pros and cons. Peer-to-peer loans offer the benefits of expedited application processing, smaller loan amounts, and shorter terms, but borrowers pay for these conveniences in the form of higher interest rates.

Prospects for Growth

In 2010, nonfarm unincorporated businesses held $3.5 trillion in outstanding credit market debt.[21] The U.S. Census Bureau projected a total of $870 billion outstanding credit card debt in 2012. Although this figure includes consumer credit cards as well, it nonetheless provides context for examining the peer-to-peer lending industry. In 2013, the top five peer-to-peer lending platforms in the United States originated $3.5 billion in loans to consumers and small businesses, marking a threefold increase over the previous year.[22] Another estimate shows that P2P platforms in the United States issued $5.5 billion in loans in 2014, and that the P2P market could reach $150 billion or more by 2025 (personal loans used for consumer and business purposes).[23] Acknowledging that debt outstanding is different than debt originated, the difference in magnitude of these numbers remains meaningful.

Lending Club data indicate a positive trend in peer-to-peer lending to small businesses. **Figure 6** shows the number of monthly small business loan issuances at Lending Club from beginning to present.[24] Evaluating these numbers within the context of small business bank loans adds depth to the story. As with credit cards, bank loan originations are much higher than P2P loans to small businesses. In 2013, U.S. banks originated 4.5 million small business loans worth $63 billion, while Lending Club has issued about 11,000 peer-to-peer loans to small businesses owners since it started lending in 2007 (**Table 3**; details in

19. *Report to the Congress on the Use of Credit Cards by Small Businesses and the Credit Card Market for Small Businesses,* Board of Governors of the Federal Reserve System, (p. 3), www.federalreserve.gov/newsevents/conferences/sbc_smallbusinesscredit.pdf, accessed July 2015. Eighty percent of applicants applied for business cards, and 20 percent for personal cards; survey specifies “for business purposes” (p. 30, E). For the survey that some of the report is based on see *Small Business Credit in a Deep Recession,* National Federation of Independent Businesses, www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-In-a-Deep-Recession-February-2010-NFIB.pdf, accessed July 2015

20. Ibid., Table 3, Panel A, p. 34.

21. *2012 Statistical Abstract,* U.S. Census Bureau, Table 1167, Flow of Funds Accounts–Credit Market Debt Outstanding: 1990 to 2010. http://www.census.gov/compendia/statab/2012/tables/12s1167.pdf, accessed July 2015.

22. “P2P lending’s success dependent on borrower credit,” Fitch Ratings, 2014. www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/P2P-Lending’s-Success?pr_id=851174, accessed July 2015.

23. “Peer pressure,” PwC, 2015.

24. Estimates in Figure 6 are based on publicly available data, which may explain the discrepancy between these numbers and Lending Club’s own numbers. See Appendix B–Methodology, for details.

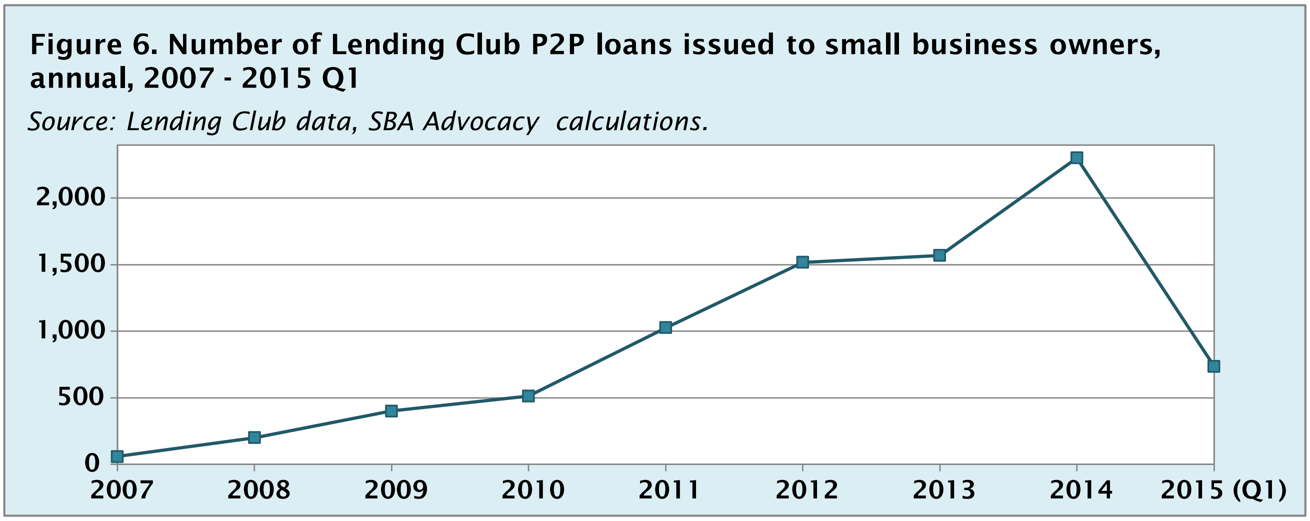


Table 3. Total lending at selected P2P and online lenders (self-reported), 2015

Lender	Total lending	Reference year
Lending Club	Over $9 billion, $1.6 billion of which was in the first quarter of 2015 (as of March 31, 2015). Small business loans make up 1.47% of all loans, or 10,694 loans*	Launched 2007
Prosper	$3 billion to 250,000 people	Founded 2006
CAN Capital	Over 156,000 small business transactions	Since 1998
Kabbage	Over $550 million to 100,000 small businesses	Founded 2009
OnDeck Capital	More than $2 billion to small businesses (as of April 2015)	Launched 2007

Source: Company websites. Retrieved July 2015. Note: Small business" is self-defined by each platform.
*This estimate may include both peer-to-peer loans used by small business owners as well as true commercial loans.

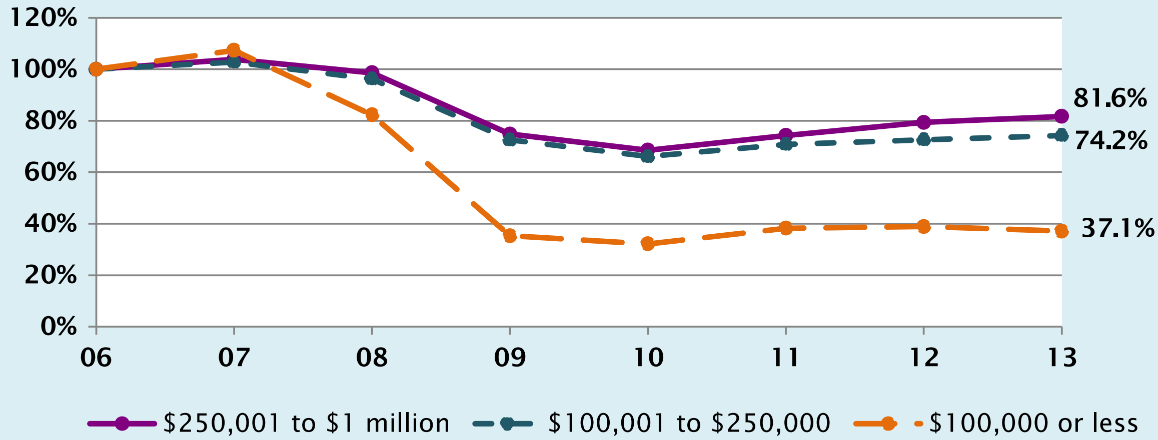
Appendix B). However, trends in bank loan data show that small business loan originations fell during the recession and have remained below pre-recession levels, particularly for the smallest business loans ($100,000 or less), as shown in **Figure 7**.[25] However, as of 2013, small business loans that are $100,000 or less still represented the vast majority (92 percent) of all small business loans. The average size of these sub-$100,000 loans was $14,159 in 2013. (It is important to note that a change in the sample of banks that report this data under the Community Reinvestment Act could also affect these trends.) Still, the data in **Figure 7** and **Figure 8** suggest that there is either (1) a decrease in demand for the smallest business loans (under $100,000) or (2) a decrease in approval rates.

Other data suggest that decreases in both supply and demand for loans are behind the drop in small business loan originations. The smallest businesses—microbusinesses or firms with revenue less than $250,000—are less likely to apply for credit, and over three out of five (63 percent) receive none or less than half of the credit for which they applied. The *2014 Joint Small Business Credit Survey Report* found that only about 20 percent of microbusinesses applied for credit in the first half of 2014, compared to

25. Within the FFIEC/CRA data, small business loans are defined as loans of $1 million or less.

Figure 7. Business loan originations, as a percentage of 2006 originations, 2006-2013

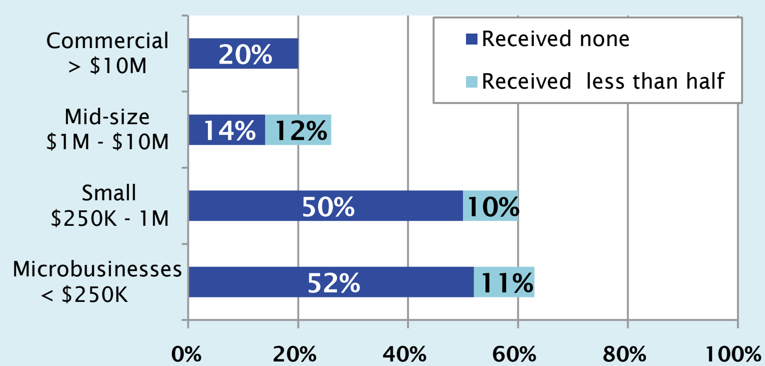
Source: FFIEC/CRA. Nominal dollars.



about 30 percent of small and mid-size firms, and about 60 percent of commercial firms.[26] Of these micro-businesses that applied for credit, 80 percent applied for less than $100,000, meaning that smaller-dollar products offered by peer-to-peer lending platforms may suit the needs of credit-seeking microbusinesses. Microbusinesses, and even slightly larger firms with revenue up to $1 million, were more likely than larger firms to receive none or less than half of the credit for which they applied (**Figure 8**).

Figure 8. Credit application outcomes by firm size in revenue (% of applicants)

Source: NY Fed Joint Small Business Credit Survey Report



Among firms that applied for credit from online lenders, microbusinesses were more likely to be approved than small or mid-size firms, suggesting that online lenders may be particularly beneficial to the smallest businesses.[27] Microbusiness credit applications were most likely to be approved at small regional or community banks, although the ease of application for an online loan may outweigh the greater likelihood of denial when small business owners are time-constrained. For example, if a business owner spent four hours applying for 10 online loans and was approved for only one loan, that owner would still get more credit than if he or she had spent four hours applying for one bank loan and was denied.

26. *Joint Small Business Credit Survey Report, 2014*, Federal Reserve Banks of New York, Cleveland, Atlanta, and Philadelphia, 2015. www.newyorkfed.org/smallbusiness/SBCS-2014-Report.pdf, accessed July 2015. Sample includes a 10-state area (Alabama, Connecticut, Florida, Georgia, Louisiana, New Jersey, New York, Ohio, Pennsylvania, and Tennessee)

27. It is worth noting that the survey describes "online lender[s]" as "lender (e.g., Lending Club, Prosper Marketplace, OnDeck, CAN Capital)." *2014 Small Business Credit Survey*, Federal Reserve Bank of Cleveland, www.clevelandfed.org/en/Community%20Outreach/Community%20Development/2014%20Small%20Business%20Credit%20Survey.aspx, accessed July 2015.

Regulatory Environment

As the data above show, peer-to-peer lending to small businesses is rising while the origination of small business bank loans is decreasing. Microbusinesses are interested in borrowing small amounts of money, although their credit applications are the most likely to be rejected. Therefore, the financial regulatory environment in which P2P lending exists is particularly important to small businesses—they may have the most to gain from the growth of the peer-to-peer lending industry but may also be more vulnerable to unforeseen risks related to less traditional lending practices.

Peer-to-peer lending is regulated at both the federal and state level under several statutes. The technical terminology of peer-to-peer lending may seem complex, but is essential to understanding relevant policy and regulations. Perhaps most counterintuitively, "lenders" are not actually lending money to borrowers, but are investors purchasing debt-backed securities. The Prosper website explains it this way:

> Although you are sometimes referred to on the Prosper website as a "lender," you are not actually lending your money directly to Prosper borrowers, but are, instead, acting as an investor purchasing Notes issued by Prosper that are dependent for payment on payments we receive on the corresponding borrower loan.[28]

Longstanding Securities and Exchange Commission (SEC) regulations limit who can invest in securities for companies that are not registered with the SEC, such as (almost all) companies that are seeking loans on P2P lending platforms.[29] Although these laws help protect investors from fraudulent financial practices, individuals who do not meet specified financial requirements may miss out on legitimate opportunities to invest, and less funds are available to small businesses seeking capital. Investors who meet the strict criteria are known as "accredited investors," and they are presumed to be savvy enough to invest in unregistered companies.[30] Implementation of the "crowdfunding exemption" in Title III of the Jumpstart Our Small Businesses (JOBS) Act of 2012 would significantly relax investor criteria, allowing non-accredited individuals to invest up to a specified amount, and thereby increasing the number of people who can lend money on P2P platforms.[31] The SEC has not definitively indicated when it anticipates issuing final rules to implement the crowdfunding provisions.

In the meantime, Lending Club and Prosper have worked around these regulations by having registration statements with the SEC that allow them to engage in continuous offerings to the public, and "[p]rospectus supplements offering multiple series of notes are filed on an almost daily basis."[32] However, some states have laws that limit investors' ability to participate in P2P lending. A 2011 GAO report notes that, "In addition to registering with SEC, Prosper and LendingClub have registered with selected state securities regulators in order to be permitted to offer and sell notes to state residents"[33]

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28. "Do I have to be licensed?" www.prosper.com/help/investing, accessed July 2015.

29. *The Regulation of Peer-to-Peer Lending: A Summary of the Principle Issues* (2014 Update), Peter Manbeck and Samuel Hu. Chapman and Cutler LLP. www.lendacademy.com/wp-content/uploads/2014/04/Regulation-of-P2P-Lending-Chapman-and-Cutler.pdf, accessed July 2015.

30. A key requirement for SEC-accredited investors is having either earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, *or* a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

31. Pub. L. No. 112-106, 126 Stat. 306 (2012).

32. "Current crowdfunding methods," Andrew Hecht, 2013. www.hechtbizlaw.com/CurrentCrowdfunding.pdf, accessed July 2015.

33. *Person-To-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows,* U.S. Government Accountability Office, (GAO-11-613), 2011. www.gao.gov/new.items/d11613.pdf, accessed July 2015.

Some states where Prosper and Lending Club are permitted to operate have state-specific financial suitability requirements for individual investors, and Lending Club has voluntarily adopted these standards in all states in which it operates. As of August 2015, individuals in 32 states and the District of Columbia can invest in Prosper notes, although financial suitability requirements only apply in certain states.[34] Lending Club is available to investors in 33 states, but maintains financial suitability requirements for all investors.[35] The most common financial suitability requirements require investors to meet one of the following criteria in order to "lend" on Prosper or Lending Club:

- $70,000 in annual income combined with $70,000 net worth, *exclusive* of home and furnishings, or
- A net worth of at least $250,000 with the same exclusions

Although these requirements are less stringent compared to current federal requirements to be an accredited investor, they still preclude the majority of Americans from participating. In 2011, U.S. median household net worth, excluding equity in one's home, was $17,000. In 2012, median household income was $52,300.[36] For households in the 80th percentile of monthly income, median net worth exclusive of home equity was $45,300.[37] While there is a need for consumer financial protection, it seems entirely possible, for example, that an individual earning $50,000 annually with a net worth of $30,000 could responsibly invest a portion of his or her wealth in peer-to-peer loans. Implementation of the crowdfunding exemption would allow individuals with an annual income or net worth of less than $100,000 to invest the greater of either $2,000 or 5 percent of their annual income or net worth each year. As the base of investors broadens, it is likely that the peer-to-peer lending market will rise as well. Given the extremely limited participation of potential investors at present, the growth of peer-to-peer lending could be tremendous.

Policy Implications and What's Next

Peer-to-peer lending is a relatively recent development. For example, Prosper started in 2006 and Lending Club started about a year later. This results in an inherently limited availability of data and an uncertain regulatory future. In a 2014 paper, Federal Reserve Board economists Mach, Carter and Slattery concluded, "The passage of the SEC crowdfunding rules [JOBS Act] will certainly expand the pool of individuals eligible to provide funding to small businesses but it is unclear what the overall impact will be on P2P lending."[38] However, the growth of peer-to-peer small business loans is undeniable, and peer-to-peer lending platforms appear to fill a niche in the market for small business capital. The removal of barriers to entry for both lenders and borrowers means that some small business owners may get an otherwise unavailable opportunity to finance growth, or may spend their time and effort running their firm as opposed to seeking capital. However, small business owners need to be informed about the costs and risks associated with these new lending options. Peer-to-peer lending has the potential to change the landscape of small business financing for the better. In order for this to happen, financial regulations must reflect the need for investor protection and simultaneously allow small businesses to access the capital that many individuals are willing to provide—no small task.

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34. "What states are open to investors on Prosper?" www.prosper.com/help/investing, accessed August 2015.
35. "Is Lending Club available in my state?" http://blog.lendingclub.com/is-lending-club-available-in-my-state, accessed August 2015.
36. "Household income: 2013," Amanda Noss, U.S. Census Bureau, 2014. www.census.gov/content/dam/Census/library/publications/2014/acs/acsbr13-02.pdf, accessed July 2015.
37. "Net worth and asset ownership of households: 2011," Table 1, Median value of assets for households, U.S. Census Bureau. www.census.gov/people/wealth, accessed July 2015
38. "Peer-to-peer lending to small businesses," Mach, Carter, and Slattery, 2014.

Appendix A. Additional Data

Table 4. Purposes of Lending Club P2P small business loans (random sample)

Purchase equipment for HVAC business
Purchasing initial inventory to start a small business (bedding)
“Pay off bills and enhance business”
Fund startup of business
Operating capital for a two-year-old electrical engineering company to maintain payroll while waiting on accounts receivable, as well as finance equipment and internal product development (wants to double revenue in next year)
Purchase a 10-year-old car wash business along with a business partner; current owners are retiring
Opportunity to join girlfriend’s 33-year-old, well-established businesses
Software engineer with 10 years of experience wants to expand side business as a consultant
Start a trucking company; borrower has 18 years working on the container import/export side of trucking
Start a business in which borrower has 30 years of industry experience (charged off)
Wellness center with retail products open for 10 months and has experienced revenue growth; wants to move to new location and need money for security deposit and other moving expenses
Convert an existing (10 years) restaurant into franchise: owner is retiring; need to make upgrades and buy equipment for menu changes
Consolidate debt and pay taxes
“Business capital”
“Buying a commercial property” (no other details offered)
“Funding my own business jewelry”
A teacher who wants to start a day care
Purchase inventory and [cash buffer] for a new retail home education business (tutoring, class materials for home study, etc.)—marketing executive with 30 years of experience, wife has experience as an educator (ultimately charged off)
Expanding a 3-year-old neighborhood pub/bar; reconfiguring layout to accommodate more people to accommodate customer growth
Purchase supplies and equipment to start a scented candle business
“We want to expand and need some cash to buy some things”
Online fashion jewelry business, four years, wants to expand to include tungsten and titanium rings
A recently-incorporated business owners owner wants to “expand a little bit”
Business owner who is want to get away from credit cards due to rate changes and credit score penalties when using up credit
Start a confectionary kiosk while maintaining current job—need to pay for kiosk, custom acrylic bins, inventory, and POS computer system
“To help fund a start-up internet company”

Note: The 27 reasons listed here were generated as follows. A random sample of 100 observations of business loans was taken from publicly available Lending Club data spanning 2007 until the first quarter of 2015. Thirty-one of these had entries for the field, “descr,” defined as “loan description provided by the borrower.” Four were excluded due to a lack of clarity, yielding the list of 27 reasons here. Entries in quotation marks are verbatim transcriptions; other entries were paraphrased for reasons of space.

Table 5. Interest rates for select small business credit cards, July 2015

Card name	Bank name	Purchase APR (%)	Cash advance APR (%)	Penalty rate
Bank of America Basic Card	Bank of America	9.24–20.24	24.24	None
Bank of America Cash Back and Rewards Cards	Bank of America	11.24 to 21.24	24.24	None
Business Platinum Credit Card	Wells Fargo	6.99–15.99, plus prime	Prime + 20.74	*
Business Elite Card	Wells Fargo	5.99–14.99, plus prime	*	*
Business Secured Credit Card	Wells Fargo	Prime + 9.9	Prime + 20.74	*
Spark® Cash for Business	Capital One	16.9	24.90	29.40
Spark® Cash Select for Business	Capital One	12.9, 16.9, or 20.9	24.90	29.40
Spark® Select for Business	Capital One	10.9, 14.9, or 18.9	24.90	29.40
Spark® Classic for Business	Capital One	22.9	24.90	29.40
SimplyCash® Business Credit Card	American Express	12.24, 17.24 or 19.24	25.25	29.25
Blue for Business	American Express	11.24, 15.24 or 19.24	25.25	29.25
Ink Cash	Chase	13.24	24.99	29.99
Ink Plus	Chase	15.24	24.99	29.99
Business Edge™ Cash Rewards	U.S. Bank	11.99–17.99	23.99	28.99
Business Edge™ Select Rewards	U.S. Bank	11.99–17.99	23.99	28.99
Business Edge™ Platinum	U.S. Bank	9.99–17.99	23.99	28.99

*Data could not be found online. Other notes: Credit card APRs generally vary with the prime rate, which has been 3.25 percent since January 2009. Some credit cards require other fees, such as cash advance fees, which are generally the greater of a flat rate, usually $10 or $15, or a percentage of the advance amount, usually 4–5 percent. Many small business credit cards offer rewards, such as cash back or airline miles as well.

Table 6. U.S. bank loan originations to businesses, 2006-2013

Loan size	Number of loans		Amount of loans ($1,000)	
	2006	2013	2006	2013
$100,000 or less	12,083,783	4,485,831	127,234,159	63,514,996
$100,001 to $250,000	245,389	182,192	43,280,556	31,989,670
$250,001 to $1 million	245,526	200,471	131,747,429	108,624,475
All loans	12,574,698	4,868,494	302,262,144	204,129,141

Source: FFIEC/CRA

Table 7. Credit approval and application rates by firm size in revenue

		Business Size			
		Micro < $250K	Small $250K–1M	Mid-size $1M–10M	Commercial > $10M
Approval rates (% of applicants)	Large national bank	28	27	22	80
	Large regional bank	41	33	93	97
	Small regional or community bank	61	40	67	94
	Online lender	**41**	9	28	68
Application rates (% of applicants)	Large national bank	33	53	23	32
	Large regional bank	37	60	43	17
	Small regional or community bank	30	36	42	44
	Online lender	**18**	19	1	18
	Other	19	12	21	1

Data source: New York Federal Reserve Bank calculations of *2014 Joint Small Business Credit Survey.*

Appendix B. Methodology

In this issue brief, all references to small business P2P lending refer to loans made to individuals for business purposes unless otherwise specified. Lending Club offers commercial loans, but these are backed by institutional investors, and as such, are outside the scope of this paper. Lending Club also offers 24-month loans for borrowers with the highest credit rating, but these loans are not included in the Lending Club data analyzed herein.

Lending Club data for this issue brief was downloaded in June and July 2015. Data for different periods were combined. Lending Club provides data to the public, including a field where loan applicants describe the purpose of their loan. Identification of business loans was based on whether the term "business" appeared in some form in either the variable purpose or desc. This results in a slightly larger sample than the one that Mach, Carter, and Slattery studied, which was composed solely of records where "business" was contained in the purpose variable (**Table 8**).[39] Lending Club estimates the number of business loans it has issued to date at 10,694. This figure may include true business loans, as opposed to peer-to-peer loans for business purposes.

Table 8. Estimated number of P2P business loans issued on Lending Club using different methodologies

Year issued	This issue brief	Mach, Carter, and Slattery (2014)	Increase using this methodology
2007	59	56	5%
2008	201	127	58%
2009	400	368	9%
2010	513	466	10%
2011	1,027	975	5%
2012	1,518	1,386	10%
2013	1,570	1,358	16%
2014	2,302	2,277	1%
2015 (Q1)	736	733	0%
Total	8,326	7,746	7%

39. Peer-to-peer lending to small businesses," Mach, Carter, and Slattery, 2014.