Chapter 1
To Lend or Not to Lend:
Exploring the Early Days of Peer-to-Peer Lending to Small Businesses

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ABSTRACT

The current paper examines loan-level data from Lending Club to look at peer-to-peer borrowing by small businesses. We begin by looking at characteristics of loan applications that were and were not funded and then take a more in-depth look at funded applications. Summary statistics show an increasing number of small business loan applications over time. Beginning in 2010—when consistent measures of loan purpose were recorded for all applications—loan applications for small businesses were on average less likely than loans for other purposes to have been funded. However, logistic regression results that control for the quality of the application show that, holding all else constant, applications for a loan for a small business were almost twice as likely to have been funded as loans for other purposes. Focusing on funded applications, we note that funded business loans were slightly larger on average than loans funded for other purposes but paid similar interest rates. However, relative to small business loans from traditional sources, peer-to-peer small business borrowers paid an interest rate that was about two times higher. Regression results that control for application quality show that peer-to-peer loans for small businesses were charged almost a percentage point interest rate premium over non-business loans. Logistic regression results that look at loan performance indicate that loans for small businesses were much more likely to be delinquent or charged off.

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INTRODUCTION

As distrust and dissatisfaction with commercial banks grew during the recent financial crisis, there was large growth in nonstandard types of borrowing arrangements. One such arrangement that has seen substantial growth in the past five years is crowdfunding —peer-to-peer (P2P) lending, in particular. Crowdfunding arrangements involve groups of individuals, not institutions, providing funding. As the name suggests, P2P loans are generally personal loans. However, small business owners often intermingle their personal and business finances so as overall P2P lending grew, so too did P2P borrowing for small business purposes.

The current paper looks at the individual loan-level data from Lending Club, focusing on those loans that were used by small business owners for their businesses. While there are other players in the market, Lending Club is the largest player in the US peer-to-peer lending space. In addition Lending Club provides a uniquely detailed data set that allows us to look at both the applicants and loans in more detail than is possible for other peer-to-peer sites. We begin by looking at the characteristics of loan applications that did and did not get funded. While loan purpose is not one of the criteria taken into account when evaluating loan applications, we find that loans intended for small business purposes were more likely to be funded than loans for other purposes. We then look at the interest rate paid on those loans that did get funded. Again, while loan purpose is not taken into account in assessing the credit quality of the application, loans for business purposes paid nearly one percentage point higher interest rate than other loans, holding borrower characteristics constant. Finally, we look at the loan performance. Our results indicate that loans for small business purposes were more than two-and-a-half times more likely to perform poorly.

The rest of the paper is organized as follows. We begin with a short discussion of crowdfunding and how P2P lending fits into the general crowdfunding framework. Then we look at the small business credit market and examine where small businesses have traditionally gotten their credit and how that may have been more difficult over the recent period. We next take a closer look at the data from Lending Club. The final three sections present our econometric results and the last section concludes.

Crowdfunding

The term crowdfunding has come to represent a spectrum of activities. The underlying idea is that funding that one would typically have to borrow through a bank or other financial institution is gathered from a group of individuals, or "the crowd." This is not a new concept; rotating savings and credit associations (ROSCAs) operate under a similar premise and have been long used in developing countries and within minority communities in the US.[1] However, the growth of the internet has given the concept a boost, allowing for a much larger and diverse "crowd." There is no longer a need for the individuals in the group to live in close proximity to one another or to actually know each other; crowdfunding sites are proliferating.

Early adopters of the internet for crowdfunding essentially used their websites as fundraisers. In some instances the crowd receives nothing in return, donating the money out of a sense of altruism. This is the model of websites like Kiva and Crowdrise.[2] In other cases, the crowd is essentially pre-buying the good or service being produced. This is the model of websites such as Kickstarter where funders are often given a copy of the book or CD that is being produced.[3] In both models, borrowers do not pay interest to the crowd or specifically repay the funds.