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The Case of Alternative Versus Traditional Financing: A Literature Review

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ABSTRACT

Receiving a loan from the bank has in the recent decades become a more difficult procedure with a gradually worsening percentage rate of loan application successes. Small and commercial banks are faced with several external challenges and pressures that affect their lending behaviors and force them to ration credit. Thus, they employ the cookie cutter approach to screening loan applications which tend to leave the borrowers at a greater disadvantage. Even worse, Small and Medium-sized Enterprises who are often in great need of start-up capital are faced with not just the progressively strenuous process of putting in an application at the bank for a loan which by itself goes beyond a day, but also a high chance of its rejection. On the other hand, alternative financing methods in the form of peer to peer lending, crowdfunding, and other online platforms come not just with a different level of ease of applications, but also several marketable benefits for the entrepreneur. This paper works to offer an unbiased and wider view of the current state of alternative financing growth (with a case study from China) while contrasting it with the situation of bank lending and the different levels of ease of loan access the alternative procedures offer. Also, it exposes not just upon the innovation and growing list of advantages of alternative financing, but also the risks involved for the lenders, and how risk is allocated. Finally, the paper presents an insight into the future of the alternative financing market.

Keywords: Alternative financing, Traditional financing methods, SMEs, Credit rationing, Innovation, Bank Loans

INTRODUCTION

Although the term 'Alternative finance' is one expressed in different ways, it can be understood as being the non-traditional methods of financing or fund sourcing in place of the traditional financing method which mainly alludes to receiving a bank loan. Today, alternative financing and the presence of online platforms that connect lenders and borrowers have become inseparable concepts.[1] Over the last two decades, Peer to Peer lending (P2P), and Crowdfunding among others have grown to become formidable instruments of financing.[2] In fact, the market for alternative finance as of 2014 in the UK was forecasted to £1.74 in funding provided, and P2P lending more than tripling in size in the space of one year.[3] In China, the total size of the market has already reached 101.7 billion US dollars as of 2015.[4]

Although alternative financing is gradually rising and becoming more prominent in the financing scene, traditional financing still greatly outweighs it in terms of popularity as a source of funds. The traditional means of borrowing money has been and still remains the most popular method for borrowers who are looking most often to raise capital for their businesses. Some of these borrowers are usually owners or aspirants of small businesses looking to generate start-up capital. Currently, although there still exists a big disparity

between the market value of the commercial banks compared to the alternative financing industry, the rise of the alternative financing industries cannot be denied. [5]

The OECD explains that Traditionally, most people opt to borrow from their friends, family members, or they go through the processes of gaining a loan from the bank.[6] Yet, through time, and in very recent history, several alternative methods such as using credit lines, venture capitalists, or even online lending are now available for exploitation.[7] First, when we simply consider the keystone report by the Institute of International Finance who look to discover ways to fix the capital financing issues of SMEs in Europe explain that 4 impediment sets exist for those SMEs seeking financing. These include the case of creditworthiness, competitiveness of SME, the state of banks with limited abilities to manage risks and crisis, as well as the barriers that exist for alternative financing providers. [8]

Prior literature review works carried out thus far on the topic of alternative financing look more at other aspects of it. We can consider the conference paper by Kaustubh and Aditya Sontakke which [9] focuses on the growth of crowdfunding as a type of alternative financing method in seven regions of the world including Africa, MENA, East Asia, Latin America, South Asia, and China. The paper reaches the conclusion that of all these regions, China is predicted to become a key contributor to the development of alternative finance.

At the same time, we have a working paper in the FESSUD project funded by the European Union Seventh framework programme by Isaacs [10] delves deeper into alternative finance but rather than analyze its chronological advancement over time, rather looks in details at alternative types of finance. In fact, it strains more on the different pressures that have arisen from financialization. He further considers peer to peer financing but in the light of stakeholder value banking, as well as alternative currencies.

In both cases, though the titles suggest that alternative financing is addressed up front and in an all-encompassing manner, they do not however consider the different yet highly necessary dynamics of alternative financing methods. We can consider alternative financing in more details first by providing an overview of its general conception, its growth through the decades. After which we look into the current strain on SME aspirants as regards receiving bank loans, the contrast between these methods with the traditional financing methods, and the rising competition that is becoming evident with. Finally, it is necessary to consider the risks involved as regards these two methods, as well as the advantages, or even the innovative strategies of efficiency being carried out by alternative financing producers like this paper aims to do.

The struggle to generate capital for SMEs

Amongst the challenges that SMEs face from the onset, capital generation count as the one of the most formidable foes and roadblocks that most start-ups are faced with. For the UK, the rate at which applications for bank loans are rejected, lies at 38% of applications. [2] A working paper by Gordon, an administrator of U.S Small Business Administration, who was also a cabinet member for the former president Obama's cabinet and McCartney in their research on small business lending explains that small enterprises act as a core to the competitive level of the American economy since they employ up to 50% of the country's private sector workforce. [5]

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Figure 11: About 40 Percent of Small Businesses Apply for Credit
Percentage of Small Businesses Applying for Credit

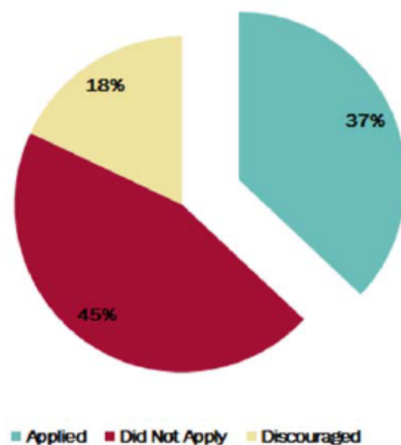
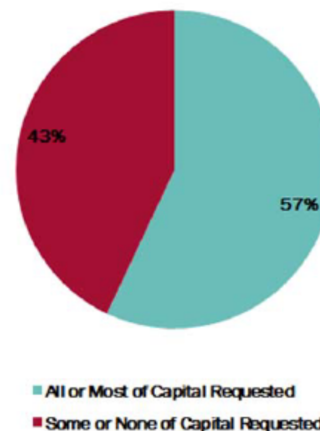


Figure 12: 40 Percent Applying for Credit Get Rejected or Less Credit Than Desired
Percentage of Small Businesses Receiving Credit



Source: Federal Reserve (Atlanta), "Small Business Credit Survey", Fall 2013.

Considering the charts above, we find that Small businesses are faced with a number of challenges when borrowing from the banks[11] and Cole and Rebel explain these reasons among which information opaqueness counts as a top reason for why commercial banks fail to lend out money to most SME borrowers. [12] These reasons were coined as far back as 2004 with the same 'cookie cutter' issue reverberations which involve relying majorly on the financial statements of an aspiring borrower. This is done in order to decide on giving the loan based on the borrowers financial capability to pay back rather than the character and financial statement approach done by smaller banks or financing firms. [6] [13] We also find that in some cases, the process of checking credit of the small business borrowers is more stringent than ever [14] and in when they are lent money they have to suffer higher interest rates. [15][16].

Bank Credit rationing and its implications for SMEs

To comprehend the level of difficulty faced by SMEs, it is important to consider the issue even more from the banks perspective as traditional finance providers. Credit rationing is a process that occurs when banks are operating under rather serious financial stress.[17] In essence, when banks experience trouble financing themselves as an institution, they are forced to ration their credits.[17] Following the analysis of the Stigliz-Weiss a 1981 rationing model done by Agur, which indicates that rationing of credit itself rises from adverse selection. In essence, the borrowers all have an equitable return to their projects, however their projects have different levels of risk due in large to their limited liabilities. This then enforces that the higher risk borrowers possess larger expected returns, and will also most likely pay higher interest rates back. Thus, with the basic outcome being that if R0 refers to project returns, we observe that the bank therefore receives

$\text{Min}[R0 + C, (1+r)B]$ from each borrower it lends money to. [18]

What this system of credit rationing implies for the SMEs, or smaller scale lenders is therefore a higher level of difficulty as many of these Small and Medium sized enterprises are not necessarily willing to bear great risks, and due to their limited liabilities and smaller levels of collateral usually unable to make the bank's stringent financial screening process. This in fact

places them at a disadvantage, and decreases their overall probability of receiving a loan from the banks.[19]

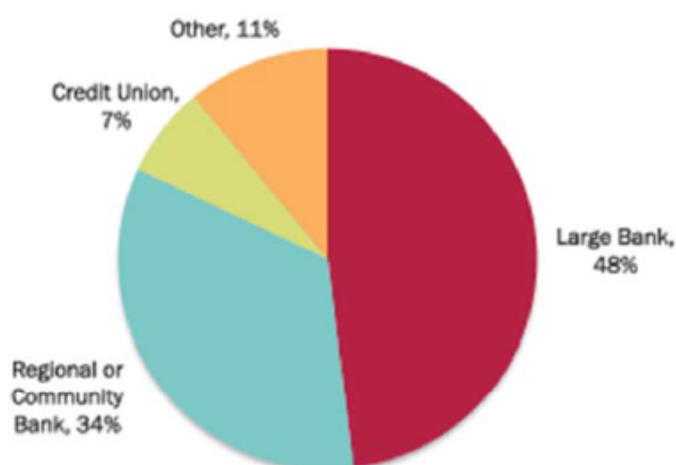
The choice between traditional and alternative business financing methods

Since people began to practice business, there have been a long trend of methods by which businesses have been financed. These methods though quite old are still in practice today in several modified yet similar forms which mainly include using personal savings and funds, getting loans from family members and friends getting a loan from the banks. A pioneering research by OECD explains that lending money from the banks is the most prevailing method and common source of external financing for most SMEs and entrepreneurs [1]

Compared to the traditional methods, the report aims to throw light at other key methods such as crowdfunding, asset based finance, lending, and leasing, alternative debt systems such as corporate bonds, covered bonds, crowdfunding, all systems that work as the alternatives to straight debt.

The rise of Alternative financing sources

Although the key traditional financing method of using bank loans for financing SME startups is still the most predominant financing method till today at the rate of being 72 times larger in terms of net worth when compared with alternative sources , the rapid rise in alternative financing methods cannot be denied. In fact with the aid of the graphs below, we find that as of 2014 when these studies were carried out, gradually but surely, SMEs are leaning more towards other sources beyond the standard bank loan in order to provide capital for their businesses. Also, we find that overall till date alternative finance sources are slowly but surely becoming more prominent, making up a growing portion of 'others' in which we find peer to peer lending, crowdfunding growing in capacity among other alternative financing forms on the rise.



[6]

Among these, alternatives like peer to peer lending (P2P), Crowdfunding, and venture capitals are in the forefront.[20] In a research carried out by Akorsu and Agyapong in Ghana a prominent West African country, identify these standard issues which limit the ability for SME loan aspirants from receiving the capital they require. These issues seem even more pronounced in West Africa and thus a need for an SMEs network funds which is the main idea

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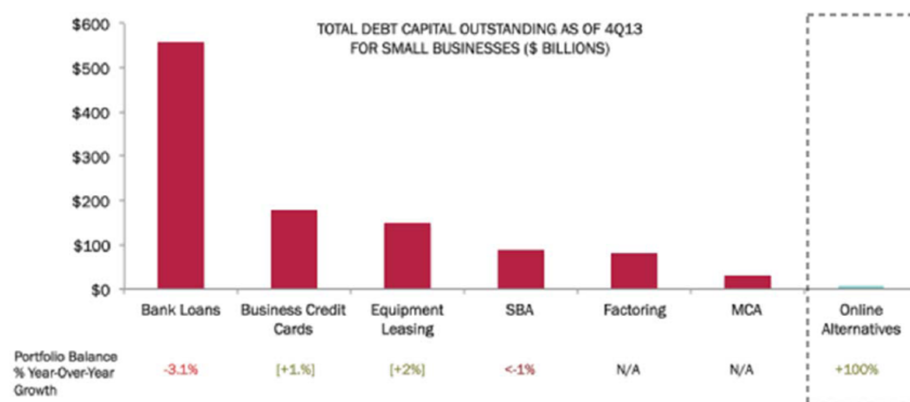
of this paper[21] At the same time, research by Yiu, Su and co, on alternative financing as regards private firm performance, we see that in the case of China, the Bank loan issue is still quite prominent and finally posit that in China's case alternative sources like underground financing and venture capitals are the more popular means that work.[22]

Source: National Federation of Independent Businesses, "Small Business, Credit Access, and a Lingering Recession", (January '12) and Federal Reserve's Survey of Small Business Finances (Released in '07).

Figure 28: Online Loan Market is Small, But Growing Fast
Total Debt Capital Outstanding as of 4Q13 for Small Businesses ($ Billions)



Source: Bank loans data taken from FDIC Call Reports; SBA data sourced from SBA publicly available information; Credit card data sourced from creditcards.com; remainder sourced from interviews with industry experts, and authors' analysis. [6]

History of alternative financing

The cookie cutter approach versus 'soft information' analysis of the banks

Today, as the number of SMEs increase around the world it is becoming more and more evident that the banks are just not willing to lend money out like they used to with rapidly decelerating figures on the success rate of loan applications. The banks are faced with a big issue of having to collect collateral when the borrower fails to pay which tends to increase costs, and waste resources. As such, the banks use that which is known as the cookie cutter approach according to Cole and co.'s words refer to standard categories and criteria which is gotten from financial statements the banks use to assess who is worthy of receiving a loan. [7] These statements include, but are not limited to one's credits, current and past loans, all their bank accounts, the different debts incurred, their ID numbers for different finance related statements. At the same time, the banks require one's insurance information, copies of their returns, their future ratio agreements, their complete financial statements including their balance sheet, income statements, their audited documents, accounts payable, just to name a few. [58]

Although this cookie cutter practice is a bit more unique to the larger banks compared to the smaller banks, the alternative financing sources tend to look more at the character of the borrower rather than looking strictly at the financial statements which in many cases are not the true indicators of a person's business potential, or even their drive to repay their debt to the bank.

When we look more into the character analysis method of lending to borrowers we find that large banks tend to completely ignore the aspect of character, and are in several instances

more favorable to larger firms, and highly selective of the SMEs they choose to lend to. [23][24]David Gaddis in his analysis of dominant banks and their impact on content and bank loan terms addresses the issue of big bank domination of the entire processes which in turn has a negative impact on the smaller lenders and borrowers. In fact, in the US today, there are 3 main banks that control more than a half of the commercial banks of the US with the syndication process. [25]

In essence, the banks conduct a rigorous time consuming application process which in itself acts as a means to dissuade borrowers, many of whom get discouraged and instantly feel unfit for receiving a bank loan.[26][27] In other foundational research on the different ways corporate loan lending done by finance companies in comparison to banks carry out their analysis. They find that the financing companies compared with banks tend to lend to more or arguably riskier borrowers more especially those who are leveraged. [28] Also, emphasis is laid by Gambacorta and co on the issue of bank capital which has a big influence on each bank's lending behavior after looking in detail at a sample of 40 Italian banks who finds that the well-capitalized banks are better able to protect their ability to lend even in the face of monetary policy shocks in its external environment.[29][30][31]Interestingly, Berger and co look more into the ability of smaller banks compared to larger banks to consider 'soft' information compared to the cookie cutter, hard information approach the larger commercial banks use to decide those worthy of loans.[32] De La Torre et al go into even further details of banks relationship with SMEs, and the real struggle for capital generation through bank loans.[33]

Case study: Internet financing in China, and the diminishing overall role of banks

Internet financing in China is a phenomenon that is rapidly evolving. It is becoming a formidable financial instrument that supports SMEs and entrepreneurs in China. In fact, a major boost has been seen in East Asian countries such as Singapore, Indonesia, Malaysia, and more especially China. Due to this rise, China's state controlled banks are beginning to lose their share of the 44.8 trillion-yuan worth of the deposits of household [61] China has in fact as of 2017 become the world's largest P2P market. This is also due to the government's encouragement of online financing. One such major online platform of internet financing in China is Alipay which as of 2014 boasted of 300 million users who through the platform have access to various financial services that are gradually replacing the role of the banks. The users do not only use it to make all form of utility payments, and online purchase payments, but also save money on it for interest, as well as participate in the crowdfunding services offered therein.

When we consider China alone as a case, we can see and clearly understand that Alternative financing even in form of internet financing services is already challenging the status quo and traditional methods of accessing financial services standardly provided by the banks.

Efficiency and Innovations in Alternative financing

Today, due to the rapid progression of technology, many processes which were in the past impossible such like the introduction of ATMs and several online banking services[34]to replace long waits at the bank in front of a clerk. In fact, businesses are progressing faster, and formerly longwinded processes such as job applications of the jobs of Human resource staff which formerly involved endless processes of file keeping has now been transformed into online quicker and easier processes with the onset of EHRM. In the same light, the rapid evolution of the internet has also brought about different variations of online lending, processes that were almost unimaginable only a few decades back.

The alternative financing online platforms have revolutionized the way money is being

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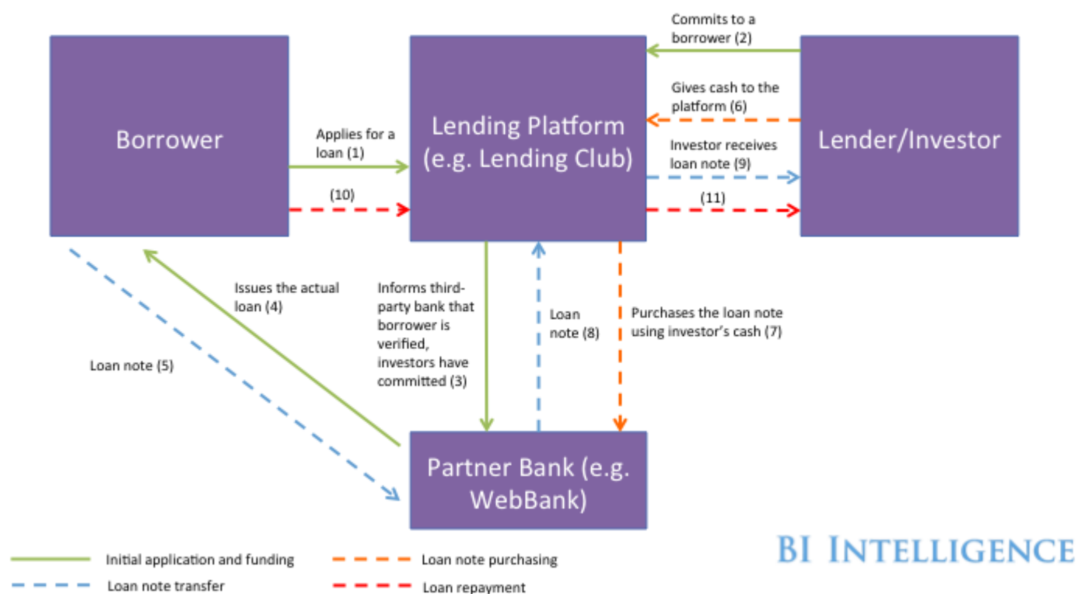
borrowed.[35][20] In fact, we find that an average bank loan application even before consideration takes a whopping 25 hours to complete while most online platforms offer less convoluted processes with 30 minutes to an hour being enough to complete the application process for a loan to an alternative finance source. [6]

Peer to Peer Lending (P2P)

More foundational research on alternative financing sources, more known as Group lending in general rather than the more specific names for it in its online dimensions considers effective cost of borrowing, and the important role peer selection plays in the success of loan receipt via this alternative source.[36][37] However, commercial and online Peer to Peer (P2P) lending as we know it today began in 2005. We find that in this form of lending, the financial institutions play only an intermediary role on the online based platforms where in private individuals in social networks online initialize lending and borrowing.[38][39] A clearer more graphical explanation is shown below with the help of arrows to show the connection of the borrower to the financing source or in the more social light, 'lending club'. Source: Business Insider [59]

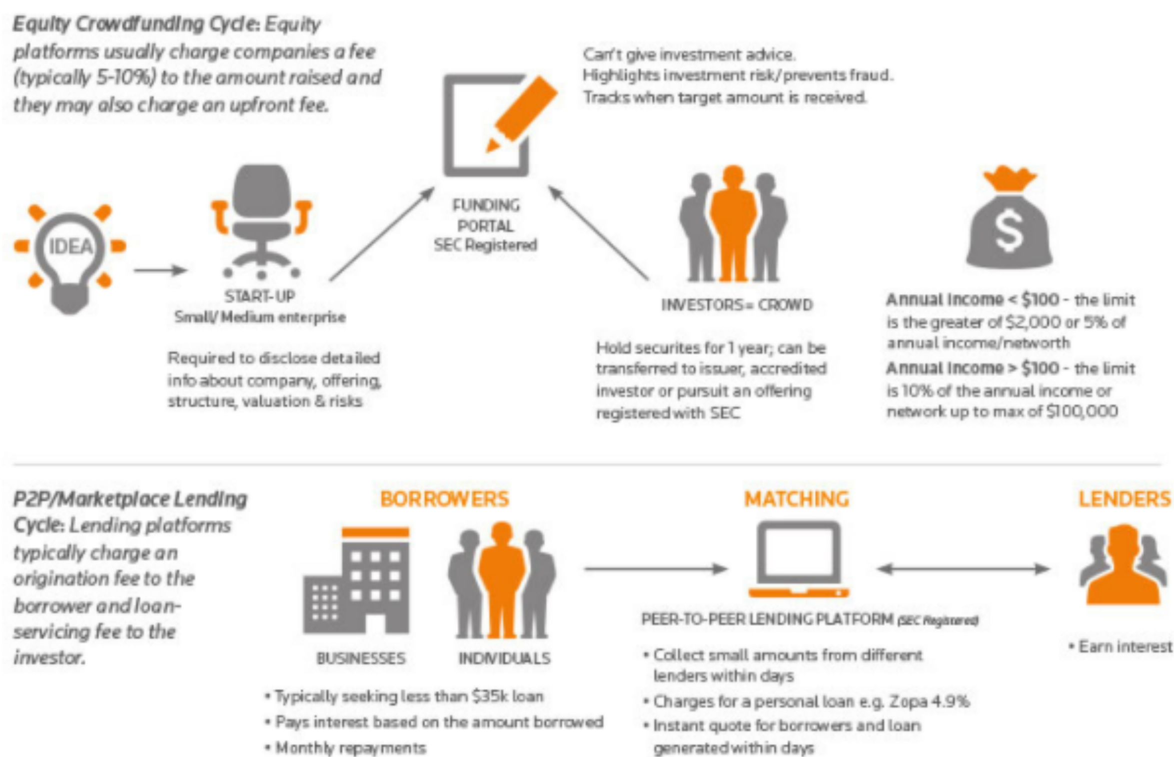


We see here that the financial institutions such as the banks only play an intermediary role at most, and have no right to necessarily accept or reject the offering of a loan to a borrower. This throws light to its efficiency as the notion to lend or not to lend is not a necessarily institutionalized procedure reliant on bank capital reserves, or even standardized cookie cutter processes. In essence, one can clearly see that the future of peer to peer lending is now becoming a sweet blend of internet innovations, and gregarious and aggressive entrepreneurship sparking innovation.[40]

Crowdfunding

Besides peer to peer lending, we can also consider the considerable ease with which borrowers earn funds through crowdfunding. Crowdfunding in simplistic terms as the name implies refers to the procedure of raising funds for a venture in many small quantities from a large number of people 'crowd'.[41][42][43] Many researchers have considered the topic of crowdfunding from different perspectives. From the aspect of efficiency over bank loans[44], in terms of strategies to motivate the crowds[45], or even in terms of the advantages crowdfunding has for SMEs as

an alternative finance source. Below is a graphical representation of this process Source: Thompson Reuters [60]



Some of the key benefits and advantages this model of crowdfunding possesses include first that the crowd has a wisdom in itself, and is able to decipher which projects look successful. This wisdom is also able to remove delusions from the borrower's minds and help them even produce better ideas and modifications.[46] Next, crowdfunding unlike other alternative financing methods like peer to peer lending, or even angel investments do not have to worry about losing any portion of future equities from initial stage, the lack of geographical barriers due to the online nature of the agreements, and product promotion among other benefits.[47]

Alternative financing and risks

Although alternative financing may appear at first to not consider the risk of lending as seriously as the banks do it is also faced with the same uncertainties the banks work to avoid. Risk which mainly revolve around the borrower's ability to pay back with interest in due time. It is truly arguable that from the lenders perspective, rather than being an investment, lending is more like gambling simply because of the unfavorable profit model being worked with. Simply put their probability times the payoff presents unfavorably higher chances of risk especially for smaller borrowers whose financial status of ability to pay back are simply dubious and difficult to estimate at best. Simply put:

Expected return = (Gain on success chance x probability of success) + (Losing on a loss chance x Probability of loss).

In the case of peer to peer lending, lenders look to reduce risk by screening through multiple peers, and ascertaining a peer's creditworthiness using soft information as mentioned earlier, and their ratings from other lenders.[48] However, in the case of crowdfunding, the risk is shared among a large group of lenders which then minimizes each lenders risk level when considered with the simple probability times payoff model.[49]

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Despite all the benefits already outlined regarding alternative financing, it is important to present a more balanced view where in the prevailing disadvantages can be reviewed, in other words the risks. E. and B. Lee analyze this in their empirical investigation considers more serious issues of information asymmetry [50]in the lending and borrowing process posing a risk for the lenders, and even the general lack of financial expertise most of the members of these online platforms possess.[51] Looking more in details at Herding which arises from abundance of information that is imperfect.[52][53]

In fact, the serious issues of moral hazards which places the lenders at a great disadvantage cannot be ignored when considering the rise of alternative financing.[54] We can even say that the security issues of online theft [55][56] and the jeopardy and susceptibility to hacking and phishing apply in full to online procedures of lending and borrowing money as alternative financing methods.[57]

CONCLUSION AND INSIGHTS

The paper aims to consider and analyze the overall state of alternative financing with a more detailed look at two prevailing forms: peer to peer lending, and crowdfunding, as compared to traditional financing method which is primarily the process of receiving a bank loan. This paper goes on to consider not just the benefits of the alternative financing but also the innovation, efficiency, effectiveness, and also risks involved.

Nonetheless, currently, it can be said that the benefits outweigh the disadvantages of alternative financing especially as an alternative form to the traditional process that has become far more convoluted for many considerable reasons in the recent decades. In fact, it can be predicted that with the rate at which the internet is becoming more instrumental to businesses, lending and borrowing will also shift slowly but surely to become a predominantly online process. We can point to the ease of access, the efficiency, and even marketability of alternative financing sources. At the same time, the continued pressure on both small and commercial banks by the bigger banks to employ the cookie cutter approach rather than the soft information consideration strategy throws light on the probability of an even lower probability for borrowers especially for SMEs to gain access to capital to start and run their businesses.

In fact, with added bonuses of simultaneous product promotion, quicker application processes, less stringent evaluation processes, and the overall ease of access to these platforms and in essence lenders, it can clearly be seen that alternative financing will in no time become the main way to generate capital. However, whether this will become a convoluted process like the bank loans due to increased popularity in the far future, 10 or 20 decades from now, is a phenomenon yet to be deeply analyzed, clearly considered, or nearly forecastable.

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