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Small Business Credit: How Entrepreneurs Finance the American Dream

This issue of *Consumer & Community Context* explores credit options for small businesses. First, it discusses why access to business credit is important and describes the types of credit providers in this space. The article then reviews the types of available credit products, and it concludes by summarizing key considerations small business owners may want to keep in mind when weighing their credit options.¹

Understanding Small Businesses and Their Credit Needs

Small businesses, defined for the purposes of this article as firms with fewer than 500 employees, play a vital role in the U.S. economy. They make up 99.7 percent of all U.S. businesses with employees, produce nearly half of the country's gross domestic product, and employ just under half of all American workers.² Many small businesses need financing to launch and grow successfully over time. While some entrepreneurs rely on their own personal savings, personal loans or credit cards, home equity loans, or funds from friends or family, this article focuses on credit products that are designed for small business use.

The Small Business Credit Survey (SBCS)—fielded annually by the 12 Federal Reserve Banks—provides valuable insights on the financing needs of small firms across the United States.³ Though application rates have fluctuated in recent years, the most recent SBCS data show that

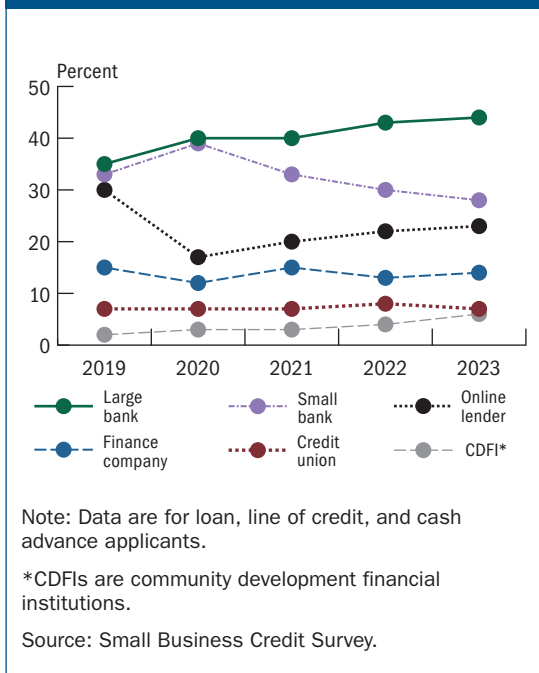
Note: The views expressed here are those of the authors and do not necessarily reflect the position of the Federal Reserve Board or the Federal Reserve System.

¹ The staff contact for this issue is Kim Wilson, and the contact for the *Consumer & Community Context* series is John Rodier. Jordan Manes, Lucas Misera, and Ann Marie Wiersch provided research, analysis, and editorial support on this topic. Lincy Chacko and Pam Wilson provided editorial support.

² U.S. Small Business Administration Office of Advocacy, "Frequently Asked Questions About Small Business, 2024," July 23, 2024, <https://advocacy.sba.gov/2024/07/23/frequently-asked-questions-about-small-business-2024/>.

³ SBCS findings cited in this article, as well as data and reports for all survey years, are available at <https://www.fedsmallbusiness.org/>. The SBCS received over 6,000 responses in 2023 collected as a convenience sample. Though survey respondents are not randomly selected, the data are weighted to match the U.S. small business population by number of employees, age, industry, geographic location, gender of owners, and race or ethnicity of owners. The weighting techniques used make the SBCS a valuable resource on small business lending activity in the absence of a comprehensive national dataset. Given the representativeness of the weighted data, and for consistency, this article exclusively leverages SBCS data for small business financing market insights.

Figure 1. Credit sources applied to in prior 12 months, by survey year



37 percent of small employer firms applied for a loan, line of credit, or merchant cash advance during the prior 12 months in 2023.⁴ The survey also found that of those applicant small employer firms, 50 percent applied for a total of \$100,000 or less, and 30 percent applied for \$50,000 or less in total.

Small businesses seek financing from a variety of sources, including large and small banks, credit unions, online lenders, and other nonbank financing companies.⁵ Large and small banks provide the majority of small business financing in the United States, although some small businesses, especially those that are looking to receive funds quickly, turn to nonbank lenders to meet their financing needs (figure 1).⁶

Types of Financing Providers Available to Small Businesses

Large and Small Banks

The 2023 SBCS found that nearly half (44 percent) of small business loan, line of credit, and cash advance applicants applied to large banks, and about a quarter (28 percent) applied to small banks. Many of these applicants were successful—especially those that applied to small banks. In 2023, small banks approved 75 percent of loan, line of credit, and cash advance applicants for at least some of the financing they sought, while large banks approved 66 percent of applicants for at least some financing in 2023.

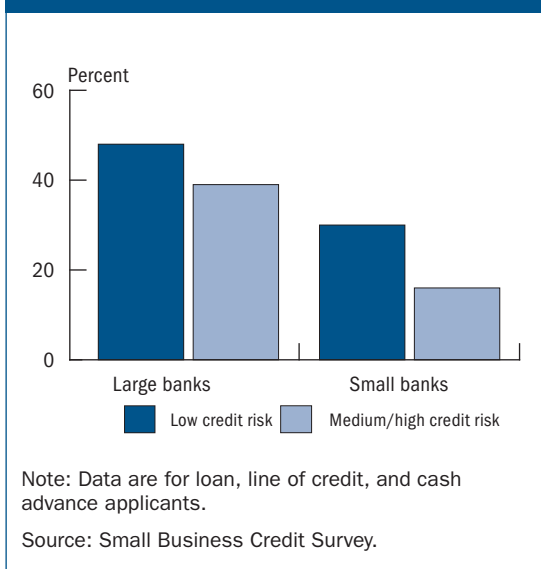
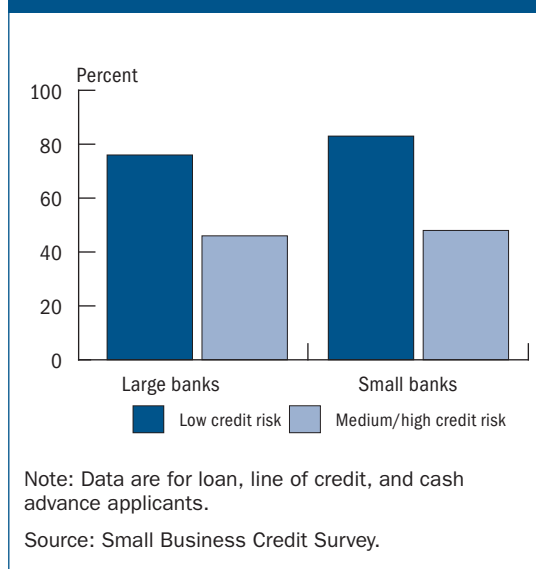
Small business owners with low credit risk were more likely to apply to banks—particularly, large banks—and to be approved than those with medium or high credit risk in 2023 (figures 2 and 3).⁷ Low-credit-risk firms were slightly more likely to be approved by small banks (83 percent) than they

⁴ In this article, “merchant cash advances” are also referred to as “cash advances” for brevity.

⁵ The SBCS defines large banks as having \$10 billion or more in assets and small banks as having less than \$10 billion in assets.

⁶ The SBCS methodology was revised in 2022 to enable more accurate identification of lender types than in prior years. See the “Methodology” section of the SBCS 2024 *Report on Employer Firms* for more detail.

⁷ The SBCS defines “low credit risk” as having a business credit score of 80–100 or a personal credit score of 720 or higher, and “medium or high credit risk” as having a business credit score of 1–79 or a personal credit score of 719 or lower. Credit risk is determined by the self-reported business credit score or personal credit score, depending on which was used to obtain financing for the business. If a firm used both, the higher risk rating was included in the data.

Figure 2. Application rate by credit risk, 2023**Figure 3. Approval rate by credit risk, 2023**

were by large banks (76 percent), while approval rates for medium- or high-credit-risk firms were about the same at both large and small banks (just under 50 percent).

Why do businesses seek credit from banks? The most significant reason that SBCS respondents cited for applying to a large or small bank was that they had an “existing relationship with [that] lender” (over two-thirds of applicants).⁸ Other reasons, such as “chance of being funded” and “speed of decision or funding,” were cited by about one-third of applicants or less.

Among applicants that were at least partially approved, the SBCS has consistently found that applicants to small and large banks were more likely to be satisfied with their lender (74 percent and 53 percent of applicants respectively, on net, in 2023) than were applicants to nonbanks.

Online Lenders

Nonbank online lenders represent another part of the small business credit landscape. These financial technology-based or “fintech” lenders first emerged in the wake of the 2007–09 Global Financial Crisis, when bank lending tightened in response to the recession. Online lenders use data and technology to offer a wide variety of credit products to small businesses through their websites or mobile apps—often in amounts under \$100,000.⁹ Their software typically leverages

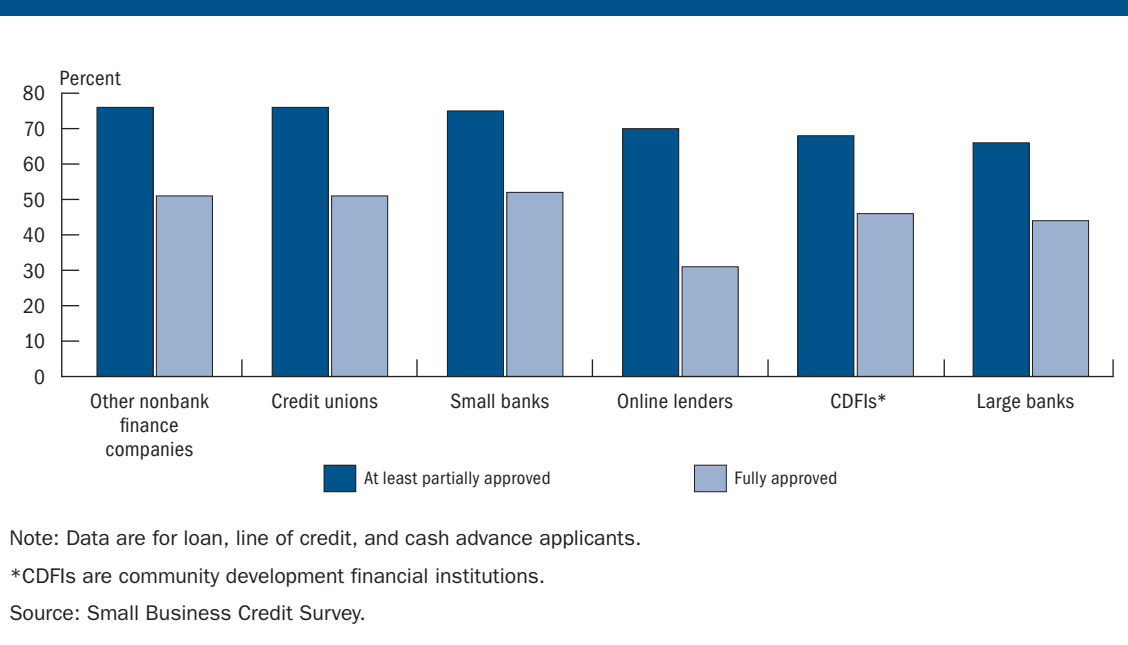
⁸ Insights from the SBCS on the reasons why small businesses chose their lender and whether they were satisfied with their lender are limited for credit unions (due to their small market share) but available for large and small bank applicants.

⁹ Ann Marie Wiersch, Barbara J. Lipman, Kim Wilson, and Lucas Misera, “Clicking for Credit: Experiences of Online Lender Applicants from the Small Business Credit Survey,” Federal Reserve Bank of Cleveland, Community Development Reports (August 2022), <https://www.clevelandfed.org/publications/cd-reports/2022/sr-20220816-clicking-for-credit-experiences-of-online-lender-applicants-from-sbcs>.

advanced technology to analyze a business's cash flow and other data in underwriting and pricing loans.

In 2023, less than one-quarter (23 percent) of small businesses applied for loans, lines of credit, and cash advances from online lenders. SBCS findings indicate that some small businesses turn to the online financing marketplace because they believe that these lenders are more likely to approve them and fund their loan quickly. While online lenders have historically had higher approval rates than banks and other lender types, in 2023, their approval rate for at least some financing (70 percent) was lower than the approval rates of other nonbank financing companies (76 percent), credit unions (76 percent), and small banks (75 percent). They were also the least likely type of lender to approve credit seekers for the full amount of the financing they sought in 2023 (figure 4).

Figure 4. Credit approval rates, 2023



Online lenders have also received the lowest satisfaction rates in the SBCS each year. In 2023, only 15 percent (on net) of online lender applicants that were at least partially approved reported that they were satisfied with their lender. A historic low of only 4 percent of approved applicants (on net) reported satisfaction with online lenders in 2021. Online lender applicants cited “high interest rates” and “unfavorable repayment terms” as their most significant challenges with their lender (55 percent and 42 percent of online lender applicants, respectively). In comparison to bank and other nonbank lender applicants, online lender applicants were most likely to experience at least one type of challenge with their lender (67 percent of online lender applicants, compared to 48–58 percent of applicants to other lender types).

Other Nonbank Finance Companies

While many nonbank alternative finance companies operate primarily online, some nonbank lenders offer financing over the phone, by email, or in an office setting.¹⁰ Only 14 percent of loan, line of credit, and cash advance applicants applied with one of these nonbank finance companies in 2023. Applicants to (not-online) nonbank finance companies were most likely to report selecting their lender because they felt they were likely to be approved and receive funding quickly. SBCS data suggest that applicants to these lenders do, in fact, have a high likelihood of approval. In 2023, these nonbank finance companies reflected the highest approval rate of all lender types—potentially because a higher share of their loans were secured by collateral (76 percent of applicants for loans, lines of credit, and cash advances were approved for at least some financing).

Credit Unions

Credit union small business lending has historically been very limited, largely due to lending caps established by the 1998 Credit Union Membership Access Act and other regulatory restrictions on credit union business lending. The SBCS has consistently found that about 7 percent of small business credit applicants have sought loans, lines of credit, or cash advances from credit unions each year since 2019. Credit union approval rates for business loans, lines of credit, and cash advances were nearly identical to small bank and other (not-online) nonbank finance company approval rates in 2023 (with 51 percent of applicants fully approved and 24 percent partially approved).

Community Development Financial Institutions

Some community development financial institutions (CDFIs) offer financing to small businesses that may not qualify for traditional financing from banks or credit unions.¹¹ In 2023, only 6 percent of SBCS respondents applied at a CDFI. Of the small businesses that applied with CDFIs, 88 percent were approved for at least some of the financing they sought. In addition to providing credit, many CDFIs offer business development programs, such as one-on-one business coaching, mentoring, or training courses. Some CDFIs also provide incubator facilities for aspiring or early-stage entrepreneurs to launch or grow their businesses.

¹⁰ The SBCS “finance company” category may include some specialized lenders such as auto finance companies and equipment dealers.

¹¹ The CDFI category in the SBCS includes mostly nonbank loan funds, as well as a limited number of CDFI banks and credit unions. Lenders were assigned to one lender category (e.g., “CDFI,” “small bank,” or “large bank”) based on the respondent’s selection rather than according to the financial institution’s name—though respondents were given the option of naming their lender as well. An analysis of the lender names provided by respondents indicated that the majority of lenders categorized as “CDFIs” were nonbank loan funds, while only a select few were CDFI banks or credit unions.

Types of Credit Products Available to Small Businesses

In addition to choosing a credit provider, small business owners must consider what type of credit product best meets their financing needs. Business loans and lines of credit are among the most widely used forms of small business credit. The SBCS found that in 2023, 53 percent of employer firms used or carried a balance on business loans on a regular basis, and 34 percent of employer firms used lines of credit. Business credit cards are another primary form of financing—and liquidity—for small businesses. Over half (56 percent) of employer firms used credit cards on a regular basis in 2023.

For small businesses that are unable to secure business loans or lines of credit from banks or credit unions, the Small Business Administration (SBA) offers several options—often at a lower cost than nonbank financing products (table 1). Eligible small businesses can apply for SBA 7(a) loans through approved SBA lenders (including banks and credit unions, as well as some CDFIs and nonbank lenders). These loans range in size from under \$100,000 to a maximum of \$5 million—with an average loan amount of about \$480,000 in FY 2023.¹² The SBA also provides microloans through approved intermediaries (which are CDFIs and other nonprofit lenders). Microloans are offered in amounts of up to \$50,000, though the average loan is only about \$13,000.

Table 1. Types of small business financing products and typical features

Business credit cards	Business lines of credit	Business loans	Invoice factoring	Merchant cash advances (MCAs)	SBA loans (7(a) and microloans)
Similar to consumer credit cards; used as needed for business expenses	Revolving credit line; used as needed for liquidity	Fixed, longer repayment term (>12 months) and payment amount	An up-front advance on unpaid invoices in exchange for a fee	Shorter-term (<12 months) and repaid as a percentage of sales	For businesses that do not qualify for traditional bank credit products

Merchant cash advances and other similar financing products (known as “revenue-based financing” or “sales-based financing”) are less commonly used than loans, lines of credit, and credit cards, but it is important for potential borrowers to understand their unique features. These products are offered by nonbank financing providers in smaller amounts—typically under \$100,000—and are repaid as a percentage of sales or revenue rather than in fixed payment amounts. Lenders may require that the business owner authorize automatic payments from the business’s checking account or from each swipe of credit and debit cards. In exchange for the

¹² U.S. Small Business Administration, “7(a) & 504 Summary Report,” <https://careports.sba.gov/views/7a504Summary/Report>.

“advance,” merchant cash advance providers typically charge a “factor rate” and often do not express costs to applicants in terms of an interest rate or annual percentage rate (APR).¹³

Another less-frequently-used form of financing, invoice factoring, involves the sale of unpaid invoices in exchange for a “factor rate” or fee. With factoring products, the small business sells one or more unpaid invoices (that are typically owed by another business for goods or services rendered) to the factoring provider at a discount. The factoring provider then contacts the invoiced third party to collect their payment. Once the third party pays the factoring provider the amount they owe, the factoring provider keeps a portion of those funds as a financing fee and returns the rest of the funds to the small business borrower. Factoring financing offers, like merchant cash advances, typically do not express the cost of financing to the potential borrower in the form of an interest rate or APR.

Key Considerations for Small Business Owners Searching for Credit

In considering different types of lenders and financing products, it is important for small businesses seeking credit to carefully review the cost and terms of any financing offers they receive. Truth in Lending Act (TILA) disclosure standards for consumer credit products do not apply to small business credit, so financing offers may quote pricing differently than what business owners are accustomed to seeing on consumer credit disclosures. Focus groups conducted by the Federal Reserve Board and the Federal Reserve Bank of Cleveland found that some small business owners were unfamiliar with the terminology used by certain nonbank financing providers.¹⁴ For example, some nonbank financing providers may not include an APR or interest rate but may instead provide a “factor rate.” A “factor rate” is very different than and not comparable to an APR or interest rate. An analysis found that one lender’s website advertised a “factor rate of 1.15,” which amounted to an undisclosed estimated APR of approximately 70 percent.¹⁵ Additionally, lenders may disclose an interest rate but not an APR, meaning that fees may not be reflected in the interest rate.

Financing offers may also contain very different repayment terms. Some products have a fixed payment amount that is due monthly over a set term (e.g., 60 months). Other products may require weekly or daily payments, which may be based on a percentage of the business’s weekly or daily sales. And as noted earlier, the lender may require the business owner to authorize automatic payments from the business’s checking account or from credit and debit card sales. Lenders also may offer varying degrees of flexibility for payment modifications during off-seasons or times of

¹³ Small business financing disclosure requirements vary by state and are discussed further in the “[Key Considerations for Small Business Owners Searching for Credit](#)” section of this article.

¹⁴ Barbara J. Lipman and Ann Marie Wiersch, “Uncertain Terms: What Small Business Borrowers Find When Browsing Online Lender Websites,” Federal Reserve Bank of Cleveland, Community Development Reports (December 2019), <https://www.clevelandfed.org/publications/cd-reports/2019/sr-20191219-uncertain-terms>.

¹⁵ See note 14.

economic hardship. Additionally, different financing offers may include a wide range of fees or collateral requirements. It is important that business owners carefully consider the terms and type of credit that will best meet their needs and whether taking out new credit is the best option for them.