STONE RIDGE

Investor Education

Alternative Lending and Equitable Access to Credit

Credit empowers consumers and helps small businesses invest in their communities. After witnessing the track record and economic merits of alternative lending, ESG investors have also increasingly recognized its social value in expanding access to credit.

Credit for Consumers

Access to affordable credit is fundamental to the economic well-being of households. Loans allow families to pay for children's education and buy a home — keys to building wealth. But to borrow at attractive rates, consumers need a strong credit history.

The 2008 Financial Crisis altered consumers' relationship with credit. For example, recent graduates with high paying jobs were denied credit due to traditional underwriting models that relied on credit history, rather than repayment potential. Consumers also witnessed the dangers of too much debt, and turned away from credit cards as they sought more disciplined ways to borrow.

Lending platforms emerged during this period to offer an alternative to traditional banks.

Passing on the Efficiencies: More Affordable Credit

Lending platforms set out to fully leverage technology in their underwriting. Unburdened by physical bank branches or legacy systems, the platforms could operate more efficiently than banks — and pass along the savings in the form of lower interest rates to borrowers.

16.7%	13.0%
Credit Cards National Average	LendingClub Borrowers Using Proceeds to Repay Credit Cards or Consolidate Debt

Source: Based on national credit card interest rates from creditcards.com and Lending Club loan originations in 2017-2020.

Expanded Access: Qualified but Underserved

Across Geographies — **Credit access is no longer restricted by physical proxmity to banks**

Research by the **Federal Reserve Bank of Philadelphia** has shown that alternative lenders make more loans in markets with fewer bank branches per capita and less bank competition.[1]

These are likely socioeconomically disadvantaged areas with less access to affordable credit from traditional banks. Lending platforms represent a valuable alternative in these underserved markets.

Across Borrower Segments — **New models enhance credit access across all race, ethnicity, and gender segments**

In partnership with the **Consumer Financial Protection Bureau**, Upstart conducted a study of its underwriting to assess the real-world impact of alternative data and machine learning.

Compared to a traditional model, their models:

- Approved 27% more applicants
- With 16% lower APRs

All tested race, ethnicity, and gender segments benefited, as well as low-income and younger applicants.

"The Bureau encourages lenders to develop innovative means of increasing fair, equitable, and nondiscriminatory access to credit, particularly for credit invisibles and those whose credit history or lack thereof limits their credit access."[2]

Alternative lenders are actively working to meet these goals, to make the opportunities enabled by fairly priced credit accessible to all.

Credit for Small Businesses

Credit is critical for businesses. Small businesses in particular have long been reliant on relationships with neighborhood banks to invest in and grow their businesses, which in turn strengthened the community.

With the waves of bank mergers in the 1990s and 2000s, local banks were gradually replaced by national banks. National banks favored lending to larger businesses and making larger, more profitable loans. Small businesses have faced chronic funding shortfalls, and their growth potential was often limited by the owner's personal savings or credit score.

56% Relied on personal savings, friends, or family for business funding

49% Received less financing than they applied for

Source: 2020 Small Business Credit Survey.

Technology Enables Lending Small

Lending small is harder than lending big — especially for banks relying on traditional paper-based, labor-intensive underwriting methods. But alternative lenders have leveraged technological and data advantages to profitably make smaller-dollar loans.

For example, Square has daily visibility into the cash flows of merchants who use their payment processing software. This data advantage enables them to economically underwrite flexible, small dollar loans that meet business owners' needs.

Technology Enables Agile and Inclusive Lending

Agile Lending — **Adapts to changing business conditions**

Data advantages have also enabled platforms to continue lending very selectively, rather than cutting off credit in broad strokes when COVID-19 hit. Square was able to continue lending to businesses in severely challenged industries (e.g., restaurants, tourism) because they could observe daily transactions and evaluate whether the particular business remained strong.

Inclusive Lending — **Expands access beyond traditional recipients of credit**

The ability to lend flexibly has enabled platforms like Square to expand credit to those who previously had less access:

85% of merchants live outside of 25 most populous US cities

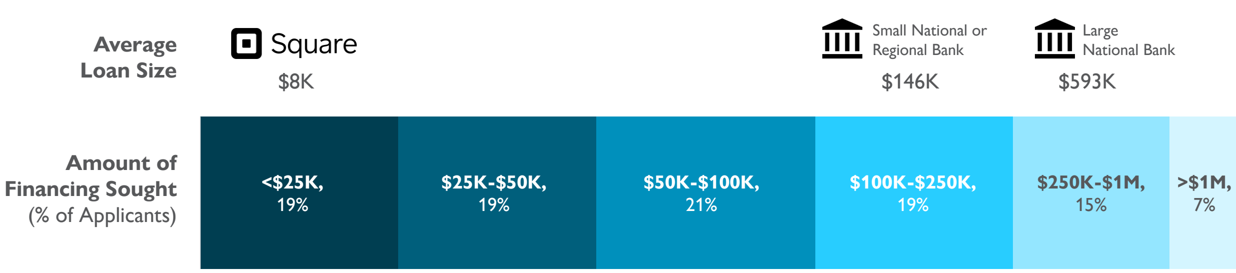
56% of loans to women-owned businesses (vs. 18% of traditional loans)

36% of loans to minority-owned businesses (vs. 27% of traditional loans)

Source: Square 2019 Corporate Social Responsibility Report

To date, investors have primarily evaluated alternative lending through an economic lens. The resilience of the asset class during the recent market disruption provided welcome validation.

We believe investors judging alternative lending by an even higher bar — having positive social impact — will increasingly recognize its role in expanding credit access and helping individuals, small businesses, and communities thrive.



Source: 2020 Small Business Credit Survey, Value Penguin, Stone Ridge.

Endnotes

1 Jagtiani and Lemieux, "Do Fintech Lenders Penetrate Areas That Are Underserved by Traditional Banks?" Federal Reserve Bank of Philadelphia working paper.

2 CFPB Blog, "An update on credit access and the Bureau's first No-Action Letter," 8/6/2019.

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