Scholedge International Journal of *Management & Development*
ISSN 2394-3378 Vol. 10, Issue 07 (2023)
DOI: https://dx.doi.org/10.19085/sijmd100701

Exploring Non-Banking Sources of Business Finance for Small Businesses: Pros, Cons, and Scholarly Insights

Satish Kumar
SKS Consulting & Advisors, India

Abstract

Financing is the foundation of any business, including small businesses, helping innovation, operational growth, and market differentiation while promoting business sustainability. Traditional banking has long been the primary source of funds for businesses, but small enterprises often face challenges like cumbersome eligibility requirements, insufficient collateral, or assets. All this has led to alternative financing methods like crowdfunding, peer-to-peer lending, trade credit, and venture capital. This study examines the benefits and drawbacks of these non-banking financing options, especially for small businesses, studying their potential availability to address the financial gaps small businesses face. By analyzing some of the academic theories and works, this study highlights how these alternatives of non-banking finance can promote financial inclusion and support entrepreneurial growth. This paper also analyzes the risks and other practical issues coming with the non-banking financing, including regulatory complexities, high-interest rates, and lack of financial diversity. Studying the existing literature and real-world implications of these sources, this study suggests a balanced perspective on how non-banking financial tools can complement or replace traditional sources of business finance, and what are the actionable takeaways for policymakers, lenders, and entrepreneurs.

Keywords: Non-banking financing, Small businesses, Financial performance, Entrepreneurship, Finance

Introduction

Startups and small businesses drive innovation, generate job opportunities, and promote growth across sectors of an economy. However, access to proper finance and funding to grow and sustain business operations is one of the most significant issues faced by enterprises, especially small and medium-sized businesses. Any startup seeking to grow and expand its operations needs to have easy access to capital for arranging resources, technology, marketing, and human resources vital for achieving market

Cite this article:

Kumar, S. (2023). Exploring Non-Banking Sources of Business Finance for Small Businesses: Pros, Cons, and Scholarly Insights. *Scholedge International Journal of Management & Development*, *10*(7), 85-94. https://dx.doi.org/10.19085/sijmd100701

competitiveness. This issue makes it important to review the traditional sources of funds available to small businesses, generally provided by the formal banking sector through loans and credit lines. However, the financial ecosystem for startups and small businesses has started changing significantly recently, as non-banking sources of business finance have emerged as sources of capital necessary for any small business.

Non-banking financing sources, such as funding by family and friends, crowdfunding platforms, peer-to-peer lending, venture capital, angel investors, and the use of trade credit, have increasingly emerged as alternatives to formal sources of banking finance for new startups and small businesses. These alternative non-banking financing sources provide small businesses with the flexibility to access a broad investor base and have access to competitive financing even from formal banking channels. The availability of non-banking financing has democratized the funding environment for small businesses, which have previously been suffering from overly complex regulatory and eligibility issues in accessing funding from formal banking sources.

This study aims to explore these non-banking financing sources for startups and small businesses. The analysis of this paper will help researchers further explore this area in the future, focusing on an analysis of advantages, disadvantages, and perspectives that different authors have suggested regarding these alternative sources of business finance. The paper seeks to increase existing awareness among entrepreneurs, policymakers, and other researchers by reviewing different dimensions of these non-banking financing sources and their effects on the growth, sustainability, and financial performance of startups and small businesses. This study further contributes value to the existing body of knowledge regarding non-banking financing sources available to small enterprises, with recommendations on how to evaluate the pros and cons of these alternative funding sources.

Traditional Financing vs. Non-Banking Financing

Traditional sources of finance for start-ups and small enterprises included bank loans, which have structured terms of repayment, collateral requirements, and interest rates dependent on creditworthiness. In contrast, alternative forms of financing loosen this rigidity, allowing access to a broad set of investors through crowdfunding, peer-to-peer lending, venture capital, and trade credit—collectively referred to as non-banking channels (Mandler and Scharnagl, 2019). Whereas traditional bank loans are directly related to an individual borrower and a lending financial institution, nonbanking channels more often facilitate funding through multiple investors or platforms.

Advantages and Disadvantages of Traditional Financing and Non-Banking Financing

Funding from traditional banking sources of business finance can provide a sense of security for both the small business and the lender, with stability and predictability of repayment schedules and interest rates. However, these loans have stringent requirements for collateral, credit history, and financial documentation that can be challenging to meet by startups or small businesses with limited assets or a lack of operational history. Opposite to this, non-banking sources of business funding are expected to provide entrepreneurs with easier access to funding with fewer restrictions. Crowdfunding, for example, allows a business to raise capital from a large number of individuals, while venture capital provides funding along with managerial expertise and networking opportunities (Pyka & Nocoń, 2021).

Like other sources of business funding, non-banking sources also have their own drawbacks. For instance, the interest rates associated with non-banking financing sources may be higher than those offered by banks, primarily due to the increased risk involved. Also, sources of non-banking financing lack the regulatory control and consumer protection systems that traditional banks are required to follow, which adds to borrowers' risk. The non-banking financing is also a time-consuming and competitive process, which requires startups and entrepreneurs to actively market their business ideas to potential investors (Shi, 2020).

The Role of Personal Finances in Early-Stage Funding

Personal finances typically constitute a significant part of early-stage funding for startups and small businesses, particularly where bank loans are unavailable. Consequently, most entrepreneurs utilize their savings, investments, or financial resources from family members and friends to establish a business. After showcasing the validation of their business idea, they approach external financing sources. This initial personal investment not only validates the commitment and trust of the founder in the business, but also reduces dependence on external equity or capital funding, which affords the startups or entrepreneur a greater control over the business and decision-making processes (Febriana, 2024).

The traditional bank financing offers stability and established financing procedures, while alternative non-banking sources of financing maintain a flexible nature for startups and small businesses. Entrepreneurs need to understand the advantages and disadvantages of each source of funding to evaluate the most appropriate funding source and effectively manage the various financing options available to their business. In the early stage of a startup, personal finances may act as a potential source of funding, complementing external funding resources and also demonstrating the owner's commitment to the validation of their business venture.

Pros and Cons of Non-Banking Financing Channels

Non-banking sources of business finance for small businesses have garnered significant attention in recent times, particularly when traditional banking institutions fail to fulfill the funding requirements of small enterprises. Promoters, Family & Friends, Crowdfunding, and CISA Lending represent several non-banking sources of small business finance. Each of these options offers its own advantages that promote flexibility, accessibility, and expedited approval processes. However, certain non-banking sources of business finance present potential drawbacks, including increased costs of borrowing and higher interest rates, complex regulatory requirements, and risks associated with informal lending schemes. This section examines the advantages and disadvantages of non-banking financing, explaining a balanced approach to guide small enterprises in successfully venturing out under alternative funding mechanisms.

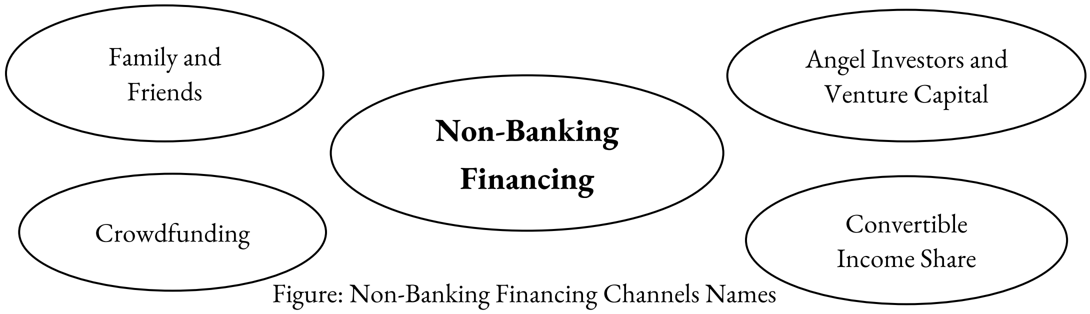

Figure: Non-Banking Financing Channels Names

Family and Friends

Pros: Accessibility, Flexibility, Emotional Support

According to Hussain (2024) friends and family become readily available sources of funds for both start-ups and small businesses, offering flexibility in terms of repayment terms and conditions preferable than the one that conventional bank loans provide. In this respect, this sort of informal source of capital provides appreciable emotional support to the entrepreneurs, thereby providing a sense of trust and brotherhood besides the financial transactions. Moreover, the family and friends could be in a position to take on more risks due to innovative business ideas, which would be rejected by traditional lenders as too hazardous or unconventional.

Cons: Strain on Personal Relationships, Lack of Formal Agreements

While there are benefits related to financing through family and friends, the relationship between a businessperson and personal acquaintances may be strained in case of business failures or when the payment schedule is not convenient. A typical feature of such cases is the informal nature of arrangements, with no formal agreement or other papers, which become x ground for disputes and misunderstanding regarding the nature of repayment, which may affect personal relationships (Hussain 2024). Moreover, the informal nature of these transactions may not duly provide legal protection or any redressal mechanism in case of disagreement or defaults.

Crowdfunding

Pros: Broad Reach, Validation, Community Engagement

Through crowdfunding websites, start-up ventures can connect with a huge audience of investors and supporters to validate their business ideas and engage in establishing a network of backers in connecting. According to Ngoc, 2022, By utilizing the power of social media and online platforms, a crowdfunding campaign provides a lot of noise and action around your business, securing finance but also receiving very useful two-way feedback and market validation.

Cons: Platform Fees, Competition, Unpredictable Outcomes

Crowdfunding is one way through which businesses can raise finances from large numbers of people; however, it usually has fees and charges that might substantially reduce the money raised, Ngoc, 2022. Since crowdfunding campaigns are very competitive, a business has to revisit strategies that can make it stand out among many projects competing for similar attention, and this may be tricky when trying to attract backers. Moreover, crowdfunding is not guaranteed to succeed because one cannot be sure whether the funding raised would reach the target or be continuous.

Angel Investors and Venture Capital

Pros: Expertise, Network, Substantial Funding

Angel investors and venture capital firms not only provide financing but also bring great value to a startup or small business through expertise, industry knowledge, and an extensive network (Moirangthem and Nag, 2021). Moreover, investors know how to scale businesses; they bring strategic advice, mentorship, and access to key partners and customers. The other benefit is that an angel investor and ventures are obviously sources of heavy funding that can allow a startup to grow and expand very rapidly.

Cons: Equity Dilution, Loss of Control

One major drawback for availing funds through angel investors and venture capital firms could be dilution of equity. Most of these investors demand ownership stakes in exchange for capital. Hence, because of external investors, the founders may very well lose control over strategic decisions or governance structure or even their exit strategy. In the quest for investments from angel investors and venture capital firms, entrepreneurs need to first consider this against loss of autonomy and ownership, in particular to the advantages accrued manifested in expertise and funding.

Convertible Income Share Agreements (CISAs)

Pros: No Equity Dilution, Flexible Repayment

Conventional equity investments CISAs are a differential alternative source of finance to traditional equity investment, with no equity dilution involved in raising finance for a startup (Mason & Stark, 2004). In the case of a CISA agreement, an investor receives a share of the revenue generated by a business for a stipulated period instead of owning its shares. It therefore creates a flexible structure of repayment commensurate with business income generation. It is essentially an alternative way of raising finance without giving up ownership or control of the company.

Cons: New Concept, Limited Awareness

Although the CISA financing model has several advantages, it is still a relatively new financing model and might therefore not be well understood or accepted by the investment community, as indicated by Mason and Stark in 2004. A lack of awareness of CISAs among investors and entrepreneurs could generally present problems regarding fund-raising. Laying the foundation for the popularization and scaling of CISAs will require education of stakeholders about what CISAs are and their many benefits, along with the building of trust in this alternative financing approach.

For a startup or small business seeking alternative sources of funds, success would depend on the ability to navigate a rather complex landscape of nonbanking financing options still available. This calls for understanding the pros and lack thereof that an individual funding option has and taking serious consideration of how these options best align with the growth strategy and financial needs of a business. By carefully weighing the pros and cons of these funding options, entrepreneurs can make well-informed decisions that will enable them to hit their financial objectives and be on the road to business growth.

Scholarly Research Findings on Non-Banking Financing

The availability of non-banking financing sources has gained significant scholarly attention, which has analyzed their impact on the growth of small enterprises and financial inclusion. Researchers have investigated the ways in which these non-banking financing sources serve the purpose of filling the gaps left by traditional banking institutions, particularly for small businesses in their early stages or those considered high-risk. The findings of these studies provide key information regarding the efficacy, challenges, and long-term impacts of non-banking financing sources, specifically in relation to entrepreneurial success, market dynamics, and regulatory frameworks. This section presents a synthesis of key scholarly studies, offering evidence-based insights that increase our understanding of these alternate financial products.

Empirical Evidence on Success Rates

The impact of non-banking financing sources on start-ups and small businesses has similarly been considered by researchers. Tuomi and Harrison, in their study in 2017, studied the equity crowdfunding in four countries regarding the implications for business angels. They identified a deficiency in balancing benefits and risks, which may lead to the misinterpretation of these financing sources. A recent study by Silver et al. (2016) demonstrated the role of crowdfunding in entrepreneurial startups, reflecting contemporary trends in Sweden and an ongoing condition of entrepreneurial financing. These studies thus emphasize the significance of comprehending the success rate and risk factors associated with non-banking financing sources to facilitate informed decision-making.

Impact on Business Growth

In the study, Huang (2023) pointed out the relationship between gender, external financing, and firm performance by proving that external financing acts as a positive mediator between entrepreneur's gender and business performance. Adelino et al. (2017) examined the role of firm age and investment opportunities in job creation and proposed that elements like organizational flexibility and innovativeness are factors instigating job growth within start-ups. These findings underline the role that external sources of finance can play in helping firms to scale their business and create jobs, and further support the need for access to finance from non-banking sources.

Risk Factors and Challenges

Berger and Udell (1998) examine the economics of small business finance in which they focus on the role of private equity and debt markets in the financial growth cycle. Their study of research and policy issues emphasizes the importance of addressing the risk factors and barriers in small business financing. Nigam et al. (2020) had further taken their study a step ahead by examining the importance of intellectual capital in financing startups adopting new business models and establishing significant relations with financing and various related characteristics of intellectual capital within the knowledge-intensive industry. These findings from those studies give an in-depth understanding of the issues and factors that need to be considered while continuing to tread nonbanking financing channels and reducing the risk associated with those for startups and small businesses.

Scholarly research results contribute significantly to knowledge about success rates, influence on business growth, and risks associated with non-banking financing channels for startups and small businesses. Empirical evidence on such alternative funding sources ought to be recognized so entrepreneurs, policy framers, and researchers can make knowledgeable decisions and navigate through incessantly changing realms of entrepreneurial finance. Scanning through the available research on academic financing and other empirical studies, therefore, remains the plausible contribution for stakeholders to gain more profound insight into the implications of non-bank financing arrangements and creative strategies that can be effectively explored toward such channels for continued growth and prosperity.

Case Studies and Examples of Successful Businesses Funded through Non-Banking Sources

Case Study 1: Uber - Venture Capital Triumph

Uber is one of the famous examples of companies that were quite successful with venture capital financing, an alternative financing channel compared to more traditional avenues for bank financing. Founded in 2009, Uber was the first company to transform transportation by offering a ride-hailing service that connects drivers and passengers through a mobile app. Thus, heavy investments from venture capital firms, whose investment went beyond just money and also provided expertise, networking, and strategic direction, supported fast growth and international expansion of the company, according to Kashyap & Stein, 1995.

Analysis and Outcomes

The collaboration of Uber with venture capital investors did help in scaling the operations, entering new markets, and enhancing service offerings. However, the inflow of venture capital also leads to equity dilution and loss of founders' control since the investors are active participants in shaping strategic decisions and governing structures, as argued by Kashyap & Stein, 1995. Notwithstanding, if it weren't for some form of equity financing, such as venture capital, the chances are that the success story of Uber may not have materialized.

Case Study 2: Patagonia - Family and Friends Support

One such example of a successful company whose seed fund sources include families and friends is Patagonia, which is an outdoor apparel manufacturer. In 1973, Patagonia was founded by Yvon Chouinard and financed initially with money lent by his family and friends for the then-start-up to realize its state-of-the-art climbing gear line, as indicated by Isa et al. in 2019. That initial financing turned out to be quite a stepping stone towards turning Patagonia into that influential, environmentally responsible outdoor apparel manufacturer.

Analysis and Outcomes

The Patagonia experience proves that a company can grow out of the seed provided by family and friends to meet its matching and creating great business and social impacts. While the ease of access to this source of funds and the flexibility involved are quite beneficial, the nature of these relationships is usually informal, which could have stretched personal relationships or made formal arrangement agreements difficult to put into place whenever necessary (Isa et al., 2019). While the support from family and friends was instrumental—that is, gave it the necessary resources and motivation that helped drive forth its vision of creating environmentally conscious high-quality products—the informal arrangements, however, could have strained personal relationships or caused problems in formalizing agreements. Yet, despite all odds, it is a classic example of how much businesses benefit from early-stage support from family and friends.

The cases illustrate how different financing avenues opened up the possibility that businesses could succeed outside traditional bank financing channels. These options bring very different benefits, challenges, and results—all illustrated by the quite disparate outcomes awaiting those who seek crowdfunding, venture capital, and family and friend support. Such real-world examples can be of critical help to an entrepreneur seeking insights into how to maneuver through the labyrinthine and constantly changing world of nontraditional finance to power his own entrepreneurial ventures.

Conclusion

Scholarly research has revealed the opportunities and accompanied challenges with the non-banking financing sources and how these sources of finance play a role in promoting early-stage startups and small businesses. These alternative finance sources, like crowdfunding, venture capital, and family and friends, play a critical role as the seed money for entrepreneurial ventures. The empirical evidence underlined the influence of external finance on business growth, performance, and innovation within startups and small businesses.

The research results have significant lessons for entrepreneurs; every entrepreneur who is determined and proactive to scale their businesses must explore various sources of finances, including the non-banking sources of funds. The options outside formal banking can provide capital, competence, and networking opportunities beyond what traditional banking institutions can offer. It is, therefore, imperative that entrepreneurs understand the pros and cons associated with alternate sources of finance and make decisions aligned with their business's vision and development plans.

Policymakers can facilitate a favorable regulatory framework for innovation, entrepreneurship, and access to capital among start-ups. Policymakers can help create an environment that addresses the diverse funding needs of small businesses and promotes financial inclusion within the entrepreneurship and small business ecosystem.

Although the existing literature has contributed significantly to the subject of reviewing non-banking financing sources for small businesses, it remains an explorable area for future research. Future studies need to differentiate various alternative financing channels, such as equity crowdfunding, peer-to-peer lending, and initial coin offerings, and to understand their differential impacts on startups and small businesses (Bertoni et al., 2021). There has been found a relationship between corporate governance, financing risk, and performance of banks in developing economies, which can further offer valuable inputs to practitioners and policymakers. (Mutamimah & Saputri,2022).

Stakeholder analysis of alternative sources of financing, mitigation of risk factors, and examination of early-stage business models will increase knowledge on entrepreneurial finance for sustainable growth and success of startups and small business ecosystem. Future research should focus on the impact of these alternate funding sources on the small businesses and explore and suggest more favorable methods of making them as recognized as other formal sources of business finance. This can help in minimizing the legal risks for both the lenders and well as the funding seeking startups and small businesses.

References

Adelino, M., Ma, S., & Robinson, D. (2017). Firm age, investment opportunities, and job creation. The Journal of Finance, 72(3), 999-1038. https://doi.org/10.1111/jofi.12495

Berger, A. and Udell, G. (1998). The economics of small business finance: the roles of private equity and debt markets in the financial growth cycle. Journal of Banking & Finance, 22(6-8), 613-673. https://doi.org/10.1016/s0378-4266(98)00038-7

Bertoni, F., Bonini, S., Capizzi, V., Colombo, M., & Manigart, S. (2021). Digitization in the market for entrepreneurial finance: innovative business models and new financing channels. Entrepreneurship Theory and Practice, 46(5), 1120-1135. https://doi.org/10.1177/10422587211038480

Febriana, A. (2024). Analyzing the influence of bank competition on credit risk: perspectives from indonesia's dual banking system. Jurnal Ekonomi Kuantitatif Terapan, 17(1), 52. https://doi.org/10.24843/jekt.2024.v17.i01.p04

Giordana, G. and Schumacher, I. (2013). Bank liquidity risk and monetary policy. empirical evidence on the impact of basel iii liquidity standards. International Review of Applied Economics, 27(5), 633-655. https://doi.org/10.1080/02692171.2013.778821

Huang, L. (2023). Gender, external financing and firm performance: evidence from chinese private firms. Gender in Management an International Journal, 39(3), 370-387. https://doi.org/10.1108/gm-10-2021-0322

Hussain, M. (2024). A critical study of startup financing dynamics and emerging approach to attracting capital resources. Journal of Corporate Finance Management and Banking System, (44), 1-14. https://doi.org/10.55529/jcfmbs.44.1.14

Isa, M., Latif, R., Zaharum, Z., Nasrul, F., & Noh, M. (2019). Internal factors influencing commercial banks' lending behaviour in malaysia. Advanced International Journal of Banking Accounting and Finance, 1(1), 48-58. https://doi.org/10.35631/aijbaf.11005

Kashyap, A. and Stein, J. (1995). The impact of monetary policy on bank balance sheets. Carnegie-Rochester Conference Series on Public Policy, 42, 151-195. https://doi.org/10.1016/0167-2231(95)00032-u

Mandler, M. and Scharnagl, M. (2019). Bank loan supply shocks and alternative financing of non-financial corporations in the euro area. SSRN Electronic Journal. https://doi.org/10.2139/ssrn.3473018

Mason, C. and Stark, J. (2004). What do investors look for in a business plan?. International Small Business Journal Researching Entrepreneurship, 22(3), 227-248. https://doi.org/10.1177/0266242604042377

Moirangthem, N. and Nag, B. (2021). Value-added activities of venture capitals in entrepreneurial finance: evidence from the growth of flipkart. Asian Journal of Management Cases, 21(1), 57-68. https://doi.org/10.1177/0972820121998120

Mutamimah, M. and Saputri, P. (2022). Corporate governance and financing risk in islamic banks in indonesia. Journal of Islamic Accounting and Business Research, 14(3), 436-450. https://doi.org/10.1108/jiabr-09-2021-0268

Ngoc, N. (2022). Financial resources for innovative startups – studies in emerging economies and trends for studies in vietnam. International Journal of Management & Entrepreneurship Research, 4(11), 458-468. https://doi.org/10.51594/ijmer.v4i11.404

Nigam, N., Mbarek, S., & Boughanmi, A. (2020). Impact of intellectual capital on the financing of startups with new business models. Journal of Knowledge Management, 25(1), 227-250. https://doi.org/10.1108/jkm-11-2019-0657

Pyka, I. and Nocoń, A. (2021). Responsible lending policy of green investments in the energy sector in poland. Energies, 14(21), 7298. https://doi.org/10.3390/en14217298

Shi, Z. (2020). Credit versus online loans: a case study from china. Journal of Management and Humanity Research, 3, 1-8. https://doi.org/10.22457/jmhr.v03a01101

Silver, L., Berggren, B., & Fili, A. (2016). The role of crowdfunding in entrepreneurial ventures: an analysis of recent trends in sweden. Investment Management and Financial Innovations, 13(1), 221-229. https://doi.org/10.21511/imfi.13(1-1).2016.09

Tuomi, K. and Harrison, R. (2017). A comparison of equity crowdfunding in four countries: implications for business angels. Strategic Change, 26(6), 609-615. https://doi.org/10.1002/jsc.2172