This was originally published on boostcapital.co.uk, which is no longer available.

HOW DO BUSINESS LOANS WORK?

Whatever industry you're in, your business needs money to function. But small businesses in particular often struggle with cash flow.

In fact, according to research by the Asset Based Finance Association (ABFA), seven out of 10 small business owners cite cash flow as being their number one threat.

With a shortage of funds, your business might not be able to make the investments it needs to make in order to grow or expand. These investments can include anything from replacing stock or machinery, to hiring and training new staff for an upcoming busy period.

A business loan can help by giving you a much-needed injection of cash. But how do they actually work and what are the different types of business loan?

In this guide, we'll cover everything to do with business loans – and other kinds of business finance too.

If you want to apply for a business loan from Boost Capital, visit this page.

CONTENTS

WHAT IS A BUSINESS LOAN?

Put simply, a business loan is an amount of money which is lent to a business and repaid over a period of time. The business repays the total amount they've borrowed (which is called the principal) plus interest.

The interest is generally worked out as a percentage of the total amount the business borrows. For example, if a business borrows £10,000, the lender might charge an interest rate of 30% - meaning the business will have to repay £13,000 in total (£10,000 + £3,000).

The interest rate can be either fixed – meaning it doesn't change throughout the term of the loan – or variable – which usually means it goes up and down depending on market interest rates (for example, the Bank of England base rate).

Some lenders might also charge extra fees for administration or early repayment on top of the total repayment amount.

These fees usually include:

- **Origination fee** – Origination is the term used to refer to the creation of a loan. An origination fee covers the cost involved in this process. It's usually added to the total repayment amount and worked out as a percentage of the principal (the amount the business borrows). It may also be called an arrangement fee.
- **Servicing or processing fees** – These fees are usually charged to cover the costs to the lender for managing your loan over the course of its term. The fees might be rolled up into the total repayment amount or charged at regular intervals.
- **Early repayment fee** – Some lenders will charge you a fee or a penalty for repaying your loan early. This is because, in some circumstances, paying the loan early means the lender will get less interest. So they charge an early repayment fee to make up for this loss (and to discourage you from repaying early in the first place).
- **Late payment fee** – When you take out a loan, you'll agree with the lender to stick to a regular repayment schedule. If you miss a repayment date and pay late, most lenders will charge a penalty fee.

Each lender will have their own fee structure and this should be explained to you before you take the loan out. The lender will usually send you a contract to read through and sign. Make sure you read the contract carefully so you know what fees might be owed in what circumstances.

Back to top

WHAT ARE THE DIFFERENT TYPES OF BUSINESS LOAN?

"Business loan" is a broad term which can refer to a number of different types of business finance, which all work in different ways.

Some of the most common types include:

- **Asset finance** – With asset finance, you can borrow money either based on an asset your business owns or to buy an asset for your business
- **Bridging loans** – Bridging loans are designed to give you quick access to capital until you can arrange more permanent finance (for example, when you're planning to bid for a property at an auction)
- **Invoice finance –** Invoice finance lets you borrow the money your customers owe you but haven't paid back yet (called accounts receivable)
- **Merchant cash advance –** A merchant cash advance is a lump sum which you repay as a percentage of your future daily card takings
- **Peer-to-peer lending –** Peer-to-peer lending works by letting you borrow one lump sum which has been lent from a number of different individuals
- **Term loan –** A term loan is a lump sum which is lent to a business and repaid over a fixed period of time

Generally speaking, when we use the term 'business loans' at Boost Capital, we're talking about term loans. And that's what we'll be focusing on for the rest of this article.

If you want to learn more about different types of business finance, check out our knowledge centre.

Back to top

WHAT TYPE OF LENDERS OFFER BUSINESS LOANS?

There are two main types of lender which offer business loans:

- **Banks** – Traditionally, businesses got their loans from the same bank which provided their current account. But since the financial collapse in 2008, banks are increasingly reluctant to lend to small businesses. The application process for bank loans tends to be complicated, involving lots of documents and long waiting times.
- **Alternative lenders**: An alternative lender is basically any lender that's not a bank. They're relatively new and increasing in popularity. Getting a business loan from an alternative lender tends to be much faster than from a bank, usually because they use technology or artificial intelligence to underwrite the loan. Their eligibility criteria is also likely to be less restrictive than the banks'. Boost Capital is an alternative lender.

Back to top

WHAT'S THE DIFFERENCE BETWEEN SECURED AND UNSECURED LOANS?

An important distinction between different business loans is whether they're secured or not. In this context, security refers to an asset which you or your business owns.

- **Secured loans** – A loan is secured when you need to offer an asset as collateral. This means that if you can't pay the loan back, the lender can take the asset from you instead. An asset used as security could be your home or business premises. Because the lender has the added reassurance that they can repossess the asset when you can't repay, they tend to charge a lower rate of interest. This is because there's less risk to them. However, if you don't own your own home or business premises, a secured loan might not be an option. You might also be unwilling to put your assets at risk of repossession to get hold of finance.
- **Unsecured loans** – With an unsecured business loan, you don't need to offer an asset as collateral at all. Because the lender doesn't have any assets to fall back on if you can't repay, unsecured loans are higher risk for them and tend to cost more. However, sometimes they're the only option if you don't own your own home or if you lease your business premises.

Back to top

HOW LONG ARE THE TERMS ON A BUSINESS LOAN?

The term of a loan is the length of time it takes for you to repay it. Business loans can broadly be split into long-term and short-term:

- **Long-term** – A long-term loan usually lasts for two or more years. Because you're repaying the loan over a longer period, the individual repayment amounts are usually lower. However, you might end up paying more in total. You could also be paying the loan off for years to come, which can limit your access to further finance when you need it.
- **Short-term** – A short-term loan can be anything from a few months to just under two years. The repayments on a short-term loan might be higher than a long-term loan but you'll pay it off much quicker.

Back to top

WHAT'S THE TYPICAL INTEREST RATE FOR A BUSINESS LOAN?

Interest rates for business loans can vary wildly, depending on the type of loan you take out as well as the specific circumstances of your business and the industry you're in.

There are also different ways of measuring the interest rate:

- **Annual interest rate** – This is how much interest you'll pay over the course of a year expressed as a percentage
- **Monthly interest rate** – This is how much interest you'll pay each month expressed as a percentage
- **Annual percentage rate (APR)** – The APR is similar to the annual interest rate but it also includes any additional costs and fees

Long-term loans tend to have lower annual interest rates than short-term loans. However, the total amount you pay back may actually be higher.

The average interest rate for a long-term business loan from a bank tends to be around 8-12%. The average interest rate for a short-term loan from an alternative lender tends to be around 30-55%.

Back to top

WHAT CAN YOU USE A BUSINESS LOAN FOR?

Depending on the lender, there may be restrictions on what you can use the funds for. In general, though, the most common reasons businesses take out a loan include:

- To replace stock or buy in bulk to make savings
- To replace or repair equipment or machinery
- To hire new or train existing staff
- To launch a marketing campaign
- To relocate to new premises
- To pay off existing debts
- To pay an upcoming tax bill

Some lenders will ask you up-front what you plan to use the funds from the loan for. They can then use this in their decision on whether or not to let you borrow the money as well as what terms or stipulations might apply to the loan.

We wrote about the various things you can use a business loan for here.

Back to top

CAN I USE A BUSINESS LOAN FOR PERSONAL EXPENSES?

In most cases, lenders will place restrictions on what you can use the loan for. In these cases, it's unlikely you'll be able to use a business loan for personal expenses.

If this is the case, and the lender finds out that you're using it for personal reasons, they may call in your loan and demand that you pay it in full.

We wrote about the main differences between personal loans and business loans.

Back to top

WHAT'S THE ELIGIBILITY CRITERIA?

Before a lender will let you take out a loan, they'll want to be as sure as they can possibly be that you're likely to repay it. If they didn't do this, their default rates (the number of customers who aren't able to repay their loans) will go up and they'll lose money.

For this reason, all lenders will have certain criteria which you'll need to meet in order to be approved.

The criteria can vary from lender to lender, but it usually includes things like:

- **Time in business** – For example, they might only allow business who have been trading for three years or more to apply
- **Annual turnover** – They might only let business who have an annual turnover of £70,000 to apply
- **Credit score** – Some lenders might use your personal or business credit score as lending criteria
- **Business type** – Whether you're a sole-trader, partnership or limited company may also determine your eligibility
- **Industry** – It might also make a difference depending on the industry your business is in. For example, some lenders might exclude transport businesses

Back to top

WHAT ARE THE REASONS A BUSINESS LOAN APPLICATION CAN BE REJECTED?

There are a number of reasons a lender might reject your application for a business loan, including:

- Your business hasn't been trading for long enough
- Your personal or business credit score is too low
- Your business doesn't have a high enough turnover
- Your business has a weak cash flow
- The lender disapproves of your intended use for the funds
- You're in a restricted or risky industry
- You don't have any assets to offer as security (for secured loans only)
- You already have other, similar loans (this is called stacking)
- The lender doesn't have enough information to make a decision

Back to top

HOW DOES THE APPLICATION PROCESS WORK?

Every lender has their own application process with different steps and pieces of information that are required. They can also vary in speed – some applications can be completed in a matter hours, whereas some might take days or weeks.

In general, though, the application process works as follows:

1. **Initial application** – You'll usually either apply direct to the lender or through a broker. The lender will ask for certain pieces of information up-front, such as how much you want to borrow, your personal details and details about your

business. They may also ask you to send supporting documents with your application.

2. **Underwriting** – Once the lender has the information they need, they'll start the underwriting process. Here, the lender will assess how risky it will be to give you a loan. If they're unsure about something, they might ask you for more information. They will either approve or reject your application. In some cases, they might lay down additional stipulations which you'll need to comply with in order to be approved.
3. **Offer** – If your business was approved in the underwriting stage, the lender will make an offer to you. This will usually consist of how much the lender is willing to let you borrow, along with your total repayment amount, interest rate and a repayment schedule. It will also include any stipulations that may have been added at the underwriting stage. It will then be up to you to accept or reject the offer.
4. **Contract signing** – Once you've accepted the offer, you'll need to read and sign a contract. You should make sure you read the contract in detail to make sure you understand what it is you're agreeing to. Once signed, the contract will become legally enforceable so you must make sure you know what you're getting into. If you're in doubt, get a solicitor to check it over for you.
5. **Funding** – When the contract's signed, the lender will transfer the funds over to you. This is usually done as a lump sum in your business's bank account. You'll usually need to start paying off your loan within a month of receiving the funds, but this depends on the repayment schedule you've agreed.

Back to top

HOW DO THE REPAYMENTS WORK?

The repayment structure will vary depending on the lender and the product. But in most cases, you'll repay the loan plus interest in monthly chunks. This is usually taken as a direct debit on a certain schedule – for example, on or around the 1st of the month.

The repayments are usually fixed, but with some lenders, they might slowly reduce as you pay off the loan.

With Boost Capital, you can choose to repay your loan in fixed daily or weekly repayments. Breaking them down into smaller, more regular chunks like this allows them to blend into your business's cash flow and can make them more manageable.

Back to top

WHAT HAPPENS IF YOU WANT TO REPAY THE LOAN EARLY?

Business loans are designed to be paid off over the loan's term but some lenders may allow you to pay it off early. In some cases, you might have to pay an early repayment fee – so make sure you check with the lender first.

At Boost Capital, we allow you to repay your loan early. And in some cases, you may be eligible for a small discount on the remaining repayments.

Back to top

WHAT HAPPENS AFTER I'VE PAID MY BUSINESS LOAN OFF?

After you've paid your loan off, the lender will probably send you a confirmation email or letter. This might include a statement showing a breakdown of much you've paid in total.

If you need more finance, you may be able to reapply with the same lender. Providing you paid your loan off on time and in full, they may be able to offer you a competitive interest rate.

Back to top

WHERE DO LENDERS GET THEIR MONEY FROM?

In order to lend money to businesses, the lender needs to have that money in the first place. Depending on the type of lender, the money can come from a few different sources.

Banks can use the money they already have in their control. This usually comes from the cash their customers have stored in their current or savings accounts.

But some lenders might also borrow the money from someone else, usually paying their own interest rate on that sum themselves. They might also get money from investors who take a percentage of the profit made by the lender.

Back to top

ARE BUSINESS LOANS REGULATED?

It depends on the amount of the loan and the type of business.

Because of the Consumer Credit Act, lenders must be regulated by the Financial Conduct Authority to lend £25,000 or less to sole traders or small partnerships (of three people or fewer).

However, it's not currently mandatory for lenders to be regulated when they provide business loans above £25,000 or business loans of any amount to larger partnerships (of more than three people) and limited companies registered with Companies House.

Despite this, some commercial lenders have signed up to regulation voluntarily.

Whether commercial lending regulation should be mandatory or not is a controversial political issue which is still being debated.

Back to top

RELATED ARTICLES

Here are some related articles if you want to read more about the different aspects involved in getting a business loan:

- Business loan FAQs (specific to Boost Capital small business loans)
- Why business loan interest rates aren't everything
- 5 reasons banks don't lend to small businesses any more
- Do you have to be a homeowner to get a business loan?
- What credit score do you need to have to be eligible for a business loan?
- What can you use a business loan for?
- What if you can't pay your business loan back?