Get ready to ramp up small business lending: Do this, not that

Dos and don’ts for building and updating SMB loan policies

Financial institutions must take calculated risks to drive growth, and small business lending presents a unique opportunity to expand market reach. However, creating new loan policies and processes can be challenging for banks and credit unions who haven’t focused on this sector before or are automating small business lending for the first time. A structured approach to preparing for small business lending will enhance efficiency, mitigate risk, and drive successful implementation.

Do assess existing capabilities

Many FIs focus primarily on recruiting or identifying experienced small business lenders to grow the portfolio quickly, and staffing is important. However, a critical first step to an efficient, profitable process is assessing existing infrastructure to proactively ensure their organizations will support small business lending. The fastest-growing small business lenders automate the process, but before considering small business loan origination software, financial institutions should:

- **Engage key stakeholders.** Small business lending requires buy-in from leadership, loan officers, risk management, compliance teams, and IT.
- **Identify critical gaps.** If a financial institution doesn't already have a lending policy tailored to SMBs or lacks credit expertise in underwriting small business loans, it will be difficult to grow this side of the portfolio efficiently.
- **Evaluate current lending technology and workflows.** Since small business loans often carry smaller balances than larger commercial loans, lenders need an origination process that makes small business loans a more profitable undertaking. If a $50,000 loan goes through essentially the same underwriting process as a $5,000,000 loan, the cost of originating the small loan may outweigh the benefit.

Don’t apply existing policies to small business loans

It can be tempting for financial institutions to apply their existing commercial lending policies to small business loans, but this can lead to inefficiencies and added risk. A few reasons why commercial policies fall short include:

- **Complexity of documentation:** Small businesses lack the extensive financial history required in commercial lending.
- **Underwriting speed**: Traditional commercial loan underwriting can take weeks, whereas small business lending must be fast and automated where possible to meet customer expectations and compete with fintechs.
- **Collateral requirements:** Small business borrowers often have fewer assets to pledge as collateral compared to commercial clients, requiring more flexible lending criteria. An SMB lending policy must reflect this difference in collateral according to the bank’s risk tolerance.

Don’t assume what works for consumer lending works for small business loans

Many FIs expect they can use their existing consumer loan policy and LOS for small business loans. That might be especially tempting for credit unions that historically have concentrated most efforts on consumer loans. But the reality is that small business lending involves critical differences that traditional consumer loan origination systems are not designed to assess, such as:

- **Data differences:** Consumer LOS platforms don’t typically incorporate business-specific factors like revenue, cash flow, and operational risks. FIs using a consumer LOS for small business loans may end up relying on manual workarounds to account for this data, adding unnecessary delays, increasing operational costs, and introducing risks tied to human error.
- **Structuring differences:** Consumer LOS platforms lack the flexibility needed to structure loans with the customized terms and repayment options that small businesses require.
- **Risk evaluation differences:** Unlike consumer loans, which rely on personal credit scores and income, small business loans require an assessment of both personal and business financials.
- **Compliance differences:** Regulations for small business loans differ from those for consumer loans. The CFPB 1071 rule, if it remains on the books, will require different reporting for FIs that process at least 100 covered SMB loan types in each of the 2 preceding calendar years. Credit unions must comply with member business lending regulations, which may impose stricter guidelines on small business lending than traditional consumer lending.

Do ensure an effective small business lending policy

Banks and credit unions looking to revamp or write a new small business lending policy should use the checklist below to ensure a comprehensive policy document:

Portfolio guidelines, policy thresholds, and ranges

- List structure and underwriting requirements
- Define product mix and decisioning criteria
- Simplify small business loan underwriting criteria and eliminate unnecessary documentation
- Remove excessive approval layers
- List off-balance sheet loan products
- Include loan pricing according to the level of risk accepted
- Summarize legal lending limits and in-house limits, including state regulatory limits
- Name loan to deposit, loan to capital, loan to asset, and loan mix targets
- Include regulatory guidelines on credit concentrations

Roles and responsibilities

- Note the duties of all involved in lending and credit risk
- Describe loan authority and approval processes
- Specify the roles of internal loan committees and board committees and reduce where possible

Risk grading and policy exceptions

- Describe the process for downgrading loans
- Describe risk ratings and characteristics
- Describe types of acceptable exceptions and note how they will be monitored and documented
- Note who will approve policy exceptions
- Consider alternative portfolio monitoring metrics to reduce time spent during manual annual reviews

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