Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers

The federal financial institutions regulatory agencies[1] and the state supervisors [2] (collectively, the "regulators") are issuing this *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* (the "Statement") to restate and elaborate their supervisory views on prudent lending to creditworthy small business borrowers.[3] This Statement builds upon principles in existing guidance, including the November 2008 *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* and the October 2009 *Policy Statement on Prudent Commercial Real Estate Loan Workouts*. The regulators note that while the October 2009 statement focused on commercial real estate, many principles articulated in that guidance are applicable to small business lending.

Some small businesses are experiencing difficulty in obtaining or renewing credit to support their operations.[4] Between June 30, 2008, and June 30, 2009, loans outstanding to small businesses and farms, as defined in the Consolidated Report of Condition (Call Report), declined 1.8 percent, by almost $14 billion.[5] Although this category of lending increased slightly at institutions with total assets of less than $1 billion, it declined over 4 percent at institutions with total assets greater than $100 billion during this timeframe. This decline is attributable to a number of factors, including weakness in the broader economy, decreasing loan demand, and higher levels of credit risk and delinquency. These factors have prompted institutions to review their lending practices, tighten their underwriting standards, and review their capacity to meet current and future credit demands. In addition, some financial institutions may have reduced lending due to a need to strengthen their own capital positions and balance sheets.

Supervisory Expectations

While the regulators believe that many of these responses by financial institutions are prudent in light of current economic conditions and the position of specific financial institutions, experience suggests that financial institutions may at times react to a significant economic downturn by becoming overly cautious with respect to small business lending. Regulators are mindful of the harmful economic effects of an excessive tightening of credit availability in a downturn and are working through outreach and communication with the industry and supervisory staff to ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound small business borrowers. Financial institutions that engage in prudent small business lending after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for loans made on that basis.

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[1] The federal financial institutions regulatory agencies consist of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, and the National Credit Union Administration (collectively, the "agencies").

[2] The state supervisors are represented through the Conference of State Bank Supervisors.

[3] Financial institutions should apply the principles of this Statement in accordance with their internal definitions of small business loans or as appropriate in their loan portfolios. Small business lending includes loans to small businesses and farms, such as working capital lines of credit, secured and unsecured term loans, as well as unsecured revolving credit.

[4] Responses to the Federal Reserve Board's Senior Loan Officer Opinion Survey indicate that the net fraction of banks that tightened credit standards and terms on C&I loans to small firms was very high in 2009, and exceeded its previous highs in the past twenty years.

[5] The data is for commercial banks, where small business loans, as reported in the Call Report FFIEC 031 and 041, schedule RC-C, part II are defined as loans with original amounts of $1 million or less that are secured by nonfarm nonresidential properties or commercial and industrial loans plus loans with original balances of $500,000 or less for agricultural production or secured by farmland.

Underwriting and Risk Management Considerations

An institution should understand the long-term viability of the borrower's business, and focus on the strength of a borrower's business plan, including its plan for the use and repayment of borrowed funds. The institution should have an understanding of the competition and local market conditions affecting the borrower's business and should not base lending decisions solely on national market trends when local conditions may be more favorable. Further, while the regulators expect institutions to effectively monitor and manage credit concentrations, institutions should not automatically refuse credit to sound borrowers because of a borrower's particular industry or geographic location. To the maximum extent possible, loan decisions should be made based on the creditworthiness of the individual borrower, consistent with prudent management of credit concentrations.

For most small business loans, the primary source of repayment is often the cash flow of the business, either through the conversion of current assets or ongoing business operations. An institution's cash flow analysis should cover current and expected cash flows, and reflect expectations for the borrower's performance over a reasonable range of future conditions, rather than overly optimistic or pessimistic cases. Many small business borrowers also rely on their personal wealth and resources to support loan requests. A borrower's credit history and financial strength, including credit score, are components of assessing willingness and ability to repay, and should be considered in conjunction with other judgmental factors, such as the strength of management. The loan structure should be appropriate for meeting the funding needs of the borrower given the type of credit and expected timing of the business' cash flow. Further, an institution should analyze the secondary sources of repayment, such as the strength of any guarantor or collateral support, and the ability of the borrower to provide additional capital. Institutions should not place excessive reliance on cyclical factors, such as appreciating or depreciating collateral values.

An institution should have robust risk management practices to identify, measure, monitor, and control credit risk in its lending activities. Further, institutions should promote a credit culture in which lenders develop and maintain prudent lending relationships and knowledge of borrowers. This culture should encourage lending staff to use sound judgment during the underwriting process. While institutions may use models to identify and manage concentration risk, portfolio management models that rely primarily on general inputs, such as geographic location and industry, should not be used as a substitute for the evaluation of an individual customer's repayment capacity.

Examination Reviews

Examiners will not discourage prudent small business lending by financial institutions, nor will they criticize institutions for working in a prudent and constructive manner with small business borrowers. Examiners will expect institutions to employ sound underwriting and risk management practices, maintain adequate loan loss reserves and capital, and take appropriate charge-offs when warranted. As with all lending, examiners are expected to take a balanced approach in assessing the adequacy of an institution's risk management practices in its small business lending activities. As a general principle, examiners will not adversely classify loans solely due to a decline in the collateral value below the loan balance, provided the borrower has the willingness and ability to repay the loan according to reasonable terms. In addition, examiners will not classify loans due solely to the borrower's association with a particular industry or geographic location that is experiencing financial difficulties.