Fourth Quarterly Report from John Trethowan, Credit Reviewer

This is my fourth quarterly report on the activity of the Credit Review Office, and the market conditions observed in the work performed in the reviews and target monitoring.

My first and second reports outlined my observations on the issues on credit availability both on the supply side by the two main banks, and on the demand side by borrowers for bank lending. My third report detailed the responses AIB and BoI are making to:
a) increase market confidence that they are open for business, and
b) to address skill deficits in cashflow lending following a period of extensive staff movements.
These reports can be found on the Credit Review Office website www.creditreview.ie
This fourth report moves on to look at what steps are required to support businesses through a recovery stage.

Credit Review Office Activity

	Application Rec'd but held at Office until eligibility confirmed with Bank	Application Received and proceeding through Review process	CRO Decision			Total
20/05/2011			Banks' Credit Decision Upheld	Bank's Credit Decision Disputed / Bank Subsequently Provided Credit	More work required by Borrower and Bank or withdrawn by customer	
AIB	9	6	11	11	3	40
BoI	4	6	11	12	3	36
Total	**12**	**12**	**22**	**23**	**6**	**76**

Formal Appeals	Banks' Credit Decision Upheld	Jobs		Bank's Credit Decision Disputed / Bank Provided Credit	Jobs protected
Total Numbers	**1,633,835**	**130+7p/t**		**€1,777,300**	**210+13p/t**
AIB	€574,082	73+7p/t		€685,300	121+5p/t
BoI	€1,059,753	57		€1,092,000	89+8p/t

(I have also shown the Credit Review Office year end activity for the reporting period until the 1st April 2011 at the foot of this paper).

Outcomes of Banks' Formal Internal Appeals

April to April 2010 2011	Bank's Decision Upheld	Overturned/ Sanctioned with Conditions	Work in Progress	Ineligible/ Withdrawn By borrower	Total
AIB	70	33	12	4	119
BoI	102	7	0	0	109
Total	172	40	12	4	228

Helpline/ Web Activity

- The helpline has taken 823 calls to date.
- The website has had 7,518 visitors since inception. These web visitors have made 10,133 visits.

Demand for the Credit Review Office formal appeals process remains steady and the helpline continues to receive numerous calls which result in some cases and issues for SMEs being resolved without recourse to formal appeals.

I have taken the learnings of the past twelve months operations, and responded to comments on the Credit Review Office service, by implementing two improvements to the process over the past few months:
(i) In response to the criticism that the reviewers are all ex-bankers reviewing bank lending performance, every review is attended by my office manager, who is an experienced public sector business analyst, as a non banker panellist.
I have also established a separate panel of experienced non-bankers to separately overview any appeals upheld in the banks' favour. These panellists include a Chartered Accountant, and senior staff from an SME trade body, and from a County Enterprise background.
I am very clear that the mission of the Credit Review Office is to assist viable borrowers to obtain credit. The nature of the credit reviews is to seek to make an acceptable banking deal from a challenging set of circumstances; such deal seeking is best performed by experienced bank lenders.

(ii) I have redesigned the review process application forms to minimise the time and effort required by borrowers to have a credit refusal appealed. The application form is now shortened to basic questions on a pro-forma. Credit Review Office staff will then obtain the information required for the review from the applicants' banks, and have this subsequently agreed with the borrower in due course. These overviews have not reversed any of the opinions.

Where businesses consider themselves viable now or into the future and have been refused new or additional credit, the Credit Review Office is here to help. This is a borrower driven process, so the initiative to contact the Credit Review Office is with those SME principals which have been declined credit. To ensure that eligible SMEs are aware of the service, all AIB and BoI borrowers who are eligible are advised of the banks' internal appeal process and also of the Credit Review Office service; in addition the Credit Review Office has quarterly radio and print media advertising campaigns.

The current cap of €250K means the service presently is limited to smaller borrowers from AIB and BoI and we thus cannot formally help every SME which may wish to use the service, albeit that we welcome enquiries from borrowers of any institution and will try get issues resolved informally. I have made proposals to Government to raise the current cap to at least €500K, and to work with the Central Bank to extend the remit of the service to the Non NAMA banks regulated here, which are signed up to the Code of Practice for SME Lending.

The Fourth Report

This fourth report moves on from the previous reports on the observations of the market and the improvements the two banks are making, to look at what steps are required to support Irish SMEs through a recovery stage. It is too simplistic to demand that banks lend more, as this takes no account of the viability and underlying problems which face some SMEs and thus make advancing ongoing/ additional funds difficult from a prudent credit perspective to avoid further bank losses, which are unacceptable to the public who have suffered enough from the bail-outs to date.

Over the past few weeks the Credit Review Office has dealt with a number of larger lending cases (>€1M), where additional funding within the €250K criteria has been declined by banks. Undoubtedly these businesses have very challenging backgrounds and recent histories, and all operate in difficult trade sectors, however they were able to present credible business plans and show progress against these plans for future viability. In such cases the Credit Review Office has been able to secure deals for ongoing support from the bank to allow these businesses to work through their recovery plans.

It is essential that any business that is fighting for survival prepares a recovery plan – supported by cashflow forecasts to establish future viability. There is a role for banks, small business organisations, trade bodies and accountants to facilitate and support SMES in producing such plans in an affordable and timely way. There may be a role for Government to lead and co-ordinate a programme to facilitate recovery plans being prepared for SMEs, in a way that ensures it does not become a fee fest on hard pressed SMEs.

Many of the challenged SMEs are facing not only liquidity problems but are also technically insolvent. Not only should the recovery plans identify if there is a future for the business, but when future viability can be established, the 'bankability' of the ongoing facilities required in the cashflow forecast will need to be addressed. It is unlikely that many of these required facilities will meet the new prudent lending criteria required by the banks and the Central Bank.

In recent discussions on the introduction of a Loan Guarantee Scheme with Ministers, I have made the point that a bigger issue than the lack of available security for lending is this [in]solvency of many small businesses through legacy bank and trade debt levels, from the continual erosion of profitability over the past three years.
The examinership route is too expensive for SME's (average cost €75,000) so there needs to be a process where businesses which can demonstrate future viability through a recovery plan to be 'right sized' by e.g. (a) Debt/Equity swaps or (b) debt write-off and restructure.

It is all too easy to say 'banks aren't lending', or to call for banks to 'lend more', however this takes little account of the ability of many borrowers to repay. At present much bank lending is restructuring existing debts, and also allowing reductions of interest and/or capital on legacy loans to assist SMEs through the recession. Without such activity many more SMEs would have already ceased trading.

The restructured pillar banks are now heavily capitalised but, given the inability of many SME borrowers to meet normal repayment criteria, they are not using this capital to 'recapitalise' their customers. Instead they are subjecting some of their customers with little hope of future viability to a 'slow death', using the above mentioned concessions on capital and interest pending an economic upturn. Inevitably the banks will have to use some their capital to write off these losses – indeed some of these potential losses may already have been provided for.

Banks now need to start using their capital to 'save' good SME's, however it is my view that this will require some form of government initiative, as some of this lending will be beyond the prudent cashflow lending criteria now obligatory in banking and expected by the Regulator. Whilst this will involve a contingent risk for the taxpayer in underwriting such lending, if the entry criteria to such a scheme establishes future viability the risk of default will be minimised. The outcomes of the Credit Review Office to date indicate the potential for such a scheme in the table above, whereby the appeals upheld for the borrowers to date show that the €1.77M credit made available to the SME applicants have protected 223 jobs. Hopefully few of these businesses will fail.

I would also wish to see the banks being more creative in working with their SME borrowers in ‘making a lending proposal bankable’. This requires skilled and experienced lenders.
Most banks are signalling staff reductions in an effort to trim their costs to restore profitability, and it is likely that their more senior staff will be targeted to leave as they are paid more. It will be important that these exits do not leave a capability void to repeat the skills gaps which affected banks in 2008/9, as more experienced staff were moved to deal with NAMA loans. Forward planning to upskill and mentor those front-line and lending staff who will be remaining should be a current priority for the Boards of banks contemplating staff reductions.

During the formal quarterly reviews of bank activity with AIB and BoI which is part of this reporting process, both banks outlined the extensive efforts they continue to make across the country to get the message to the market that they are open for business. This does not bear out the ongoing mantra that “banks aren’t lending”.
I recommend that a quarterly survey be commissioned by Dept of Finance and DETI, SFA/Chambers/ISME, IBF and the quality print and broadcast media, to command universal acceptance. The survey to be carried out by an independent and respected survey company, to track both supply and demand among SME’s for credit. It may also simultaneously survey supply and demand for house mortgage credit to provide a global view of the credit economy on which policy and commentary can be more solidly grounded .

Existing ‘credit surveys’ are being used widely as a commentary on the availability of bank lending. These surveys are not quality assured by any reputable market research organisation and are misleading many businesses into not seeking bank credit and using two alternative sources of financing both of which are risky:
(i) Marginal / Challenged businesses using trade finance as a source of working capital. There may be major problems ahead for businesses that are unable to repay creditors which foreclose on long overdue trade credit; and on the other side of the coin there could be major problems from bad debts in the trade books of those businesses which have not managed their debtors.
(ii)Viable businesses using working capital to fund project finance for extension and improvement of the business. The problem with this strategy is that it works well for a while until liquidity dries up leaving inadequate capital to complete the project and the legacy business under pressure to meet its day to day requirements to continue trading.

In summary the recommendations of this report are:

1. The parameters of the Credit Review Office should be reviewed to enable more SME customers to be assisted. This should include raising the current €250K threshold, and examining how non NAMA banks can be encouraged/compelled to join the scheme.
2. The Government should examine what assistance can be given to SMEs to enable them to establish their current and future potential viability through business plans and cashflow forecasting.
3. The Government should consider some from of underwriting of credit to provide businesses with a demonstrable viable future (and jobs) to recapitalise themselves in situations where the lending would be outside the prudential lending policies of the banks and the Central Bank.
4. All businesses should pay particular attention to managing their debtor and creditor books at this time, to avoid trade bad debts; and foreclosures by creditors.

5. The banks' Boards to pay particular attention to their 'to be' front-line and lending staff capabilities and experience levels before letting more experienced staff go on redundancy packages.
6. The Government should engage all interested parties to share in the commissioning of a quarterly survey of the demand and supply of credit to SMEs, and perhaps also on home loan lending.
   END.

Banks' €3Bn lending targets

- AIB and BoI were both instructed to provide €3Bn each for the next two years = €12Bn.
- Start date was 1st April 2010.
- Both Banks submitted plans to myself/ Department of Finance in May 2010. Department Officials and myself attend formal quarterly meetings with each of the banks to review progress against these plans.
- Both banks provide monthly figures on balance sheet volumes, sanctioned facilities and geographic and industrial breakdowns of their lending.

These targets are of interest to the general public however they are commercially and market sensitive to both banks, and whilst Ministers are briefed on the detail of these figures, the public commentary has thus to be more of a general nature.

The situation at the end of the first year of these targets can be described as a paradox which requires some explanation for the general public to understand. Whilst each bank has exceeded their €3bn lending sanction targets , set for them by the Minister, the tracking of the banks' performance observes the same pattern of balance sheet contraction as reported by the Central Bank in their monitoring.

It would always have been too simplistic to have expected net gains of €3bn each in the balance sheets of both banks from their lending activity. Whilst these sanction targets have made good progress, both banks are seeing a contraction in the size of their SME/Farm balance sheets, and in order to understand this apparent contradiction a funds flow is required to explain a situation whereby the banks are sanctioning new money but seeing their balance sheets contracting at the same time.

The key elements of the funds flow are as follows:

Key elements that increase balance sheet volumes	**Key elements that decrease balance sheet volumes**
• New lending drawn down • Interest charged on current lending	• Repayments on legacy loans • Amounts transferred to Nama • Other bad debts written off

As part of my monitoring funds flow statements are completed by both banks to show their cash movements. These show the two significant trading factors influencing the balance sheet declines are :
(i) The legacy loan book on the two banks stems from a period when the economy was itself much larger, requiring higher levels of credit than today's economic activity – now smaller by some 16%. The consequences of this shift is that the repayment inflows from the higher levels of lending made in this previous period are far

outweighing the demand for new lending in the current climate.
(ii) A high proportion of the new loans which are being made are restructuring existing debts for some SMEs which are unable to service the original loan conditions on their legacy debts. Whilst it can be argued that this is providing little real economic benefit, without such restructuring activity many of these businesses would have gone out of existence. Further assistance is being given to some distressed SMEs in concessions on loan/and or interest repayments.

A further impact on the balance sheet growth in both banks is that slabs of debt from their SME books were transferred to NAMA in the period leading up to Christmas 2010.
The banks also report a slowing of the 'velocity' of money with many sanctioned loans not being drawn down for longer periods, and over 50% of sanctioned overdraft facilities not being used. The banks rationale for this is that SMEs are securing the credit they require well in advance of the time when the finance is required to ensure that the credit is available.

Whilst their balance sheets have contracted, both banks have exceeded their €3bn sanction targets in new and re-structured lending. To preserve commercial sensitivity both banks have agreed to support the findings of this report by combining their performance figures for a number of measurements. Note that these figures reflect only the SME sector which were the subject of the Minister's target, and this report does not cover any other aspects of the banks' total lending activities.

These figures are extracted from an extensive suite of formal reporting charts to the Government, which are auditable, and for which banks' boards are accountable. The figures are not therefore survey figures, but represent 100% factual coverage of the business areas subject to these targets.

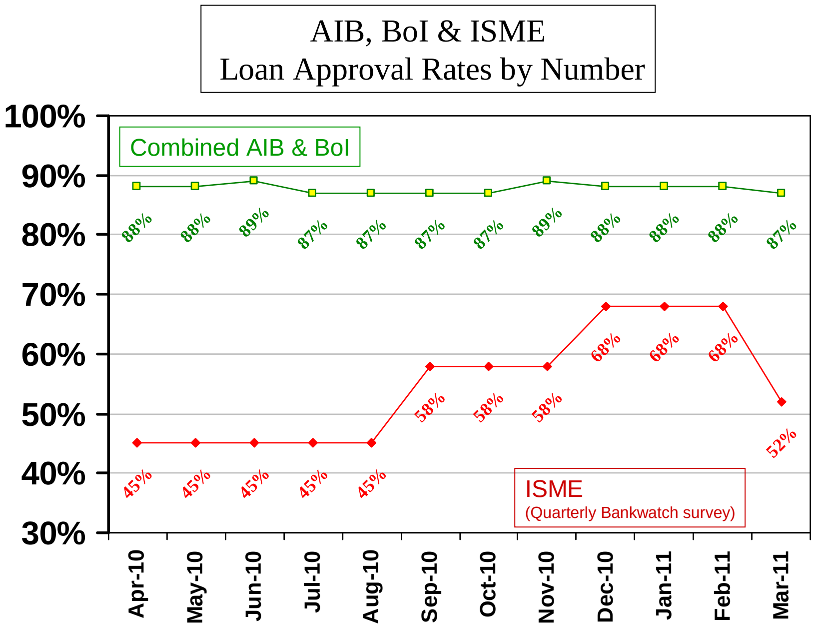
The details of the achievement of the €3bn sanction targets are shown in consolidated format adding the two banks together to protect the commercial sensitivity of each bank's numbers. The commentary refers to the year 1st April 2010 to 31st March 2011.

1. **Each bank exceeded the €3bn sanction target in its own right.**
2. **Consolidating the two banks performances together, the cumulative sanction figures was € 8.036bn. – against a joint target of €6bn. This figure includes new and restructured lending.**
3. **This figure was achieved through annual sales of 93,612 lending products as a composite figure between the two banks.**

For both these figures, there was steady month on month progress, with no significant dips or surges in the achievement of the target across the year. There was a seasonal softening of the progress over the summer holiday period, and also from the spell of adverse weather in December / January.

The learning from the first year of the targets is to improve the focus on those aspects of bank lending which support the recovery of the economy. Both banks are currently working to improve their reporting systems to identify this new lending which is 'economically productive'.

I also monitor the number and amount of formal credit applications declined by these two banks. This chart shows the high number of credits sanctioned which I have benchmarked against the quarterly ISME surveys for the period. The ISME survey covers ALL banks, not just the two pillar banks, so there is a mismatch.



The banks sanctioning performance remains in line with the three previous surveys conducted by MAZARS. (see summary at the foot of this report).

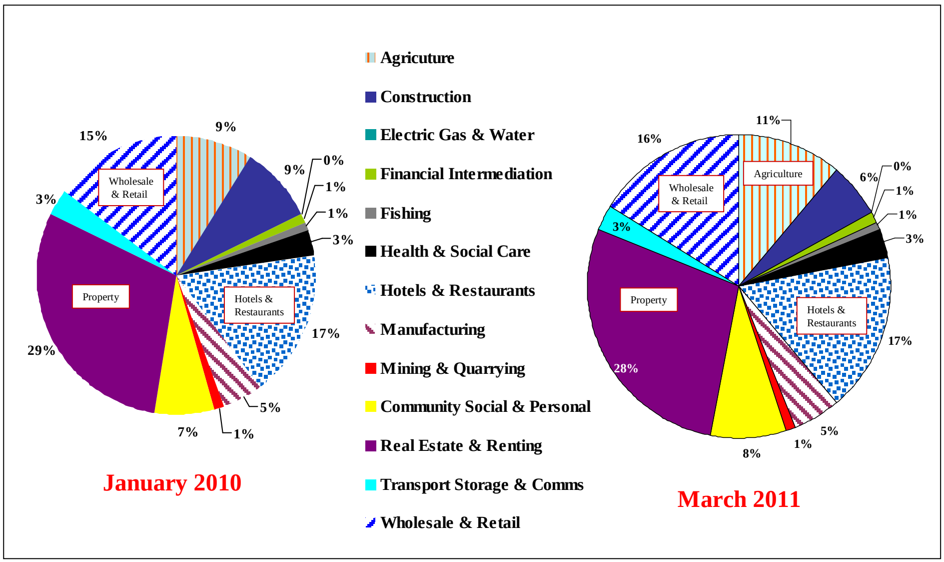
The Minister was also concerned that no geographic region or trade sector would be disadvantaged by the banks in their lending policies. Last May I visited both banks and examined all of their lending policies and was able to confirm that I saw nothing that would preclude viable businesses from obtaining credit.

As part of my monitoring I use January 2010 as a base month and by using comparative % pie charts to the current month, whilst the balance sheets have contracted in the period, I have been able to show that no region, nor any trade sector has experienced any adverse disadvantage in their proportion of bank lending. The construction sector reflect the NAMA transfers in late 2010.

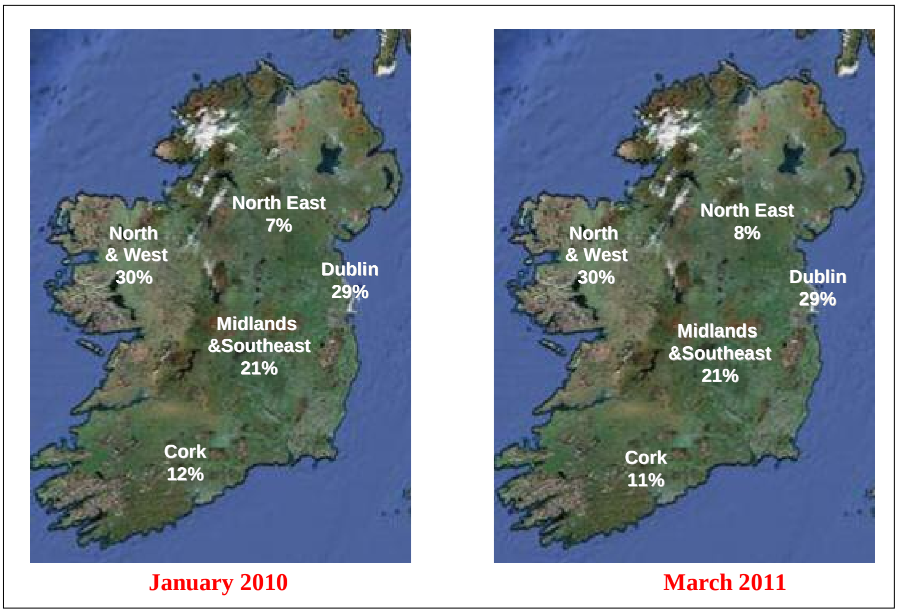
I have included charts showing the outcomes of this monitoring, again showing the composite performance of both banks to preserve the commercial confidentiality of each bank's position.

The composite figures bear out each bank's individual performance in ensuring no region or trade sector is adversely treated.

AIB & BoI Combined Sectoral Performance
-Balance Sheet Share
Movement Since January 2010



AIB & BoI Combined
Regional Performance - Balance Sheet Values
Movement Since January 2010



Finally, both banks have continued the strategies outlined in my third report to a)outreach to the market; and b) continue to raise the lending capabilities of their staff.
END.

Additional Information:

1. Summary of Mazars reports issued in 2009/10:

Mazars Summary:

Banks' claimed loan approval rates:
Jun 08 to Feb 09 = 86%, SMEs claim that the approval rate is 76%.
Feb 09 to Sept 09 = 86.4%
Sept 09 to Dec 09 = 87.5%

Banks' claimed decline rates
Jun 08 to Feb 09 = 14%,
(SMEs claim evidence of a 24% declines
(with up to 30% declines in micro businesses).

Feb 09 to Sept 09 = 13.6%, %, SMEs claim evidence of a 28% declines
(with up to 31% declines in micro businesses).
Mazars view is that the actual decline rate is @ 18%.(Sept 09).
This remained steady at Dec 09 at 18%.

2. Credit Review Office Activity for the Calendar Year 1st April 2010 until 31st March 2011

1/4/ 2011	Application Rec'd but held at Office until eligibility confirmed with Bank	Application Received and proceeding through Review process	CRO Decision: Banks' Credit Decision Upheld	CRO Decision: Bank's Credit Decision Disputed / Bank Subsequently Provided Credit	CRO Decision: More work required by Borrower and Bank or withdrawn by customer	Total
AIB	3	9	8	6	2	28
BoI	2	5	12	10	3	32
Total	**5**	**14**	**20**	**16**	**5**	**60***

*includes application awaiting eligibility confirmation

Formal Appeals	Banks' Credit Decision Upheld	Jobs		Bank's Credit Decision Disputed / Bank Provided Credit	Jobs protected
Total Numbers	**€1,563,753**	**110+7p/t**		**€1,514,000**	**121+9p/t**
AIB	€504,000	53+7p/t		€422,000*	36+1p/t
BoI	€1,059,753	57		€1,092,00	85+8p/t

Helpline/ Web Activity

- The helpline has taken 653 calls to date.
- The website has 6,152 after visitors over fifty two weeks. These web visitors have made 8,388 visits.