Seventh Quarterly Report from John Trethowan, Credit Reviewer

This is my seventh 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. These observations remain valid.

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.

The fourth, fifth and sixth reports moved on to look at what steps are required to support businesses through a recovery stage. This report will propose a system to assist borrowers in the credit application process.

These reports can be found on the publications tab on the Credit Review Office website www.creditreview.ie

	Application Rec'd but held at Office until eligibility confirmed with Bank	Overturned by Internal Appeals/ got credit*	Abandoned /Withdrawn by customer**	Application Received and proceeding through Review process	CRO Decision			Total
					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Upheld	Bank's Credit Decision Disputed / Bank Subsequently Provided Credit	More work required by Borrower and Bank or withdrawn by customer	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	4	6	6	4	23	27	8	78
BoI	4	7	6	5	20	26	7	75
Total	**8**	**13**	**12**	**9**	**43**	**51**	**15**	**153*** **

*only tracked since May 2011-new procedures
**considered withdrawn/abandoned if no response after 6 months
***includes applications awaiting eligibility confirmation

Formal Appeals	Banks' Credit Decision Upheld	Jobs at risk		Bank's Credit Decision Disputed / Bank Provided Credit	Jobs protected
Total Numbers	**3,798,553**	**228+22p/t**		**€4,747,000**	**521+21p/t**
AIB	€1,803,200	131+9p/t		€2,258,300	218+9p/t
BoI	€1,995,753	97+13p/t		€2,488,700	303+12p/t

Helpline/ Web Activity

- The helpline has taken 1,357 calls to date.
- The website has a cumulative total now stands at 12,906 since inception. These web visitors have made 17,692 visits.

Banks' Formal Internal Appeals

April to Jan 2010 2012	Bank's Decision Upheld	Overturned/ Sanctioned with Conditions	Work in Progress	Ineligible/ Withdrawn By borrower	Total
AIB Total	130	87	17	15	249
BoI Total	174	12	0	0	186
Both Banks	304	99	17	15	435

The Seventh Report

The Credit Review Office service

The Credit Review Office was established to provide SMEs and Farms with an independent opinion on refused credit applications for new or increased credit from banks, or have had existing facilities withdrawn.

The process is borrower initiated, and I consider the core objective is being achieved, in as much as the level of borrower demand for the service has materialised, there being no other independent recognised or authorised channels to intervene on a borrower's behalf to help them access credit after it has been refused or withdrawn by banks.

It is important to note that of cases that have be adjudicated upon by the Credit Review Office, the decision of the banks not to lend or withdraw facilities has been reversed in 54% of cases. This is a good overturn rate, bearing in mind that all applications are overviewed at a senior level in the banks before the Credit Review Office becomes involved.

The Mazars survey found that "In 78% of cases where the application was declined, the applicant did not agree with the reasons that the bank gave for turning down the application".
In this context, the two pillar banks are obliged to inform eligible customers, of the Credit Review Office service, and the Credit Review Office continues to spend heavily on promotional activity on radio and newspaper advertising to ensure borrowers are aware of the service, and to encourage them to appeal credit decisions they are not happy with.

The economic backdrop

Economic uncertainty has surrounded the Eurozone over the past few months and this may further dampen prospects for domestic recovery in the short term, however when a recovery does start to gain momentum, and businesses seek to trade-up from current levels of activity, demand for working capital and investment capital will increase.

Given the weakened condition of many SMEs following such a long period of subdued trading, whenever a recovery in domestic demand does take place, I expect that many requests for credit could be refused and that the Credit Review Office will be needed to ensure that businesses with existing or future potential viability can get access to credit.

In my last report I pointed out that overly rigid lending policies were a source of concern and this remains the case. I continue to see too many cases where the fundamental and common sense question of whether the bank will get its money repaid is being crowded out by adherence to overly rigid lending policies and procedures.

Possibly this rigidity, coupled with the justifiable requirement for borrowers to substantiate how they will repay the lending supported by a proper business plan and cashflow forecasts, is the underlying cause for the impression that the banks are not lending.

Improving Credit Application Process

Banks can only lend when they receive a credit request – there are too many people and businesses asserting the banks aren't lending who have never applied for a loan over the past number of years.

The recent Mazars survey, and the monthly reports I receive from AIB and BoI, suggests that a formal application from a viable business to the banks stands a good chance of being successful.

In my fifth report (see appendix 1 for extract), I called for greater effort by accountancy and the trade bodies to assist borrowers in understanding the information which banks now require in their credit decision processes.

This call was echoed in Minister Perry's report 'The Voice of Small Business' – A Plan for Action.
The section of this report 'Managing out of the Crisis – a Coordinated Approach for Advisory Services', has tasked the Credit Review Office with the introduction of 'plug and play tools to assist in forecasting and cash flow modelling as a matter of urgency that would include self-help tutorials with relevant information'.

Since my last report four major banks have now adopted a common format application for bank credit for SMEs and farms (AIB, BoI, KBC, and Ulster). In itself this is not an initiative which will allay the criticism of the underlying information requests which underpin banks' new lending application processes; however it is an essential first step.

Work is now underway, led by the Irish Banking Federation (IBF), with the support at senior level from the three main banks, to engage with the Accountancy bodies to agree a number of further steps to assist SMEs and farms through the credit application process.

First and fundamentally is an agreed definition of 'viability', which is the corner stone of the credit decision making process. Feedback from borrowers indicates that they would find this helpful. Viability is already defined in 'Your Business, Your Bank' and this definition should now be reviewed and reaffirmed by all banks and should be published more widely – see appendix 2:

I commend the progress being made by the Accountancy Bodies and the IBF on an agreed standard format for business plans to provide the required information to underpin the new standard loan applications mentioned above.

I would encourage this good work to also include a standard recognised format for cashflow planning, acceptable to the banks and accountants.

This will assist borrowers in the three main banks (ca. 75%+ of the SME /Farm market), in knowing what is required to access credit. Importantly, it will also give more clarity to accountants and other advisers who can assist SMEs and Farms through the credit application process.

One of the issues facing many accountants/business advisers at the present time is being paid for their services. A standardised system as outlined above can more easily be costed, and a maximum agreed price assigned for the service.

A system could be then considered by the Banks whereby the cost of preparing a Business Plan would be included (capitalised) into the bank facility requested.

This would also require that Accountants/ business advisers follow through on all plans and support the SME in their credit negotiations with the Bank.

Such an arrangement would provide much needed affordable business planning support for micro and small businesses, remunerated work for accountants and business advisers, and improved quality business proposals against which banks can take financing decisions.

Property Lending

It is important to ensure that overly rigid credit policies do not compound difficulties in certain sectors namely those that our current economic problems such as the commercial property development sector.

Whilst, understandably for banks and Regulators, this is a challenging sector with a risk of a general oversupply of properties and a lack of knowledge on where the bottom of the market may be; there is a need for the provision of finance for some viable deals to ‘break the circle’.

There are some properties on the market which are priced to suggest attractive rental yields with potential value to investors. Without a supply of credit to finance such deals the properties remain ‘on the market’ thus continuing the downward spiral of prices – at present this finance tap is turned off by caution and bank policies in various major institutions. However I do recognise that viability must remain the central determinant in such approvals.

Banks' €3bn Targets 2011

Level of disclosure
The information reported to the Department and myself is commercially sensitive on these banks which are stock market listed companies. As such there is limited specific detail that can be divulged in my reports on the tracking of the banks' performances and our regular discussions with the banks.

The Targets
The Minister of Finance has set SME /Farm lending sanction targets for the two pillar banks – AIB and BoI.

1. The initial target was for the period 1st April 2010 to 31st March 2011, being €3bn for each bank.
2. Following a change in Government in 2011, the period of the target was altered for year 2 to run from 1st January to 31st December 2011, being €3bn for each bank.
3. The target for the calendar year 2012 is €3.5bn for each Bank.
4. The target for the calendar year 2013 is €4Bn for each Bank

The three major banks have attended the Economic Management Council in November and in February. At these meetings the senior executives of these banks have solemnly affirmed to the Government their commitment to lending into both the SME and residential mortgage markets; and have outlined their market outreach programmes during questioning from the most senior of the Government Ministers. The Taoiseach has requested the banks to update the EMC on progress on a quarterly basis.

Report on Banks' €3bn 2011 Targets
I am pleased to advise that AIB and BoI have both achieved their €3bn on loan sanctions. This followed a period of subdued activity in the summer months which led to a comment in my 5th report that achievement of these targets may be challenging.

Following this report, some robust meetings took place between each of the two banks and the Department of Finance and myself, I am pleased to advise that lending activity increased in the following two quarters to achieve the annual targets.

There is growing interest in the level of new money: restructured money in these sanction figures. I fully accept that restructuring, while important, will not drive growth and the Government would like to see a sharper focus on the element of 'new' money sanctioned and drawn in the quarters ahead, and this is reinforced in our meetings with the Pillar Banks.

The Central Bank has already reported a contraction in banks' balance sheets in 2011 due to the level of loan repayments exceeding the demand for new lending. In this context I would make the following points:

1. One of the main profit drivers for any bank is in lending money. As such New money lending is attractive to banks.

2. The Pillar banks have been adequately recapitalised to ensure that this is not a constraint to expanding their lending.
3. New money is desirable for the market as a catalyst for economic growth.
4. Banks can only lend New Money to businesses and individuals who request credit, and show they can repay it.
5. The Mazars demand survey shows that only 36% of SMEs sought bank finance in the period April to Sept 2011, and that fewer still (24%) expect to seek bank finance in the next 6 months. as such, it is difficult to expect a high proportion of activity will be for New Money.
6. Increased demand for New Money will materialise as the domestic economy recovers (the current level of new money roughly aligns with the level of demand for bank finance outlined in the Mazars survey).
7. The €3bn targets achieved in 2011 has a majority of restructured sanctions.
8. Restructuring activity takes place on SME and farm borrowers which are experiencing difficulty in servicing existing credit obligations. A recent PWC report finds that approx. 35% of Irish businesses intend to restructure their debt this year.
9. Without this restructuring activity many more businesses would fail, leading to a risk of higher unemployment, and a knock-on impact throughout the economy of trade related bad-debts jeopardising otherwise viable businesses.

Sectoral /Geographic share of lending

When initiating the targets the Minister required the pillar banks to show that:
(i) No Geographic region was being disadvantaged
(ii) No trade sector was being disadvantaged.

This is being monitored by comparing each month's reported figures by region and trade sector against a base month by way of pie charts, showing both absolute and % values for each region and trade sector.

The Regions are measured by using each banks' regional structure.

The trade sectors are measured by a set of sectors agreed between the banks, the Department of Finance and Credit Reviewer, and the Central Bank.

Whist each banks' balance sheets have contracted during 2011, the monitoring of these figures show that no sector or geographic region has been adversely disadvantaged by each of the banks.

END

Appendix 1 (extract from 5th Quarterly report)

There appears to be a disparity on the level of information input banks now expect from their borrowers, to the recognition of what is required and the ability to provide such information from some SMEs and Farms. It appears that the banking train has left the station on the requirements for credit applications, and as left some of its SME / Farm borrowing passengers on the platform, wondering what happened.

Business Organisations and accountancy bodies should be working to upskill the SME population on their business planning and financial skills. This is critical to the survival of all individual SME/farms, but also collectively in strengthening the business stock of the nation for the future. Individuals and business organisations pointing to the behaviour of banks as the sole source of the problems facing some SMEs and farms are in denial of the scope of the problems facing our economy.

Without a clear and honest identification of the problems, finding remedies and solutions will not take place.

The requirement for SME promoters and farms to be more 'hands-on' in the management of their enterprises has never been so important as in these challenging times for the economy. It is essential that the State supports the public and private sector to upskill management capabilities especially to smaller enterprise promoters to ensure they understand and can deal with their obligations as Directors and business decision makers.

My Reviewers continue to see too many cases where the financial accounts have been produced only for a tax computation, and the cashflow forecasts have been produced at the bank's request. These vital resources are not being used as management tools and discussed with advisers and accountants to manage the business going forward.

Appendix 2 (Your Business Your bank definition of viability).

http://www.djei.ie/publications/enterprise/2010/YourBusinessYourBank.pdf

*A **Viable Business** is a business that is currently in operation and is expected to continue to remain trading for the foreseeable future. Common characteristics of viable businesses are as follows:*

- *A history of successful trading and profit and/or cash generation*
- *A management team that has adjusted its business model and cost structure to the prevailing business climate*
- *Good credit history over the previous 3-5 years*
- *For start-ups, this may relate to the promoters personal credit / financial history or any previous business ventures in which they have been involved*
- *A realistic business plan and financial/cash flow forecasts that outlines a clear action plan.*
- *Short-term cash flow projections (i.e. 6-12 months) are of particular importance in the current environment*
- *An ability to show that the business is capable of maintaining or returning to solvency within a two year trading period*