

Credit Review Office Eighteenth Report

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1. Introduction

This is my eighteenth report, which covers the period 1st July 2016 to 31st March 2017. The Credit Review Office works on individual appeal cases. These cases also provide my team with a holistic view of developing trends in the SME and farm lending markets, and provide the basis for these reports. In addition, I receive formal reports on SME and farm lending from the two pillar banks each month.

SME Performance Overview - SMEs and farms in the current economy

The trends observed in my Seventeenth Report have continued, with the financial health of SMEs and farms improving as evidenced by their individual annual accounts. SMEs and farms are now regaining some of the capital strength they lost during the downturn. The trading performance trends in the Department of Finance bi-annual SME Credit Demand Surveys clearly show this recovery taking place.

<u>SMEs Trading Performance</u> ¹	Oct 12/ Mar 13	Apr13/ Sept 13	Oct 13/ Mar 14	Apr14/ Sept 14	Oct14 /Mar15	Apr15/ Sept 15	Oct 15/ Mar 16	April 16/ Sept 16
Increased T/O in last 12 months	25%	34%	38%	49%	43%	47%	45%	46%
Same turnover	37%	38%	36%	35%	41%	38%	40%	42%
Decreased turnover	38%	28%	26%	16%	16%	15%	15%	12%
Staffing increase	14%	21%	23%	30%	24%	27%	28%	29%
Staffing decrease	16%	12%	12%	7%	9%	8%	7%	7%
Reporting Profits	40%	48%	51%	56%	56%	61%	61%	65%
Reporting losses	26%	18%	18%	13%	13%	10%	11%	9%

Most Credit Review Office appellants are now seeking to develop their business in this climate of economic growth, which is a big change from the period between 2010-2013 when survival was the main reason for appeals. There are however some businesses and farms which also continue to deal with legacy challenges from the downturn.

Credit Overview

¹ Department of Finance. *SME Credit Demand Survey April to September 2016*. 2016.
http://www.finance.gov.ie/sites/default/files/20161205%20SME%20Credit%20Demand%20Survey%20April%20to%20September%202016_0.pdf

I observe that all banks are lending to the majority of SMEs and farms, which are more straightforward cases, and thus are supporting economic growth. I have evidence of this from the monthly reporting to the Credit Review Office on the percentage of declined formal credit applications by the two pillar banks. I have however formed the view, from recent Credit Review Office cases, that banks have generally tightened their credit policies over the past year, and that more could now be done by the banks to ensure that all viable SMEs and farms are supported.

The Credit Review Office appeals process is for businesses which present with some element of credit challenge, and I continue to work to ensure those that are viable, or potentially viable borrowers (that is, borrowers who have the capacity to service their loans), receive support.

The Credit Review Office criteria for support is to determine ‘whether the bank involved would lose money on the requested borrowing’. Current banks’ lending policies are now setting the bar for lending at a much higher level.

Recent Trends

This report identifies two trends:

- 1) General levels of customer care by banks for their SME and farm customers
- 2) The treatment of SMEs and farms which are now viable but have impaired credit histories which are seeking new lending.

1) *General levels of customer care by banks for their SME and Farm customers*
The Credit Review Office only sees cases which have some form of credit challenge. I have no experience of those borrowers which are currently receiving credit without the need to appeal.

Obviously, the key objective for all business promoters is to obtain the funding the business requires; however it would be useful to understand the quality of service being experienced in these ‘normal’ lending transactions. To understand this further, there is some work identified in the Action Plan for Jobs to be undertaken on the experience of those borrowers which receive credit, and in the credit application process and the administrative burden this places on SMEs.

An issue which is constantly reported by the businesses which call the Credit Review Office helpline or apply for a review, is that of the quality of banks’ customer service. Certainly, some of the SME applicants to the Credit Review Office are experiencing poor local service and relationship management, which is a contributory factor in the difficulties the borrower has experienced in accessing credit.

As banks retreat from local relationships through branch closures, automated decision making, and much reduced levels of experienced staff, they must ensure that customer care standards are maintained at acceptable levels. Whilst all banks will comply with the specific requirements of the Central Bank Code of Practice for SME lending, this does not in itself guarantee good customer care. Customer care is not just in the prompt responses required by the Code, but in the everyday constructive helpful interactions between SMEs and banks’ Relationship Managers.

One of the barriers to using the Credit Review Office (as reported to me by SMEs) is a misplaced and perceived fear of challenging the big institutions on which their business relies upon. This may be why there is not more public feedback of the customers' experience following recent banking developments, including the more remote delivery of banking services. Perhaps there is a role for the media, and the SME and farming trade bodies, to become more active in providing a commentary and generating a wider debate on the current customers experience of dealing with their banks.

2) *The treatment of SMEs and Farms which are now viable but have impaired credit histories which are seeking new lending.*

The principal reason for the banks' past difficulties was property lending, and not in lending to SMEs' and farms' core businesses.

I observe that the pillar banks have recently been tightening credit appetite in SME and farm markets, and declining to assist some viable businesses which do not meet the banks' increasingly strict lending criteria.

Banks' current operating models increasingly rely on on-line credit applications and automated decision making, which works well in straightforward credit cases. Not all applicants are straightforward however, and this automated approach can lead to binary Yes/No answers, rather than seeking to identify possible solutions which would make the proposition work.

It may be that banks' lower front-end operating cost models no longer provide the capacity or capability to make such assessments. It may be that the banks are no longer interested in more challenging loan applications, reflecting the lack of competition in the SME market in particular, or in the level of risk capital which each bank has to allocate to these more challenging loans.

Credit Challenges

So what makes a credit application challenging? These are observations from cases over the past seven years.

Banks

- Banks themselves are relatively recently distressed businesses which are still recovering. They cannot afford to accumulate sizeable new distressed lending books. As in any organisation, bad debts eat businesses' capital, being the only 100% margin in any business.
- Banks need to accumulate their own capital to meet regulatory targets. This influences their risk appetite. Compromised or distressed lending has a higher risk weighting, and requires more capital cover, making it relatively unattractive in this market.
- Despite relatively low demand for bank credit, the small number of players supplying the SME and farm lending market means that each bank can meet their individual growth objectives by servicing lower risk non-distressed lending.
- To create capital, banks need to make profits. With low lending margins, they have cut costs in reducing staffing, and their physical market presence. This has reduced banks' capacity and capability to assess more challenging credit applications.
- Banks' loan underwriting (automated and manual), relies heavily on past performance of the borrower. Whilst this is proven to be effective in steady state conditions, there is a strong argument to suggest that past performance resultant from the period 2008-2014 is not a wholly

reliable basis on which to predict future performance. Few people whose core businesses failed in the downturn were either rogues or incompetent, however it appears that they must disprove this in some credit applications.

- Banks need to be prudent as to the impact of macro-economic influences on the local SME and farm economies – Brexit, and Trump policies on protectionism on an open economy.

SMEs

The definition of SMEs is broad and covers everything from micro sized, and start-up businesses, through to well-established and sophisticated medium sized enterprises. In particular, many of the micro/smaller sized business suffer from two challenges:

a) Being undercapitalised.

Banks require at least some of the risk to be shared with a financial stake from the business, or others through guarantees. Unless there are very strong cashflows it is unlikely that any bank will finance anywhere near 100% of the stake in any project.

b) Having inadequate financial management systems and capabilities.

The Department of Finance bi-annual SME Credit Demand Survey highlights a lack of business and cashflow planning as a growing weakness in this sector. Cash is critical to all business survival, and SMEs and farms approaching banks for finance without a realistic view of their forward cash position have little chance of accessing bank finance. Simply put, if the business promoter does not know what the forward cash position looks like, there is little chance that the bank will be comfortable that any future loan repayments can be covered.

SMEs Trading Performance ²	Oct 12/ Mar 13	Apr13/ Sept 13	Oct 13/ Mar 14	Apr14/ Sept 14	Oct14 /Mar15	Apr15/ Sept 15	Oct 15/ Mar 16	April 16/ Sept 16
Keeping Regular Management Accounts	89%	87%	87%	91%	88%	87%	87%	86%
Making Business Plans	68%	65%	66%	70%	69%	65%	68%	67%
Making Cashflow Forecasts	72%	70%	64%	74%	72%	70%	69%	61%

Local Enterprise Offices should be the first port of call for any business which requires assistance in business and cashflow planning. In addition, the banks and the business trade bodies and associations provide SME and farm borrowers with free cashflow forecasting models and advice on their websites.

Monitoring Bank Lending

The Pillar banks continue to provide monthly lending figures to the Credit Review Office, which are reviewed and sent to the Minister of Finance. Since 2010, when this reporting commenced, there has been a consistent downward trend in the SME/farm lending of both banks, as borrowers paid down their debts; or their loans were restructured, written off, or sold on to new owners. The rate at which

² Department of Finance. *SME Credit Demand Survey April to September 2016.*

the SME/farm loan book is shrinking, has slowed over the past couple of years, as reduction in existing debt is counterbalanced by stronger new lending.

The Department of Finance's bi-annual survey of SME lending demand and trading conditions has consistently reported low demand for bank credit; but with the considerable majority of those which apply for credit having their loans sanctioned.

Credit Performance ³	Oct 12/ Mar 13	Apr13/ Sept 13	Oct 13/ Mar 14	Apr14/ Sept 14	Oct14 /Mar15	Apr15/ Sept 15	Oct 15/ Mar 16	April 16/ Sept 16
SMEs requesting credit	40%	36%	35%	31%	32%	30%	26%	23%
Anticipate seeking credit (next 6 months)	25%	26%	26%	27%	26%	27%	20%	20%
Credit Approved / Partially Approved	60%	65%	65%	74%	71%	73%	80%	76%
Credit Approved (excluding pending)	76%	80%	81%	86%	84%	85%	88%	84%

The European Investment Bank Group survey on Investment and Investment Finance surveyed 400 Irish SMEs and produced a Country Overview of Ireland, as part of their wider EU survey. This survey found that 19% of Irish firms reported not investing enough over the past 3 years; whilst 51% report that they are now operating at above capacity, indicating an investment need.

This should predict an upturn in demand for bank finance to meet investment needs, however another finding from the survey is that 75% of Irish firms are using internal funds to finance their investment activities. This is higher than the EU average of 60%; furthermore 13% of Irish SMEs are considered finance constrained, again higher than the EU average.⁴

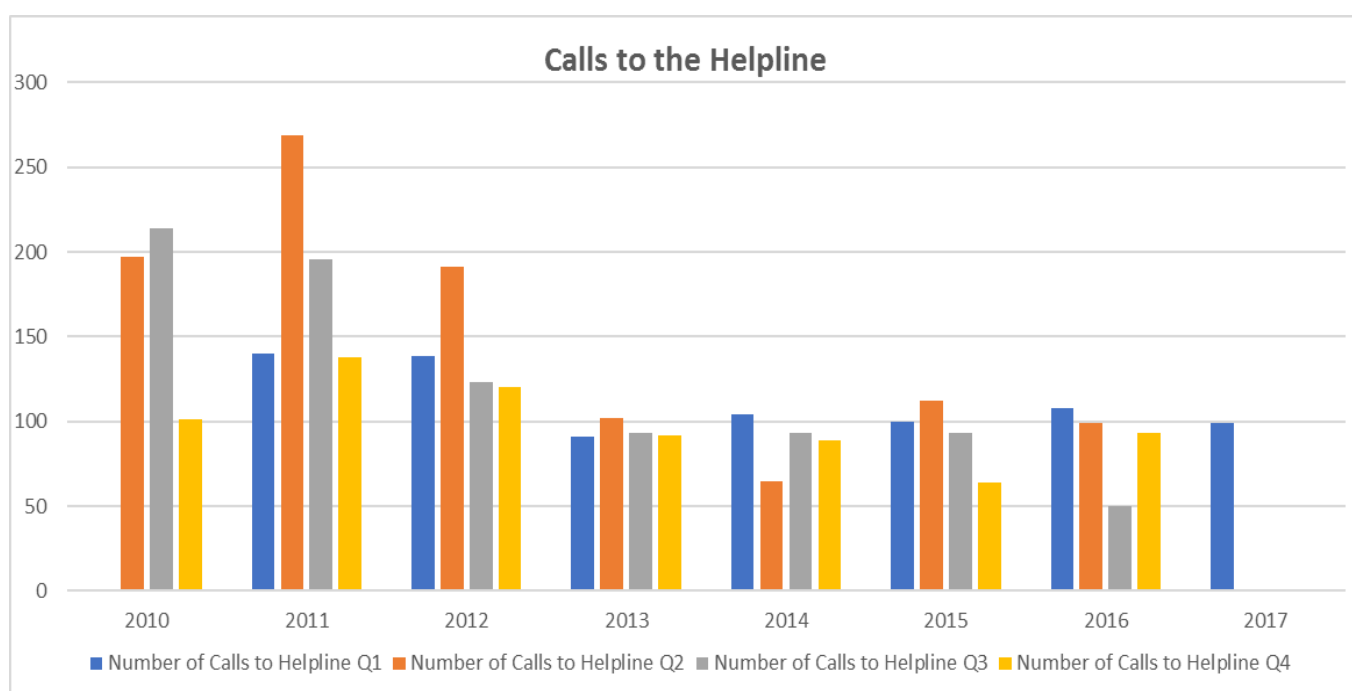
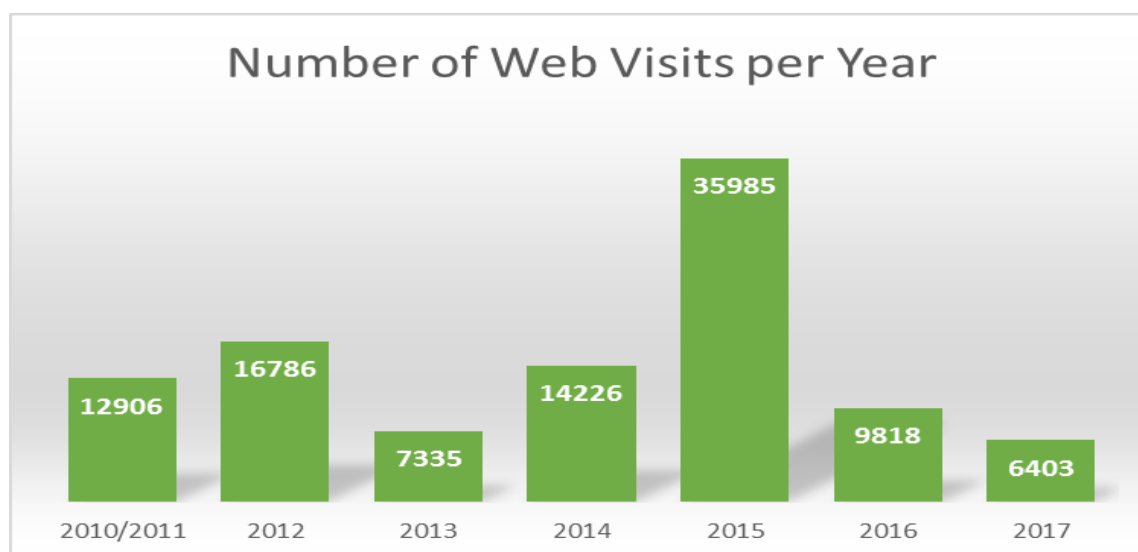
The outputs of this survey suggest that more effort is required to encourage and increase the supply of credit to viable borrowers (that is, borrowers who have the capacity to service their loans) for business purposes.

³ Department of Finance. *SME Credit Demand Survey April to September 2016*.

⁴ European Investment Bank. *EIB Group Survey on Investment and Investment Finance 2016. Country Overview: Ireland*. 2016. http://www.eib.org/attachments/efs/eibis_2016_ireland_en.pdf

2. Credit Review Office activity

This report covers the period from 1st July 2016 to 31st March 2017.



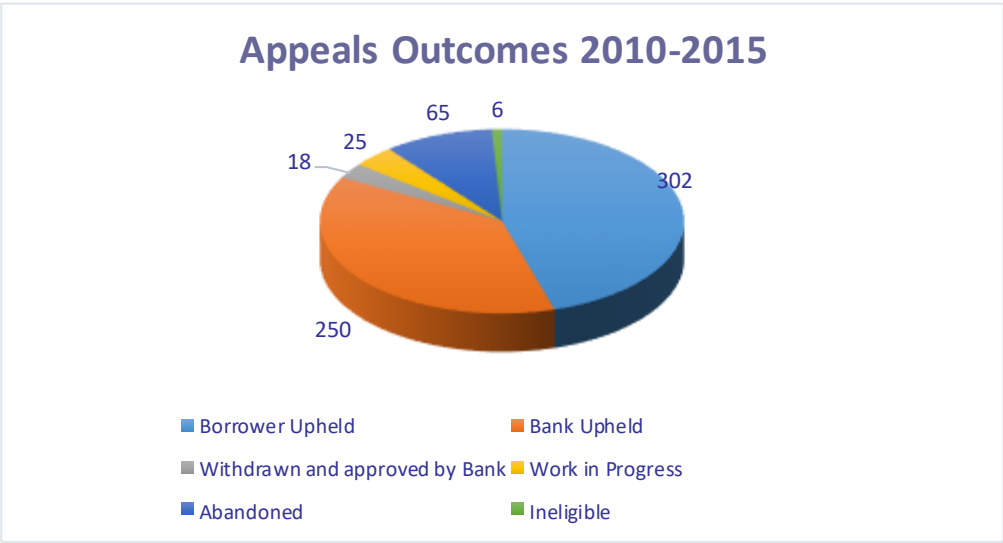
Credit appeals to the Credit Review Office

We have received 822 formal applications to date. Of these, 552 reached final conclusion and the Credit Review Office has upheld of the appeals in favour of 302 borrowers, including those with a commitment to reassess the lending in the future if agreed performance hurdles are met in the short term.

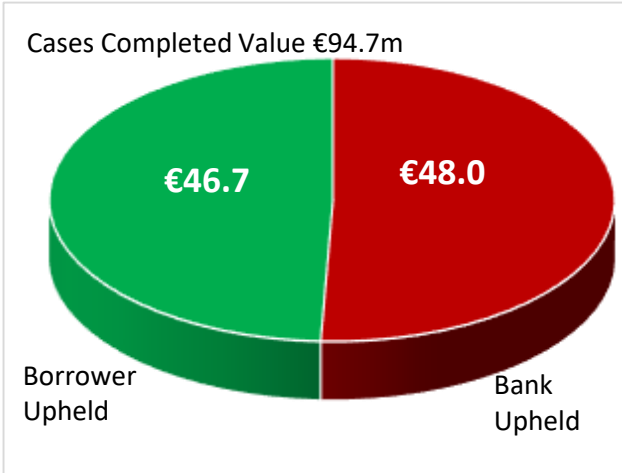
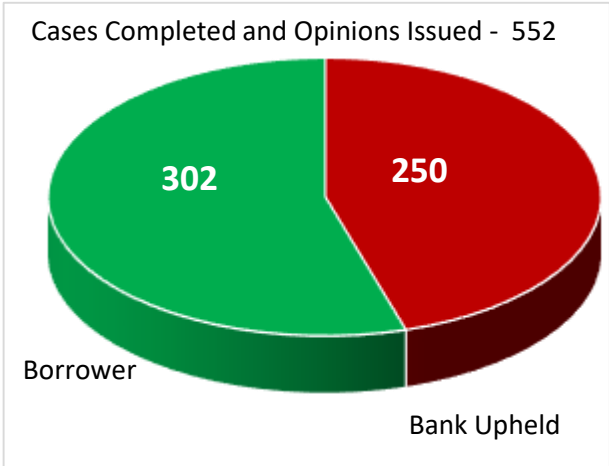
In addition to undertaking formal reviews the Credit Review Office also operates an informal 'Help Line' service where the Reviewers engage directly with SMEs/farmers who have credit/banking related

issues providing advice and guidance. Many of these conversations do not result in formal appeals but the feedback from the individuals who avail of the service is that it provides an invaluable source of advice.

The breakdown of the formal appeals are as follows:



From the above chart of the 552 cases which have been finalised as formal reviews with opinion issued, the breakdown is as follows:



The upheld appeals have resulted in €46.7m credit being made available to SMEs and farms, helping to protect/create 3,175 jobs.

Banks Internal Appeals Stats:

AIB	Appeals WIP	Borrower Appeals Upheld	Borrower Appeals Declined	Total Internal Appeals	BoI	Appeals WIP	Borrower Appeals Upheld	Borrower Appeals Declined	Total Internal Appeals
2010		22	45	67			6	83	89
2011		68	85	153			12	167	179
2012		93	191	284			7	101	108
2013		79	173	252			45	95	140
2014		56	180	236			27	101	128
2015		52	193	245			33	90	123
2016		27	70	97			38	161	199
2017	7	3	15	25		1	8	86	95
TOTAL		400	952	1359			176	884	1061

Other Credit Review Office Activity for the report period:

As part of the Office's activities, in order to gain feedback from all stakeholders and SMEs, the following groups were met with, or their member conferences and seminars addressed/attended in the period 1st July 2016 - 31st March 2017.

Updates/ Meetings

- Weekly reports to Department of Finance
- Ongoing liaison with Department of Jobs, Enterprise and Innovation
- Attendance at State Bodies Group on SME finance
- Attendance at Quarterly meetings with Department of Finance and each Pillar Bank
- Separate informal 'housekeeping meetings' with banks to improve case management
- Workshops and meetings with newly joined banks
- Liaison meetings with SBCI and MFI
- Part of Supporting SMEs Communications team (set up by SBG)
- Update meeting with BFPI
- Attendance at 6th ECB Post Surveillance visit on SME lending
- SME/Farm Trade Bodies – Chambers, IFA, ISME, RAI, SFA
- Saudi Central Bank SME Finance meeting

Conferences, Seminars, Workshops

- Local Enterprise Office presentations – Sligo and Dublin
- ACORNS 2 (Department of Agriculture program for female rural entrepreneurs)
- Network Ireland Events (SBCI) – Kildare, Cork, Galway
- Chambers (SBCI) Limerick
- KPMG/SBCI, Galway

- LEO Staff Briefings Portlaois and Dublin
- CPA Ireland Member CPD events, Dublin and Cork
- Employer Networking Events – Cavan and Monaghan

Tradeshows/Exhibitions

- Ploughing Championships
- ISME Annual Conference