Credit Review Office Nineteenth Report
John Trethowan

1. Introduction

This is my nineteenth report, which covers the period 1st April 2017 to 31st December 2017. The Credit Review Office works on individual appeal cases. These cases also provide my team with an 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 three State supported banks each month, and meet with them each quarter with Officials from the Department of Finance.

SME Performance Overview - SMEs and farms in the current economy

The trends observed in my Eighteenth Report have continued, with the financial health of SMEs and farms improving as evidenced by their individual annual financial accounts. SMEs and farms are now regaining some of the capital strength they lost during the downturn. I welcome the recent Teagasc report showing average farm incomes rising in 2017; and the trading performance trends in the Department of Finance bi-annual SME Credit Demand Surveys[1] which clearly show recovery continuing in this sector also.

Credit Overview

A persistent finding in the Department of Finance SME Demand surveys has been a decline in the demand for bank lending by Irish SMEs. This has fallen from 40% in the initial survey in the depths of the downturn in early 2013 to the current level of 23% in the most recent survey at September 2017.

Department of Finance SME Credit Demand Survey

Credit Performance	**Oct 12/ Mar 13**	**Apr13/ Sept 13**	**Oct 13/ Mar 14**	**Apr14/ Sept 14**	**Oct14/ Mar15**	**Apr15/ Sept 15**	**Oct 15/ Mar 16**	**Apr16/ Sept 16**	**Oct 16/ Mar 17**	**Apr17/ Sept 17**
SMEs requesting credit	**40%**	**36%**	**35%**	**31%**	**32%**	**30%**	**26%**	**23%**	**20%**	**23%**
Anticipate seeking credit (next 6 months)	**25%**	**26%**	**26%**	**27%**	**26%**	**27%**	**20%**	**20%**	**13%**	**20%**

The most recent European Investment Bank Group survey on Investment and Investment Finance[2] surveyed 400 Irish SMEs and found the share of firms relying on internal finance has increased significantly.

[1] http://www.finance.gov.ie/updates/sme-credit-demand-survey-april-september-2017/
[2] http://www.eib.org/attachments/efs/eibis_2017_ireland_en.pdf

One in three firms in Ireland report they did not apply for external finance because they are using internal funds or did not have a need for it (31%). This represents a significant increase on the previous survey (22%) and is substantially higher than the EU average (16%).

The outputs of this survey suggest that more effort is required by banks 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.

The use of SMEs own funds, or funds from other investors, to service investment needs has been cited locally as a reason for the very low demand for bank credit. This report will explore the risks in over reliance on self-funding; and also highlight that the supply side changes in how banks are addressing the SME and farm lending market may be inadvertently suppressing demand for credit.

A. The risks in over-reliance on self-funding.

a) Running out of cash.
The availability of adequate working capital is the absolute priority for the survival of any business. Tying up the business's cash in capital investment projects can be risky. The Credit Review Office has helped a few successful businesses which set out to fund expansion and major projects using their own cash, only to find that they have run short of funds prior to completion of the project.

This puts the business's current account under pressure, which in turn can result in banks reluctance to provide facilities to rectify the situation, as they view the business as a 'distressed borrower'.

The Credit Review Office has had to work with some clients to identify the sunk costs in the project and make a case for term funding for the whole project to release working capital back into the business.

b) How banks assess past financial performance gives little or no credit for self-financing.
We see many cases, particularly farms, where the borrower has worked hard, and has invested time and their own cash in building up the business/farm. When they do ask to borrow, the Credit Review Office has observed that banks are mainly focussed on the last few years profit and loss performance. Such 'desktop views' fail to recognise forward potential earnings from self-investment. We frequently find that a visit from the banks' own farm specialist is required before the potential from the previous self-investment is recognised. However, such visits and assessment are normally only available at a higher level of funding request.

c) The advice from the Credit Review Office is that, whilst self-funding is the cheapest source of investment funding, SMEs and Farms need to consider a viable funding plan as part of any expansion or major capital project from the outset. I will be asking the relevant trade journals to carry this extract from my report, and have put guidance sheets on this subject onto the Credit Review Office website. http://www.creditreview.ie/news/

B. How banks are addressing the SME and farm lending market may be inadvertently suppressing demand for credit.

Bank regulators are asking Institutions to pay attention to 'Behavioural Economics' and how this is affecting their customers' decision making. Behavioral economics looks at how suppliers' decisions and offerings influence the market, and the mechanisms that drive public choice. Largely this relates to sales incentives, but it may also help to explain why demand is depressed.

There are two elements of banks' behaviours which may be the cause of suppressed demand for credit from SMEs and Farms, and they are

(i) the changes over the past ten years in how banks interact with the SME and Farms sectors, and

(ii) the lowering risk appetite for lending to the SME and Farm sectors, which I will deal with later in the bank lending section of this report.

The changes over the past ten years in how banks interact with the SME and Farm sectors

Ireland has experienced a closure of between 200 /250 bank branches since the financial crisis. Branch closures and service reductions are unpopular with the public, and have a wider economic impact on many rural towns and villages in reducing regular customer visits from the catchment areas of these locations- people previously visited the bank and then 'shopped locally'.

Banks however, have to manage their cost bases, and invest in technology to be competitive into the future, and can no longer sustain the traditional local bank branch network. Correctly, they also state that the digital transactional platforms they now provide are popular for transactional banking, and some simple SME lending. They must also look to the future when holders of mega-data will digitally disintermediate the credit market, and threaten their business. Ironically, the best defence against these new entrants may well be the banks' depth and quality of relationships with their customers.

This move from physical channels and local relationship management, may however be a cause of the lowering reported demand for SME lending. The Economist magazine reports:

"The loss of a bank has a significant impact on communities," says James Chessen of the American Bankers Association. The cost is greatest for small businesses, which often lack audited financial statements and other information that can be analysed remotely. "At the local community level, so much of that business is driven by relationships," says Chris Vanderpool of S&P Global Market Intelligence. "The farther out you are, the harder it is to manage those relationships." A study in 2014 by Hoai-Luu Nguyen[3]*, now at the University of California, Berkeley, estimates that when*

[3] http://economics.mit.edu/files/10143

branches close, new small-business lending falls by 13% in the surrounding area. In low-income [less economically active] *neighbourhoods, such lending contracts by nearly 40%.*

Whilst the Credit Review Office has knowledge of the experience of those borrowers who have been refused credit, we have little information on those borrowers who have successfully accessed loans. Under the Action Plan for Jobs, the Credit Review Office was assigned a task to conduct a review of the bank credit application process with a focus on the administrative burden for SMEs and the time costs to them.

We decided to widen our market knowledge by carrying out a more a general survey of SMEs and Farms on their experience on accessing credit. We would like to acknowledge and thank the SME trades bodies and the IFA for their assistance in making their members aware of the survey.

This survey had a small population and we regard it as an indicative pathfinder for questions to be included in future Department of Finance SME Credit Demand surveys, however we were able to draw some outline conclusions from the survey and also from the comments supplied by the respondents.

The results suggest that Borrowers are seeking:

1. An improved two-way communication with their bank
2. A one to one enduring relationship with a business banker as a relationship manager.
3. That the relationship manager should have knowledge of the Borrower's SME/ Farm, and of business generally.
4. That the relationship manager should have greater input into the credit decision.

It is unrealistic to expect banks to invest in restoring their physical networks, however there is work to be done by all banks in improving the quality and consistency of relationship management – this is what banks' customers are asking for. The survey indicates a need to have stability in local staffing and an improved connection and empathy with the needs of the customers, rather than rigid adherence to banks' procedures.

We believe that in the case of SME & Farm lending the banks could do more to address the issues arising from the closure or re-designation of branch services. For example, the greater use of technology such as Skype or Facetime could help replace the traditional face to face meeting. As part of our process the Credit Reviewers conduct a telephone interview with SMEs & Farmers who lodge appeals, and in most cases the same level of relationship building and information gathering can be accessed over the phone as across a desk.

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. PTSB are also now reporting their lending figures, and collectively these banks account for the vast majority of the SME and Farm lending markets, with Ulster Bank and KBC being the other main finance providers.

These monthly reports show that the banks are continuing to lend. The long running contraction in their lending books is bottoming out with 'new lending' now at least stabilising the level of their loan books. The expectation in a strongly growing economy is that bank lending should also be growing. The main issue reported by the banks is the low demand for credit which I have commented on earlier in this report.

The conclusions drawn from the work of the Credit Review Office on Borrowers' appeals is that banks current lending policies have lowered their appetite for credit risk, which is limiting access to credit for SMEs and Farms, and this is having a wider economic impact.

I have feedback which suggests that Accountants and financial debt advisers are now more likely to advise clients to consider all other alternatives before seeking or increasing bank lending. As a result expansion plans are postponed or phased. When extra cash is available it is more likely to be used to reduce bank borrowings. The banks need to get these professionals back on side to increase their lending, but seem to be making little effort to do so.

Banks loan assessment is now dominated by numbers, ratios and credit bureau history, with minimal reliance placed on the borrower's track record with the bank. Little effort is now made to get to know the business, the sector it operates in and the business's future prospects, and both SME and Farm borrowers remain largely unprepared for the levels of financial information which all banks now require to assess their loan applications.

The SME and Farm sectors core business lending were not the cause of the recent banking crisis. Aside from buy-to-let lending, which banks promoted to SME and Farm borrowers during the tiger years, losses in the SME and Farm lending sectors are not problematic. Indeed, the experience of the Credit Review Office indicates how resilient the SME and Farm sectors are.

Bank policies and practices are being influenced by incoming regulatory policies and changes to accounting standards, which require them to recognise and provide for losses at an earlier stage if an SME or Farm loan becomes challenging or does not tick all of the policy boxes.

Loan provisions reduce profits, which are the key source of Banks' capital, at a time when all banks are mandated by Regulators to comply with capital targets by 2019. This is to assure the strength of the banking sector and ensure that taxpayers are protected from being asked to bail out banks in the future.

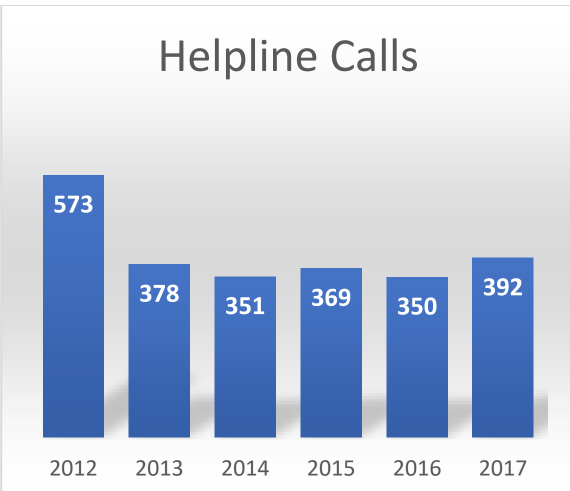
This could result in regulation which is there to ensure the ongoing health of banks, impacting on the banks' appetite for risk to fully support their local SME and Farm sectors, and consequent economic impacts on localised economies.

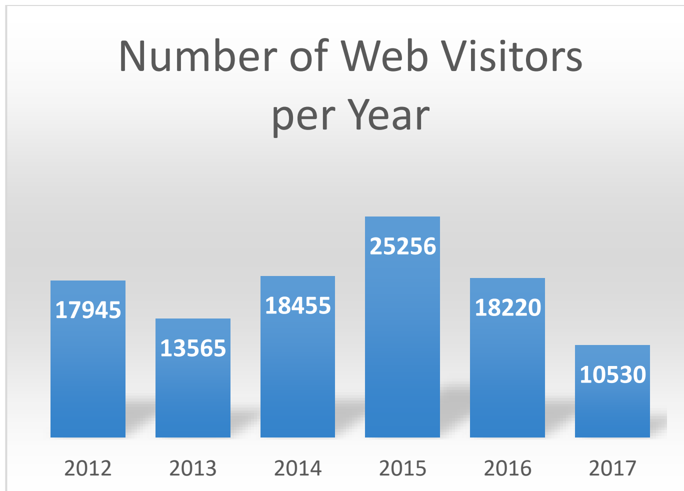
2. Credit Review Office Activity

This report covers the period from 1st April 2017 to 31st December 2017.

The Credit Review Office appeals have deepened in complexity in recent years so that reporting ‘scores’ or overturn rates, whilst required, no longer truly represents the situation. There is routinely much more debate and interaction between the banks and the Credit Review Office on the outcomes of appeals as time goes on. I value the cooperation received from the teams in all of the banks we deal with, and wish to recognise this cooperation again in this report.

Importantly, this is not about ‘wins and loses’ for the Banks and the Credit Review Office, but the outcomes for SMES and Farms, and the people they employ.



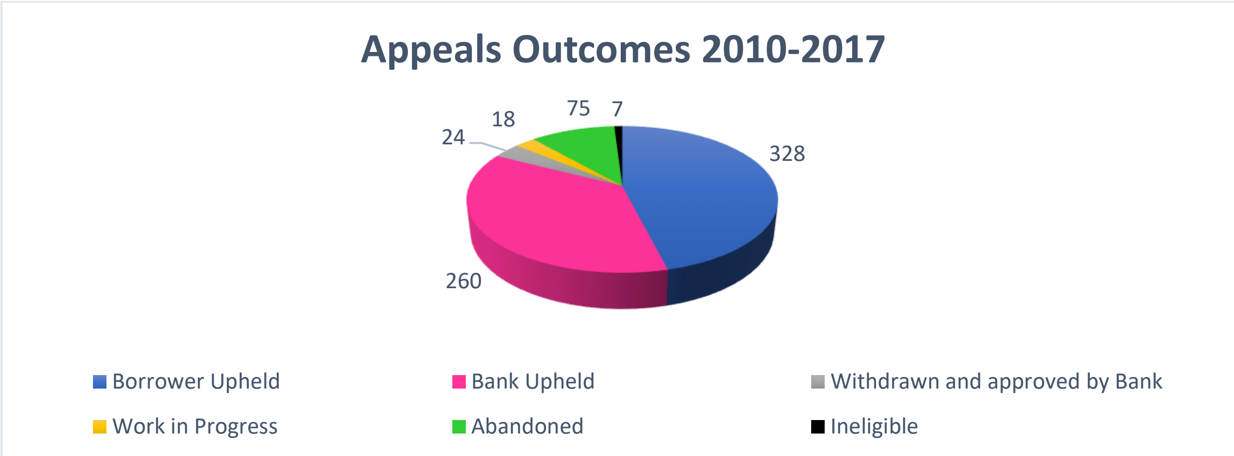


Credit appeals to the Credit Review Office

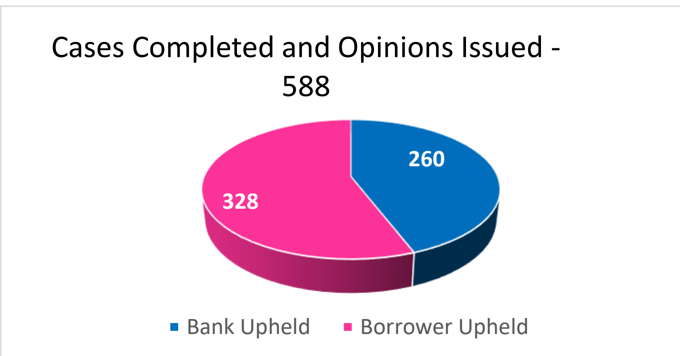
We have received 879 formal applications to date. Of these, 588 reached final conclusion and the Credit Review Office has upheld of the appeals in favour of 328 borrowers, including those with a commitment to reassess the lending in the future if agreed performance hurdles are met in the short term.

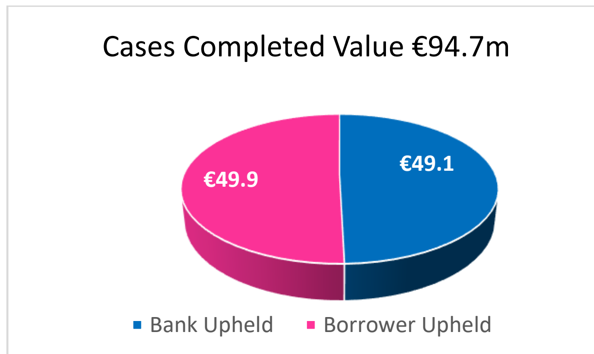
In addition to undertaking formal reviews the Credit Review Office also operates an informal ‘Help Line’ service where the Reviewers engage directly with SMEs/farmers who have credit/banking related issues providing advice and guidance. Many of these conversations do not result in formal appeals but 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 preceding chart - 588 cases finalised with Opinion issued - the breakdown is as follows:





The upheld appeals have resulted in €49.9m credit being made available to SMEs and farms, helping to protect/create 3,813 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		61	187	236			27	101	128
2015		53	201	245			33	90	123
2016		43	147	190			38	161	199
2017	6	22	131	159		0	57	213	270
TOTAL		441	1160	1601			225	1011	1236

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 April 2017 - 31st December 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)
- Ongoing liaison with BPFI
- Attendance at ECB Post Surveillance visit on SME lending
- SME/Farm Trade Bodies – Chambers, IFA, ISME, SFA
- LEO Cork

Conferences, Seminars, Workshops

- BPFI Annual Conference
- SFA Annual Conference
- ISME Annual Conference
- National Women's Enterprise Day – Leopardstown
- EI Access to Finance
- Taking Care of Business, Dublin

Endorsements

"I just wanted to say thank you for your recent help with our loan application with our Bank. We were finally able to draw down our loan of €190k in December 2017 which has put our business back on a solid footing. This would not have been possible without the help of the Credit Review Office for which we are very grateful. Without this finance our business would have struggled to survive but now we are confident in our ability to continue to grow and retain our employees"

"A big thank you to the Credit Review Office!
In line with our medium term plans we are expanding our business and we applied to our bank for a loan. We were shocked to be turned down as we had put forward a strong business plan plus we are trading profitably.
A Reviewer was assigned by the Credit Review Office to handle our appeal. He was a total professional and within a short time frame he had the banks decision overturned. To say we are delighted is putting it mildly!
Thanks again, great work Credit Review Office"

"We recently purchased a business with the assistance of the Credit Review Office. Despite the clear proposals that we presented showing our investment to be extremely viable, banks refused us funding 3 times and it was then that we approached the Credit Review Office. Using a 3rd party financial services advisor along with our accountant, our proposal was professionally packaged and presented with a great deal of financial information. Following a detailed examination of our proposal, the Credit Review Office examiner fully endorsed our business purchase plan and managed to overturn the banks refusal. The bank then offered us the necessary funding. Our overall experience with the Credit Review Office has been very positive achieving the result we wanted."