Credit Review

Twenty-first Report

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SPRING 2021

creditreview.ie

INTRODUCTION

This is my twenty-first report, which covers the period 1st January 2019 to 31st December 2020. I did not issue a report in 2020 due to the Covid Crisis.

Credit Review has worked on almost 1000 individual appeal cases. These cases provide my team with a holistic view of developing trends in the SME and farm lending markets to provide the basis for these reports. In addition, I receive formal activity 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. Credit Review also meets regularly with the main SME and Farming Trade bodies.

THE REPORT

Background

The Covid pandemic has been an irreversible tragedy for many families and their communities. It has also caused an unforeseen economic and societal shock, which will require time and coordinated effort to repair. Credit Review will continue to work with other State bodies and with the Banks, to help viable SMEs and Farms through this crisis and to ensure their future viability.

Brexit was the other major threat to access to credit across both years covered by this report. The uncertainty was a factor for many SMEs and Farms as they sought finance from our Banks. The draft Trade and Cooperation Agreement with the UK has removed the threat of a 'no deal', and it will now remain to be seen what the 'free trade' in goods and produce really means in practice, after the new procedures bed-in. It has been a bumpy ride so far.

SMEs are vital to the Irish economy - they pay taxes and employ more people than any other sector and reach across all sections of society and into every community. In turn, SME employees pay their own taxes, and spend their wages locally to support other SMEs in their own communities. These employees also borrow from Banks for their housing and personal assets. Arguably, the quality of Banks' lending to these personal customers can only be as strong as the SME businesses which employ them – which would imply a strategic need for Banks to ensure SMEs are given full support and encouragement to invest in their businesses.

The Government is rightly concerned that viable SMEs are well supported, and that they have access to credit. All that has been done, and is being done, since 2010 by various Government Departments, State Bodies, and think-tanks has been to address market failures in the supply of credit in the Banking system, particularly in the more complex banking services such as SME and Farm lending.

THE REPORT (Cont'd)

Bank leaders were already facing a challenging period to sustain their businesses prior to the pandemic. Persistently low interest rates are squeezing their net interest margins, which in turn has led to a lowering of their profits, and their risk appetite in lending. Banks have had to respond by cost cutting, largely by closing branches, reducing staff and increasingly automating to improve efficiency and productivity. Improving productivity is laudable, however this has occurred to the detriment in the quality of the relationship with their Customers, which is a key factor which we observe in most of the credit appeals Credit Review deals with.

There is a critical breakdown in Banks' communications with their Customers, as Banks have been forced to reduce costs in how they deal with Customers. Distanced / low contact relationships can work in personal packaged lending, such as mortgages and credit cards, where there are few and stable variables; however, every SME is different. In any business sector there are good operators and poor operators and, even year to year the performance of an individual SME can change. Survive or fail decisions cannot be made on historic bank account performance and reliance on Financial Accounts which are up to two years in the past. It requires, at a minimum, a conversation with the SME to understand where they are today and how they see their future.

After eleven years in Credit Review, I have observed a full cycle of credit conditions.

2011-2013 was the depth of the fall-out of the Banking Credit Crisis, when the economy faced into a severe downturn, at a time when Banks themselves were severely weakened. At this time, SMEs and Farms had also over-borrowed particularly for non-core buy-to-let property investments.

An economic recovery commenced in the first half of 2013, with a period of debt restructuring. In the period of growth which followed, the recovery was supported by a more amenable risk appetite in Bank lending up until late 2016.

After this Bank Regulators directed all Banks to focus on a more permanent resolution of their Non-Performing Loans and Non-Performing Exposures (NPL's/NPE's). This resulted in a general reduction in lending risk appetite, and more Bank resources

THE REPORT (Cont'd)

being deployed to deal permanently with their Non-Performing Loans, which comprised predominantly of the non-core buy to let housing loans the Banks had made prior to 2008. Most Banks had achieved their NPL targets by the end of 2019, some by bundling-up and selling on loans they classed as NPLs.

Due to the pandemic, we have now come full circle back to where we started in 2010 with Banks being concerned about their lending; and SMEs and Farms weakened as the economy has been closed down for prolonged periods. There are however key differences which make the outturn of this challenge different and more optimistic than between 2010 and 2013.

The Impact of the Pandemic and Brexit

1. Before Covid struck, the economy was growing strongly, and the main fear at the outset of 2020 was overheating. The impact of Covid is probably yet to be fully appreciated and will only be fully evident when the direct Government supports for business are removed, and 'new normal' trading resumes. However, the economy has already shown it will strongly rebound each time Covid restrictions are eased.

2. Banks have been building capital over the past decade from retained profits and the removal of their NPLs. Their lending is now much more robust than after the Financial Crisis. Indeed, before Covid struck, the main debate in banking appeared to be about how much capital could be repaid to Shareholders.

3. Similarly, most SMEs have reduced their borrowing and reduced their demand for new credit – possibly through under-investing in their businesses. In the SME appeals we scrutinise, it is evident that many SMEs are also (re)building their capital through improved turnover and profits. I have also observed over the past eleven years just how resilient SMEs are – most can survive whatever challenge is thrown at them.

THE REPORT (Cont'd)

4 The State is now in a better position to help, with the development of State Bodies such as SBCI, Microfinance Ireland and Credit Review. There are now various State risk-sharing schemes available to supplement Bank credit and risk taking, which can form part of a coordinated debt resolution. The Government also introduced significant supports for SMEs to help them with the consequences of Covid-19 restrictions. These include tax warehousing, the Employment Wage Subsidy Scheme (EWSS) and the COVID Restrictions Support Scheme (CRSS)..

As vaccines are rolled out in 2021 and some sort of normality returns, the focus for SMEs must move on from survival to recovery and growth. Banks have been generally supportive during the lockdowns. The move from general forbearance, to individual and creative medium-term resolution of the debts incurred is now required from our Banks.

In Credit Review we also observe that many firms are seeking credit, solely as the result of Covid disruption, and we see this as a further reason to support these firms. At least one Bank has stated a commendable policy to support those businesses which were viable prior to the Pandemic trading shock – undoubtedly this is a positive place to start a resolution of pandemic debts.

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What Happens Next?

It is a sad fact however that some SMEs will not survive the trading trauma of Covid (and possibly Brexit). However, Credit Review has cautioned against a binary description of firms that will survive, and those which will have to be let fail. We have described the recovery as having 'The Good; The Bad; and The Ugly'.

The Good will obviously quickly recover. The Bad are likely 'zombies' and will not be strong enough to recover. But there will be a large cohort of SMEs in the The Ugly category – which may well be unattractive to Bank lenders and their risk appetites and policies, but are firms which can be remediated with coordinated efforts of the Business, the Banks, and the State.

The fashionable term of 'creative destruction' is a fine principle in a perfect market, however Ireland does not have a perfect banking market. The supply side of the SME credit market is already constrained, and with the exit of Ulster Bank Group and KBC, it will become even more so.

Credit Review observes that our remaining Banks have little appetite for giving 'second chances' to those who have failed or required financial restructuring in the past – even though many of these borrowers will have learned some valuable lessons the hard way. Finally, our Banks have little credit appetite to assist start-ups, which the creative destruction principle sees as filling the gaps left by exiting businesses.

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Restructuring – Implications for SME's

The Regulators will rightly still require discipline from the banks regarding Non-Performing Loans and Exposures, and it is important how each Bank interprets the NPL requirements to avoid differences in the operationalisation of the guidance on how such loans are handled - we have seen evidence of this in some Banks in the past. Credit Review views a loan which is restructured, and then meets the repayment terms agreed over a period, as being remediated back to performing status, and not perennially classed as an NPL.

Credit Review will also be asking Regulators to ensure that the Lending Regulations be strengthened to require Banks to provide written advice to Borrowers on the future Credit implications of having their loan restructured; and to have this clearly and simply explained to the Borrowers at the time of the restructure. This should also include each Bank's terms on how to have these loans reclassified back to performing status.

Restarting Failed Businesses

Once the pandemic eases, there will be renewed demand for shops, restaurants, and hotels in places where some existing businesses will have failed. It is likely that those businesses which fail will leave gaps in the market, providing regeneration opportunities for existing and/or new businesses to fill.

For those business owners who do not survive the crisis, many will have been in business for years and will have had long experience and should also have learned new lessons from the Covid Crisis. As Banks are already averse to supporting business start-ups, and also to Borrowers which have previous credit issues, it is unlikely that there will be any appetite to lend to such people in new start-up businesses.

If these people can demonstrate that their businesses were viable before the beginning of 2020, and they have a credible plan to restart, they may need some form of Government backing.

FAREWELL

This is my last report as Credit Reviewer, as I have been in this role for over 11 years and it is now time to move on. I would like to thank my Core Team of Catherine and Jane, and the wider Reviewers' Team who have given me great comradeship and expertise over these years. I am proud of these great people and the work they do.

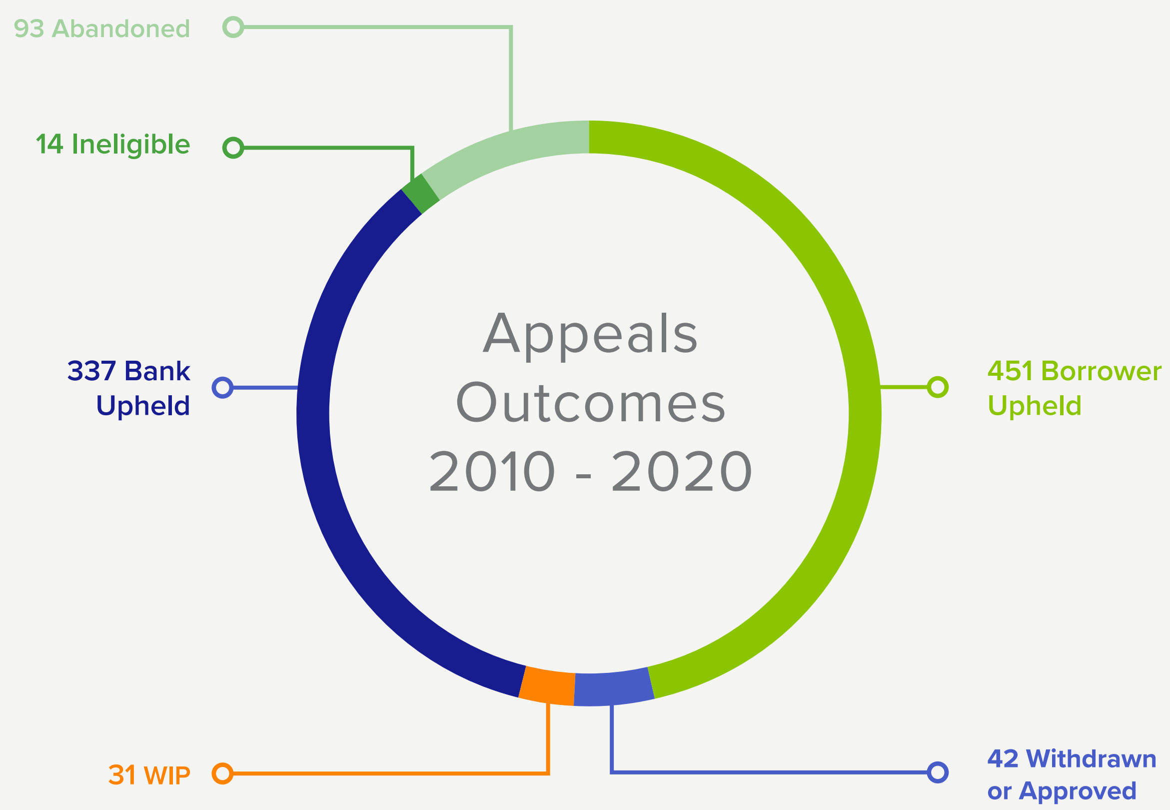
I also would like to thank colleagues in the Department of Finance for all their support and confidence in our work. In addition, I would like to express my appreciation to help and support from the various State Bodies and the various SME and Farming trade bodies. In particular, my thanks go to each of the participating Banks in cooperating with Credit Review to make the appeals system work.

CREDIT REVIEW ACTIVITY

Credit Appeals to Credit Review

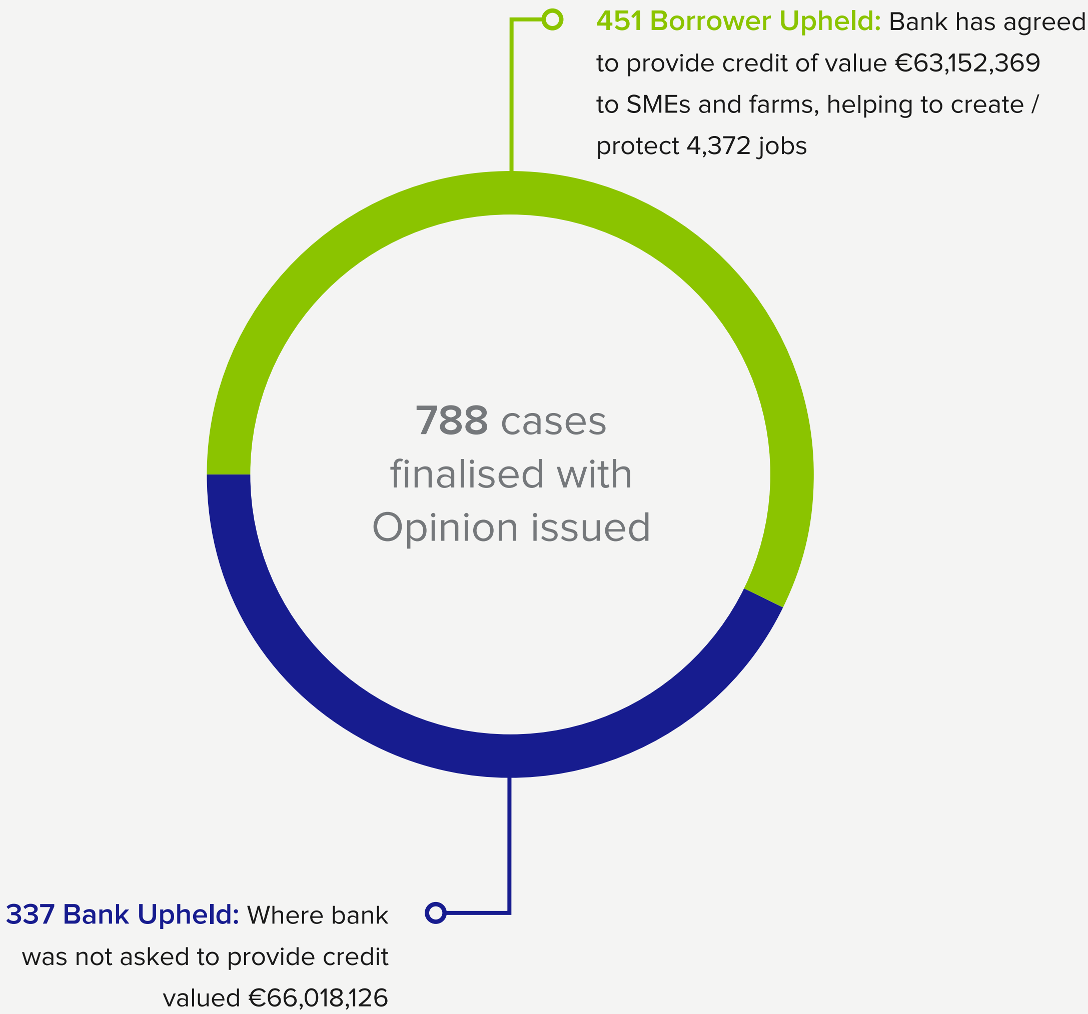
We have received 1,165 formal applications to date. Of these 788 reached final conclusion and Credit Review has upheld of the appeals in favour of 451 borrowers including those with a commitment to reassess the lending if agreed performance hurdles are met in the short term.

The break-down of the appeals are as follows:



CREDIT REVIEW ACTIVITY (Cont'd)

From the preceding chart – 788 cases finalised with Opinion issued
- the breakdown is as follows:

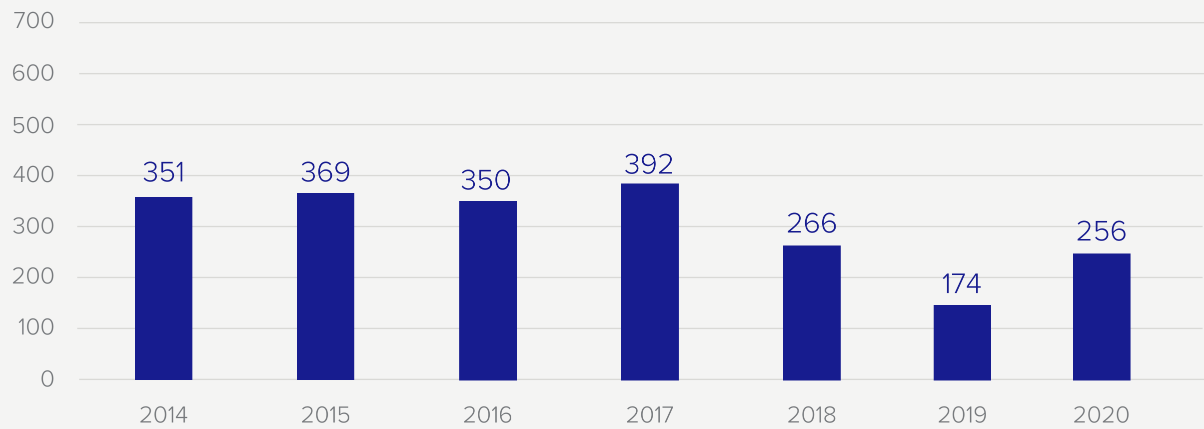


The upheld appeals
have resulted in €63.1m credit
being made available to
SMEs and farms, helping
to create / protect 4,372 jobs.

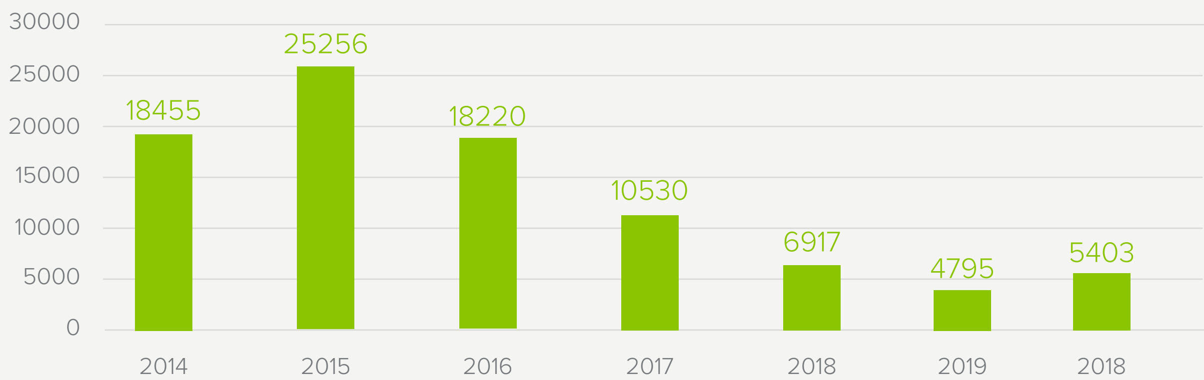
CREDIT REVIEW ACTIVITY (Cont'd)

In addition to undertaking formal reviews Credit Review also operate an informal "Help Line" service where the Reviewers engage directly with SMEs/farmers who have credit/banking related issues providing information 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 assistance.

NUMBER OF CALLS RECEIVED TO HELPLINE



NUMBER OF WEB VISITORS PER YEAR



CREDIT REVIEW ACTIVITY (Cont'd)

Banks Internal Appeals Stats

AIB	WIP	Borrower Appeals Upheld	Borrower Appeals Declined	Total Internal Appeals
2010	0	22	45	67
2011	0	68	85	153
2012	0	93	191	284
2013	0	79	173	252
2014	0	61	187	248
2015	0	53	201	254
2016	0	43	147	190
2017	0	23	139	162
2018	0	43	179	222
2019	0	37	285	322
2020	38	16	193	247
TOTAL	38	538	1825	2401

BOI	WIP	Borrower Appeals Upheld	Borrower Appeals Declined	Total Internal Appeals
2010	0	6	83	89
2011	0	12	167	179
2012	0	7	101	108
2013	0	45	95	140
2014	0	27	101	128
2015	0	33	90	123
2016	0	38	161	199
2017	0	57	217	274
2018	0	56	198	254
2019	0	34	201	235
2020	0	20	137	157
TOTAL	0	335	1551	1886

OTHER CREDIT REVIEW ACTIVITY

For the Report Period 1st Jan 2019 - 31st dec 2020

As part of the Office's activities, in order to gain feedback from all stakeholders and SME's, the following groups were met with regularly:

- Weekly reports to Department of Finance
- Ongoing liaison with Department of Enterprise, Trade and Employment
- 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

In addition, we have met with the following groups and addressed or participated in workshops, seminars and conferences:

- Central Bank
- Irish Banking Culture Board
- BPFI
- SBCI
- Microfinance Ireland
- Chambers Ireland
- ISME
- SFA
- Revenue
- Enterprise Ireland
- Local Enterprise Offices
- Community Banking Forum
- Indecon
- Back for Business
- Going for Growth
- ACORNS
- HBFI
- Swoop
- Loan Guru

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