Credit Review

Twenty-second Report

Catherine Collins

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creditreview.ie

INTRODUCTION

This is the twenty-second report from Credit Review, which covers the period 1st January 2021to 31st December 2022.

Credit Review has worked on 1200 individual appeal cases from SME and Farm business and the helpline has taken many more calls from borrowers having difficulty accessing credit from banks. These cases and calls provide the team with a holistic view of developing trends in the SME and farm lending markets which forms the basis of these reports.

In addition, Credit Review has received formal activity reports on SME and farm lending from the Banks and meets with the pillar banks each quarter with officials from the Department of Finance. Credit Review also meets regularly with the main SME and Farming Trade bodies, as well as other state bodies set up by Government to ensure SMEs are supported in accessing credit.

THE REPORT

Background

The role of Credit Review is to support viable businesses (i.e., ones that can service their loans) access credit, including those businesses that are vulnerable but viable in the medium to long term. Appropriate levels of bank credit for recovering and growing companies ensures they are able to grasp opportunities and accelerate their development, adding to the prosperity of their business, their employees, their local area and the overall Irish economy.

Business Environment

Following the Covid pandemic in 2020 and 2021, and the economic and societal shock it caused, restrictions finally eased in January 2022 and the journey back to normal trading began for many Irish businesses. However, the Russian invasion of Ukraine that started in February 2022 had a further global economic impact contributing to an inflationary shock, rising interest rates and large increases in energy costs. Ensuing financial pressures on consumers domestically and globally have affected consumer confidence and consumer demand, which in turn affects the business community.

In Ireland, these issues were compounded by political uncertainty in the UK and ongoing Brexit issues - the UK remains Irelands largest import partner and a key trading partner. Yet despite this ‘perfect storm’ for Irish businesses and their interdependence on and exposure to global markets, Irish economic fundamentals have been less impacted than might be expected. Irish SMEs appear to have remained resilient – the expected wave of business failures post-Covid has not yet materialised, unemployment remains low, and profits and revenues continue to recover towards pre-pandemic levels.

THE REPORT (Cont'd)

SME Overview and Outlook

Irish SME's have faced challenging trading conditions for over 3 years now. However, compared to their position at the start of the Global Financial crisis over a decade ago, most were better placed to face the Covid crisis and the ensuing economic uncertainty. Brexit preparations pre-Covid had led many businesses to examine their supply chains and cost base. Most had low debt levels or indeed no bank debt at all – according to the most recent SME Credit Demand Survey [1] 40% of SME's surveyed had no debt. SME businesses (and their debts) were focused on the core business rather than non-core or property investment. With the help of strong government pandemic supports and the positive banking sector response during Covid, the majority of businesses are now well on their way to recovering the lost Covid ground.

SMEs Trading [2] Performance	Sep-2017	Sep-2018	Sep-2019	Sep-2020	Sep-2021	Sep-2022
Turnover Stable/Increased	**86**	**86**	**80**	**29**	**77**	**76**
Profitable/Broke Even	**88**	**90**	**89**	**61**	**83**	**87**

In response to the difficult business environment during Covid lockdowns, businesses sought to conserve cash and reduced costs and expenditure accordingly. While this was necessary at the time, it may have led to a sustained lack of investment, which in the longer term could have a detrimental impact on competitiveness. Furthermore, there are clear sectoral disparities with some sectors heavily impacted by Covid and subsequently the rising energy costs; these sectors will need to replenish cash and working capital.

There is a general expectation that as pandemic supports unwind and inflationary pressures continue, insolvency rates and company failures will increase - government supports (including Tax Warehousing) may have been providing a life support for weaker unviable businesses.

Business failure is a natural part of the business cycle; however, it is important that businesses that are returning to viability are not prevented from so doing by shortcomings in the Irish credit market. SME's seeking finance now have less options with the exit of Ulster Bank and KBC, exacerbating an already concentrated SME bank market. In addition, we have seen a reduction in the scope of risk sharing products required for refinancing and restructuring existing SME debt.

SBCI schemes designed to fill market gaps have been highly successful, but at present do not support full refinancing; and the eligibility criteria now have a narrower focus, limiting access for some SMEs. Microfinance Ireland continues to support microbusinesses that are credit challenged, with a cap on lending of €25k, reduced from €50k available during Covid. Formal restructuring mechanisms such as SCARP are to be welcomed.

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[1] gov.ie - Credit Demand Survey April 2022 - September 2022 (www.gov.ie)
[2] gov.ie - Credit Demand Survey April 2022 - September 2022 (www.gov.ie)

THE REPORT (Cont'd)

Revenue's tax warehousing scheme has enabled many businesses to maintain a cash buffer to date, but repayments will commence in 2024. There will remain a need for informal restructuring for many SME's as they engage with all their creditors –including banks, Revenue, merchant credit providers and landlords – to ensure they remain viable.

While SME's demand for new credit remains muted, Credit Review expects the level of debt restructuring and refinance requests to accelerate by year-end, driven by the exiting banks and Covid creditor legacy described above. Credit Review expects increased numbers of appeals requests from borrowers who cannot agree terms with their bank.

Credit Review calls on Banks to provide written advice to Borrowers on the future credit implications of having their loan restructured. This written advice should clearly explain the process and implications to the Borrowers at the time of the restructure – for example, its impact on their credit classification as a Non-Performing Loan or Exposure. (More information is available at Credit Reviews website)

Banking Overview and Outlook

While the last two years have been hugely volatile for Irish SME's and Farms, the Irish Banking system has also undergone major upheaval.

1. The exit of two banks (Ulster and KBC) from the Irish market increases concentration in the banking sector and it is unlikely a new full-service bank will enter the Irish market in the near-term. While we have seen non-bank alternative lenders entering the market in recent years, and their entry to the SME credit market is welcome, they typically do not provide the full financial services from a single provider that many SMEs seek – e.g. current accounts for payments, overdrafts, stocking loans, term loans and asset finance. In addition, increasing interest rates impact heavily on many of the- alternative lenders business models as they source capital on the wholesale markets, which will necessitate even higher interest rates on their SME products and may limit their capacity to lend.

   Gaps in banking services may be alleviated by Credit Unions who have large surplus funds on deposit and a stated commitment to entering the SME credit market. However, given current Central Bank of Ireland, regulatory limitations (i.e. a 5% limit on commercial lending to SMEs for credit unions with less than €100 million asset size together with an inability of credit unions below €100 million asset size to apply for the 15% combined mortgage and commercial lending limit). it is expected that Credit Unions will not fill the entire credit gap in the short term.

   As a result, SME customers will likely have less choice and availability of credit providers and credit products in the Irish market. The remaining banks have geared up to facilitate the migration of over one million current and deposit accounts – however many SME's will require credit in the form of overdrafts, guarantees and stocking loans which do not in all cases form part of the transfer from the exiting to the remaining banks.

2. Customers seeking to migrate from exiting banks, who have any form of credit blemish on their record, will find it difficult to get credit approval from a remaining provider. Previously, when banks exited the Irish market, a government backed credit guarantee scheme was available to banks for refinancing potentially viable debt at the outer risk limits. This scheme is no longer available in the market. As a result, those borrowers who cannot re-bank with the remaining banks will have their debt sold as part of a portfolio loan sale at the end of the exit process by Ulster and KBC.

3. Loan sales will not be limited to exiting banks. As required by regulation, Irish banks continue to target a reduction of Non-Performing Loans/Exposures ratio to a level of 3% by end 2023. This will require remaining banks to work with SME borrowers to restructure SME debt sustainably – or to sell bundles of Non-Performing debt to investment funds. Credit Review is conscious that the numbers of borrowers classified as NPE's is also likely to increase due to the global economic slowdown, cost of living crisis and rising interest rates which will impact on the ability of some SMEs to meet their current debt schedules.

4. Banks risk appetites typically decrease when the economic environment is volatile. Higher inflation and increased costs affect SME profits, cashflow and ability to repay debt, which increases bank risk. The failure of Silicon Valley Bank and Signature Bank in the US due to rising interest rates has led to further concerns about US regional banks and potential contagion – all banks may suffer a lack of confidence as a result. In the aftermath of these failures it is possible that banks worldwide may be subject to further regulation which will increase bank costs and ultimately the cost of SME credit.

5. To improve efficiency and productivity, Irish banks have continued with cost cutting, largely by closing branches and reducing staff to improve efficiency and productivity. Many bank services have moved online and the banks have invested in increased automation. Credit Review recognises that digital platforms and automated credit decision-making can improve responsiveness in terms of timelines for the majority of customers, and can work well for those cases that succeed first time. However, the cases Credit Review sees have challenges or complexity and typically are not suited to the one-size fits all approach. Most of the appeals Credit Review overturn simply require more analysis and probing than the current automated processes allow for.

6. Automated credit decision-making by banks is increasingly being used for decisions of up to €200k. The banks incorporate the Central Credit Register (CCR) records on borrowers and businesses into their decisioning algorithms used in the approval process. This can work well and swiftly – but only when there are no issues or errors on the record. Over the period of this report, we have seen an increasing number of applications for appeals where the reason for credit refusal is adverse CCR records. In some cases, it appears that an adverse CCR means immediate rejection without any assessment of the viability or ability to repay. It also appears to ignore the materiality or scale of the problem loan or facility. CCR reports can contain errors and borrowers report that correcting errors is a lengthy and difficult process. Finally, the awareness level among borrowers of the existence and importance of the CCR record is very low. Credit Review suggests a concerted public awareness campaign is required to ensure borrowers are aware of the existence of the CCR and of how damaging a poor CCR record can be to their credit

applications. Banks for their part should continuously adapt their algorithms for materiality and errors to ensure viable SME’s are not prohibited from accessing credit.

Conclusion

At a time of heightened economic volatility and limited bank risk appetite, the Irish banking market is increasingly concentrated with currently just three remaining banks lending to SME’s. Irish SME’s seeking restructuring and refinancing in such a concentrated market have limited options.

State backed risk sharing and guarantee programmes will continue to be required in the medium term as businesses recover and grow post-Covid. Market gaps continue to exist and are only being filled with the help of state backed schemes, and it is questionable why the banking sector hasn’t stepped in to fill them.

Portfolio loan sales of challenged debt (NPE’s and NPL’s) are expected to continue, and again risk sharing government backed products may be required to enable businesses to re-bank with a remaining bank offering full banking services.

As productivity and cost saving measures lead to increased automation of credit decisions, banks need to be cognisant of their limitations and borrowers need to be aware of the implication of poor or erroneous credit records. Awareness raising by SME stakeholders of the existence and importance of the CCR is required, together with a clear and swift path for borrowers to ensure financial institutions amend errors, and banks algorithms are continuously refined to better reflect the magnitude of any credit issues.

Monitoring Bank Lending

Credit Review has received monthly loan sanction figures to end December 2022 from the three banks who continue to lend to Irish SMEs and farms – AIB, BOI and PTSB. These show in the period to Dec 2022 that the banks' loan books have stabilised after shrinking for most of the last decade, as borrowers paid down their debts, or had their loans restructured, written off, or sold on to new owners.

The expectation would be that as the economy gets back on its feet after the Covid pause, bank lending should also grow – but growth could be hindered by increasing interest rates and increased economic uncertainty.

Notwithstanding the impact of Covid and global economic uncertainty, economic forecasts for the Irish economy remain positive[3]. To facilitate this expected growth firms will need to invest on a continuous basis in fixed and other assets to boost output, mitigate against depreciation and enhance productivity, particularly as the labour market remains tight. Bank finance is required as part of that capital investment funding – although Irish firms depend far more heavily on self-financing than their European counterparts[4]. Whether this is due to SME's low borrowing appetite and risk aversion in the current volatile economic environment, or supply issues such as cost of, and access to credit is unclear.

Business borrowing appetite continues to be muted. Currently, SME demand for bank debt and expectations of future demand remains low, with just 17% of SME's seeking credit in the last 6 months, or expecting to borrow in the next 6 months, according to the most recent SME Credit Demand Survey. The trend is captured in the table below.

Credit Performance[5]	Sep-2015	Sep-2016	Sep-2017	Sep-2018	Sep-2019	Sep-2020	Sep-2021	Sep-2022
SMEs requesting credit	**30**	**23**	**23**	**20**	**20**	**18**	**17**	**17**
Anticipate seeking credit (next 6 months)	**27**	**20**	**20**	**19**	**18**	**12**	**7**	**17**
Credit Approved / Partially Approved	**85**	**84**	**85**	**86**	**85**	**85**	**86**	**90**
Sanctioned Facilities not Drawn	**16**	**25**	**24**	**16**	**24**	**-**	**27**	**18**
Average Turnaround Time	**19**	**25**	**25**	**25**	**22**	**-**	**26**	**26**
Average Loan Size	€478k	€105k	€138k	€228k	€266k	€192k	€268k	€279k

[3] European Commission Economic Forecast for Ireland May 2023
[4] European Investment Bank Investment Survey 2022
[5] gov.ie - Credit Demand Survey April 2022 - September 2022 (www.gov.ie)

Anecdotally, it appears that SME's may be delaying or postponing large scale expansion plans. Labour shortages and volatility in raw material prices are impacting on capital and construction projects with contractors reluctant to stand over contract prices for more than a few weeks in advance of commencement. Delaying reinvestment in the business will negatively influence the overall productivity and competitiveness of Irish SME's in the longer term and therefore Credit Review remains concerned regarding the weak demand for credit.

Looking at credit supply side issues (interest rate increases and access to credit), the rising interest rate impact has been commented on by the National Competitive and Productivity Council Competitiveness Scorecard 2023 which stated *'Faced with more costly financing options and slowing global growth projections, firms may curtail or delay investment decisions. Businesses have already faced higher interest rates in Ireland compared to the euro-area average, and these rates could rise further'.* In the Department of Finance Credit Demand Survey interest rates are not cited as a key reason for muted demand, with around one per cent of SMEs indicating price as an issue. However, the backdrop of increasing rates will not encourage borrowers to seek bank funding. In the survey, the vast majority of SMEs cite a preference to use internal funding rather than borrowing for investment. This can lead to inefficient use of their resources, tying up working capital and can prevent firms building good credit records. (A useful note highlighting potential issues with self-funding is available at Credit Review's website)

In terms of access to credit, the majority of borrowers who approach their bank will be provided with some or all of the credit they seek. It is our experience in Credit Review that the reduced number of banks operating in the Irish SME market means that options available to business borrowers with credit challenges or poor credit history are limited and even more limited for refinance requests.

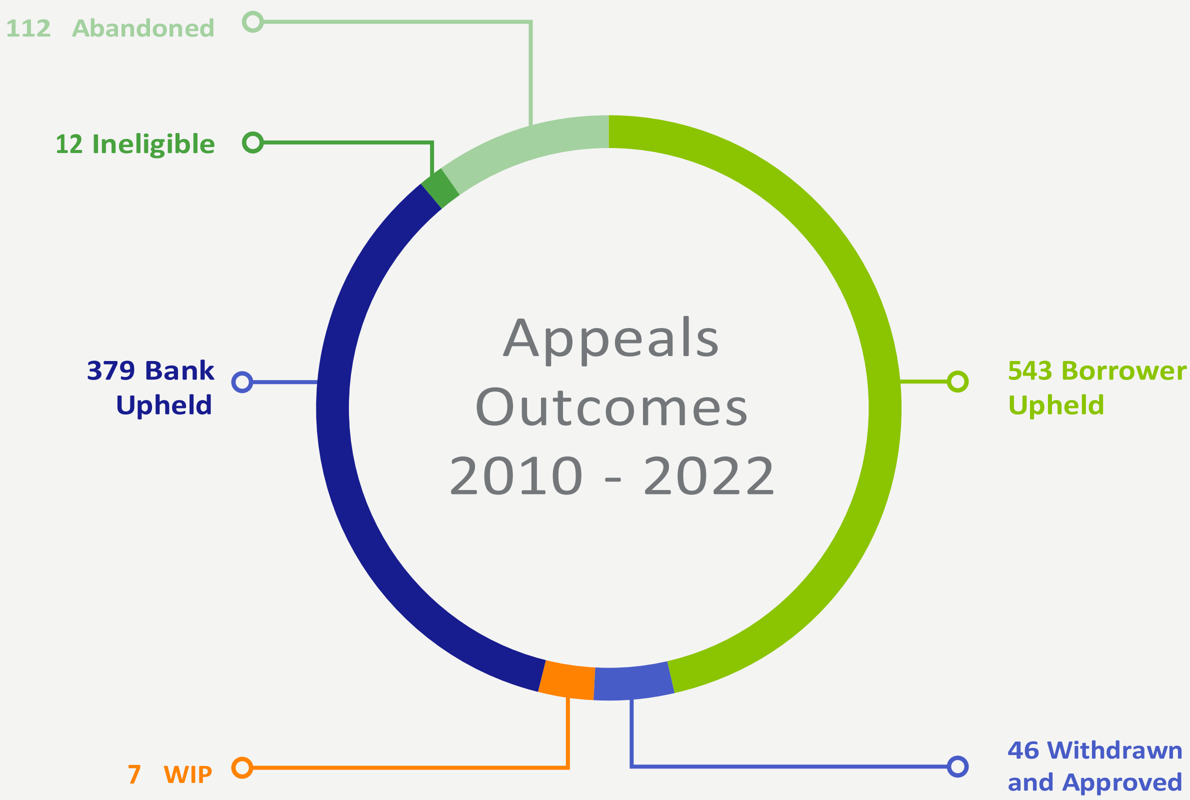
At Credit Review we typically see borrowers with some form of credit challenge but which are nonetheless viable, or potentially viable. This cohort continues to require assistance to overcome the barriers and to successfully access credit.

CREDIT REVIEW ACTIVITY

Credit Appeals to Credit Review

We have received 1,275 formal applications to 31st December 2022. Of these 922 reached final conclusion and Credit Review has upheld of the appeals in favour of 543 borrowers including those with a commitment to reassess the lending if agreed performance hurdles are met in the short term. A further 46 were withdrawn and approved by the bank.

The break-down of the appeals are as follows:

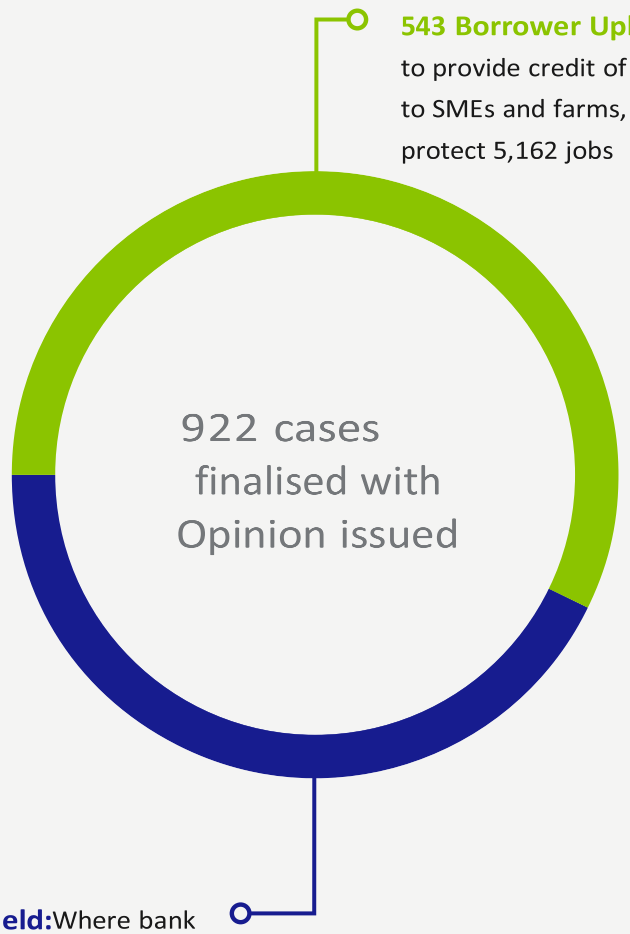


CREDIT REVIEW ACTIVITY (Cont'd)

From the preceding chart – 922 cases finalised with Opinion issued

- the breakdown is as follows

543 Borrower Upheld: Banks have agreed to provide credit of value €77,410,317 to SMEs and farms, helping to create / protect 5,162 jobs



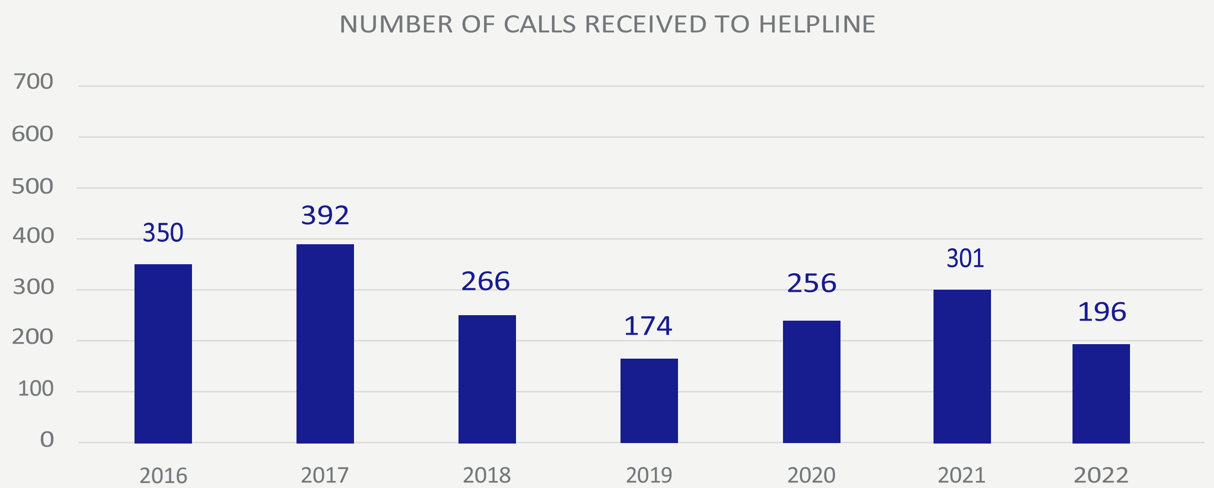
379 Bank Upheld: Where bank was not asked to provide credit valued €74,191,126

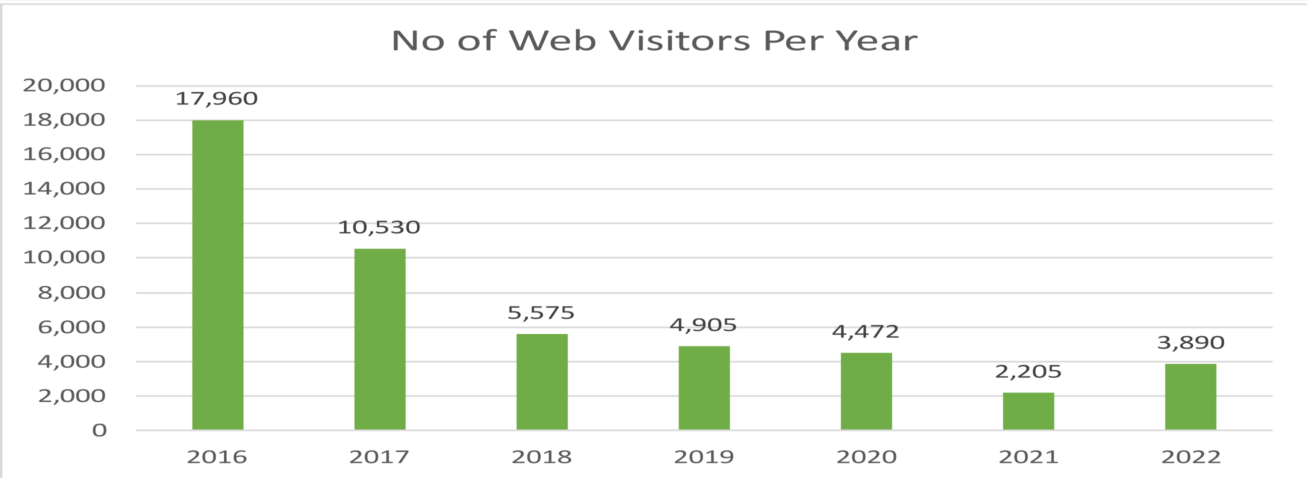
CREDIT REVIEW ACTIVITY (Cont'd)

From its inception in April 2010 to end December 2022, Credit Review has supported 59% of businesses and farms that have appealed credit decisions. As a result of our recommendations, the banks have agreed to provide credit of €77.4m to SME's and Farms, helping to create / protect 5,162 jobs in these entities.

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 updates. 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.





CREDIT REVIEW ACTIVITY (Cont'd)

Banks Internal Appeals Stats

AIB				BOI			
Year	Borrower Appeal Upheld	Borrower Appeals Declined	Total Appeals Completed	Year	Borrower Appeal Upheld	Borrower Appeals Declined	Total Appeals Completed
2010	22	45	67	2010	6	83	89
2011	67	85	152	2011	12	167	179
2012	95	191	286	2012	7	101	108
2013	85	173	258	2013	45	95	140
2014	48	187	235	2014	27	101	128
2015	58	201	259	2015	33	90	123
2016	48	147	195	2016	38	161	199
2017	28	136	164	2017	57	213	270
2018	47	136	183	2018	56	198	254
2019	94	162	256	2019	34	127	161
2020	26	173	199	2020	38	72	110
2021	57	159	216	2021	61	50	111
2022	48	149	197	2022	29	21	50

OTHER CREDIT REVIEW ACTIVITY

For the Report Period 1st Jan 2021 - 31st Dec 2022

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

- Department of Finance
- 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
- Central Bank
- Banking Review team
- Microfinance Ireland
- Irish Banking Culture Board
- IFA
- SFA
- ISME
- Chambers
- BPFI
- SBCI
- Local Enterprise Office
- Enterprise Ireland

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