

THE SME LENDING MARKET IN IRELAND AND COMPARISONS WITH EUROPEAN EXPERIENCE

This report sets out to examine the evidence in regard to SME lending and access to funds for Irish SMEs. It also reviews the basis for evaluating the credit experience of Irish SMEs with the experience of SMEs in other countries both within and outside the euro area.

SMEs and their Activities

- ✓ Small and medium enterprises (SMEs) are of vital economic importance to the Irish economy. They account for the overwhelming majority of Irish enterprises, almost 70% of persons engaged, 51.5% of turnover and 47.2% of Gross Value Added. The vast majority are micro firms, employing less than 10 persons. The profile of Irish SMEs is broadly the same as in the European economy.
- ✓ The highest concentrations of SMEs are in **Accommodation** and **Food Services, Construction** and **Real Estate. Motor** and **Wholesale Trades** and **Professional, Scientific** and **Technical services** also figure prominently.

Macroeconomic Factors Affecting SME Credit Demand

- ✓ The economic adjustment which has been underway for the past five years has been unprecedented in Ireland compared to any of the other recession based countries reviewed, apart from Greece.
- ✓ With most SMEs active in the domestic economy and dependent on household consumption and spending, they have been especially hard hit by the recession in the past five years. The following trends are evident in a review of the peak to trough trends since 2007:
 - **GNP** experienced a cumulative fall of 11.1%
 - **Domestic demand** endured a drop of 22.3%
 - **Household consumption** fell by 7.7%
 - The volume of **retail sales** declined by 22.2%
 - **Car sales** were down by 74%
 - **Consumer sentiment** fell by 62.9 percentage points
 - **Residential property values** dropped by 60%
 - **Household savings ratio** increased
- ✓ The above trends have taken their toll on SMEs. The impact of the recession on the performance of SMEs (in terms of turnover, profitability and income levels) is likely to have resulted in: 1) a reduced demand for credit; 2) a reduced ability to secure credit; and 3) a reduced ability to make repayments.
- ✓ Looking specifically at two examples across the main SME sectors:
 - The **Construction** sector experienced the most severe contraction over a short period reflecting the substantial amount of new non-residential (as well as residential) building put in place in the ten years to 2007. Much of this investment was funded by bank borrowing.
 - Much of the investment in **Retail** space, for example, would also have been funded by bank borrowing. As sales demand has fallen the requirement to invest in new capacity has fallen even faster with a consequent diminution of demand for credit based investment. Many **Retail** SMEs are more likely to be focused on **repaying or restructuring debt** than on investment and expansion.
- ✓ SMEs depend to a significant extent on **property-based collateral** to obtain finance. With property values down around 60%, this will have significantly reduced the capacity and appetite of individuals and SMEs to borrow in recent years as well as their ability to repay.

More information:

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Credit Availability, Supply and Bank Lending to the SME Sector

- ✓ Far too little attention has been paid to the balance sheets of SMEs in analysing credit demand and supply. In this regard, the above issues are likely to be among the key criteria which a bank must factor in when determining a firm's capacity to borrow as well as their ability to repay.
- ✓ Survey evidence across the EU show that sharp declines in demand are reflected in sharp reductions in loan acceptance rates for SMEs. Ireland is the only euro area country to have experienced sharp declines in both.
- ✓ A major flaw in the cross country analysis of SME borrowers' experiences has been to ignore credit supply conditions and the future balance sheet obligations of domestic banks.
- ✓ Deleveraging is shrinking the banking system but the PLAR targets are not acting as a constraint on lending to SMEs by the pillar banks. SME lending targets set by Government were met in 2011 (not less than €3bn) and 2012 (€3.5bn) with the target of €4bn in 2013 expected to be accommodated within current deleveraging targets.
- ✓ Total private sector credit demand relative to GNP rose sharply from 2003 to its peak in 2009 when it was 120 percentage points higher than at the end of 2003. Total **SME credit outstanding** (data from 2010 only) represented 60% of total credit outstanding to all enterprises in December 2010 and 64% in December 2012. Total SME credit outstanding declined by €1.3bn between 2010 and 2012. **The decline is concentrated in the very sectors which are identified as the most heavily indebted relative to value added.**

Main Findings from an Analysis of SME Lending and Lending Surveys

- ✓ SME lending data tell us a limited amount about the credit conditions for SMEs;
- ✓ The absence of significant information on the level of indebtedness and past borrowing history in the Mazars/RedC surveys means that results have to be interpreted very carefully;
- ✓ The surveys do not examine in detail the reasons for the loan rejection rates;
- ✓ One-third of all SME applications for bank finance involved a restructuring of existing facilities;
- ✓ The RedC survey suggests that the main financing difficulties facing SMEs is the inadequate nature of retained earnings, or the need, in times of economic decline, to obtain finance to offset losses;
- ✓ When firms are asked the reason for seeking credit working capital requirements dominate, but, within that category, 'recession-related' reasons – decline in revenues, slowdown in debt collection, increasing bad debts – feature for a significant number of respondents;
- ✓ The high levels of dependence on overdrafts and trade credit by Irish SMEs may be reflections of financial stress (ECB SAFE survey);
- ✓ The most pressing problem for 29% of Irish SMEs was finding customers; in line with the average for Euro zone countries (27%), (ECB SAFE survey);
- ✓ Absence of balance sheet information on the applicants makes it impossible to explain cross country variations in acceptance and refusal rates;
- ✓ While the rate at which Irish loan applications are rejected in full is at the higher end of the spectrum, the credit experience of Irish SME is not inconsistent with other economies which suffered sovereign debt shocks and/or which had a rapid expansion in private sector credit relative to income in the period 2000 to 2007;
- ✓ Overall there is little evidence from the detailed credit statistics that SMEs have fared worse than larger enterprises with respect to credit flows.

Funding Initiatives for SME

The Government introduced a range of measures in 2012 and over the course of 2013 to date which are intended to correct certain market shortcomings and fill the SME financing gap in Ireland.

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