Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

The Irish SME lending market - a snapshot, December 2010

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Economic Letter Series

Vol. 2012, No.3

Abstract

The Prudential Capital Assessment Review (PCAR) 2011 uncovered significant potential losses in the Irish banking sector, leading to a considerable recapitalisation. This letter uses a large sample of the loan level data provided for PCAR 2011 to present descriptive statistics on the SME lending market in Ireland as of December 2010. These data allow us to document the geographic and sectoral allocation of loans, exposure sizes and the performance of those loans. We find that there are significant losses, both incurred and potential, across all sectors of activity. These losses are most severe in the hotels and restaurants, construction and wholesale and retail sectors. In almost all sectors, a striking pattern in which large exposure buckets are associated with larger shares of non-performing loans, points to a higher-than-normal risk of large SME loans leading to significant losses. The contribution of property speculation to these losses is unobserved in these data but of huge policy interest.[1]

1 Introduction

The extension of credit to the real economy is a topic of keen policy interest in Ireland. Small and medium enterprises (SMEs) account for 99 percent of firms and 68 percent of employment in the private sector in Ireland (Source: Eurostat)[2]. Many observers believe that a lack of credit to indigenous firms poses a substantial risk to potential economic recovery. International evidence suggests that credit constrained firms do indeed engage in less economically valuable and growth-enhancing activity than similar unconstrained firms, thus confirming these fears.[3]

Lawless and McCann (2011) have shown that SMEs in Ireland are currently subject to credit supply conditions tighter than any other Eurozone country, even when controlling for falls in output and increases in borrower riskiness. These findings suggest that policy action on lending to SMEs in Ireland may be required to increase the likelihood of domestically-driven economic growth.

Key in formulating policy on SME lending in Ireland is an understanding of previous lending patterns and the current stock of debt on the banks' books. As part of the Financial Measures Program (Central Bank of Ireland, 2011a), Irish domestic banks were required to submit their loan-level data to the Central Bank of Ireland in early 2011. These data, used to calculate loan loss es-

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[2]Small and medium enterprises are generally defined as firms employing fewer than 250 employees.

[3]Campello et al. (2010) show that credit constrained firms are substantially more likely to decrease employment, investment, technology spending, marketing spending and dividend payouts than matched unconstrained firms. A large literature in international trade also shows that credit constrained firms are less likely to enter export markets.

timates for the Prudential Capital Assessment Review (PCAR) 2011, provided a snapshot of the full stock of loans in mortgages, SME, corporate, consumer and commercial real estate lending as of December 2010. This paper focuses on the SME loan books of selected Irish banks, which collectively account for a majority of the total SME loan exposure of Irish banks at the time of data collection.[4]

The paper provides descriptive statistics on the type of facility provided, the geographical breakdown, and the breakdown by sector of activity. The picture presented here is one of a loan book in significant distress, with 30 percent of all loans in Ireland classified as Watchlist, Past Due, Default or Impaired. This figure varies significantly by sector, with sectors such as hotels and restaurants, energy and mining and construction accounting for larger than average shares of non-performing loans.

An analysis of the performance of loans across the distribution of exposure size indicates that large build-ups of high-volume, high-risk lending exist in the system. Loans in the 9th and 10th decile of the exposure distribution with agriculture, hotels and restaurants, manufacturing are shown to have shares of performing loans below 50 percent.

The information provided in this paper can help inform policy makers on the sectors of activity currently causing most trouble to the banking sector. Comparisons between the importance of sectors in lending to their importance in economic activity can help to motivate policies for the desired direction of new lending in the economy.

2 Data description

The data in this paper cover an extremely large sample of loans extended to the SME sector from Irish covered banks. In Table 1 the distribution of the number of facilities per borrower is detailed, with the dominance of single-facility borrowers clear. Fully three quarters of borrowers are only using one facility in that bank, while a further 16 percent are using two facilities.[5]

Table 1 also looks at the type of credit facility that has been provided. Facility type is defined differently across banks. For the purposes of this paper, we have grouped "Overdrafts" and "Revolving Credit" under the term Revolving, and have grouped "Term Loans", "Hire Purchase", "Loans" and "Leasing" under the broad heading of Loans. Of the facilities in the data, 80 percent of them had information provided on the type of loan. We see that between Loans and Revolving facilities, the sample is split almost perfectly evenly. However, unreported calucations of facility size show there is almost three times as much exposure in Loans as in Revolving credits, which we would expect given the nature of these products.

The share of loans classified as performing, watchlist or past due, and defaulted or impaired is detailed across regions in Table 2. The figures suggest that SME loan performance is relatively stable across the country, with the share of performing loans between 68 and 72 percent in each region. Table 3 explains which counties are allocated to which region.

3 Sectors of economic activity

The sector of activity of the borrower is perhaps the most interesting disaggregation of business loans from a policy perspective. The differing nature of firms in different sectors of the economy in terms of employment, investment patterns, engagement in exports and usage of technology provide important delineations along which policy can be based. An important part of strategy for Irish economic recovery will be based on the current and desired future allocation of resources across sectors.

Table 4 breaks the data down by broad sector of activity. A full quarter of the loans are in the agriculture and food sectors. The next most important sector is professional services and real estate, which accounts for nearly one-fifth of loans, while the wholesale and retail sectors account for 16 percent. Other large sectors in terms of number of loans include the public, community and local services sector and SMEs operating in the construction sector.

The wholesale and retail sectors account for

[4] One caveat to comparing these data with aggregate SME data is that, as this was the first time data was provided to the Central Bank at this level of disaggregation, banks classification of SMEs in these data does not match the traditional definitions used by statistical agencies. In some cases, the majority of business banking, which may include firms with more than 250 employees, is included in the SME loan books. A consistent definition is being developed so that future data drops contain information on the exact same type of firms across banks.

[5] We do not have information that can link a borrower with facilities in different banks.

the largest share of total exposure, with one fifth of the total SME loans in Ireland going to firms in these sectors. Agriculture & food, hotels & restaurants and the financial sector are the next largest sectors with 15 percent of total exposure going to each of these.

Compared to the average loan size, the hotels and restaurants, financial, and energy and mining sectors seem composed of extremely large loans. This can be seen by their larger share of total exposure relative to their share of facilities. Hotels and restaurants is the sector that is most over-represented in terms of total exposure relative to the amount of loans in the sector (15 percent as opposed to 5 percent of loans).

Table 5 documents the share of loans in each sector that fall into the categories of performing, watch list, and default or impaired. The table reveals that loans in the agriculture and food sectors appear by a distance to have the highest share of performing loans as of December 2010. This is consistent with evidence on the economic performance of the agri-food sector in Ireland, as evidenced by the increase of 17.1 percent year-on-year in the value of exports in this sector (Central Bank of Ireland, 2011b).

Of the sectors which account for large shares of the total SME exposure of the Irish banks, the figures for the hotel and restaurant sector are particularly troubling. In a sector that accounts for 15 percent of the total SME exposure of banks in our sample, fully 51 percent of loans are either defaulted, impaired or on watch/past due. Wholesale and retail and the financial sector, two others with large exposures, have healthier figures in comparison, however performing loan shares of 69.31 and 65.79 percent respectively still remain low.

Table 6 reports the shares of arrears and provisions made in each sector as of December 2010. We see again that the hotels and restaurants sector accounts for high levels of arrears relative to its share of loans (one seventh of arrears, as opposed to one twentieth of loans). In terms of provisions made, one quarter of total SME provisions are in the hotel and restaurant sector which is again striking.

Other sectors where arrears and provisions are large are the agriculture and food sector, the professional and real estate sector, and wholesale and retail. It should also be noted that construction's share of arrears is very large relative to its share of loans and total exposure.

4 Loan risk across the distribution of exposure

Lessons contained in the information in Table 5 and 6 are limited to shares across sectors. Knowledge of how loan performance varies across the loan distribution is crucial to our understanding of the risks inherent in the Irish SME loan market. Figure 1 plots the share of performing loans in each of 20 quantiles of the distribution of exposures. From this we see that, for the vast majority of loans, the share of performing loans hovers between 70 and 80 percent. Above the 15th quantile however, we see performing shares fall below the 70 percent mark, and in the 19th and 20th quantile, i.e. the largest loans in the market, we see the largest shares of non-performing loans. This suggests a very worrying picture in terms of expected losses from these loan books, and also points to particularly risky behaviour on the part of Irish banks, who placed their largest exposures in disproportionately risky projects.

Figures 2 to 6 give the share of performing loans across the deciles of exposure within sectors of interest. The pictures show that agriculture, despite appearing as the safest sector in terms of share of loans that are performing, does pose something of a risk: the only deciles in which there is a larger than 20 percent share of non-performing loans are the 9th and 10th decile, with 40 percent of the largest loans classified as non-performing.

The professional and real estate sector follows a similar pattern to agriculture and food in this regard. In wholesale and retail, the performance of loans is more steady, but consistently poorer than the previous two sectors below the 8th decile, with the performing share remaining between 60 and 75 percent across the whole distribution of exposure. The manufacturing sector follows a more volatile pattern, with huge non-performing rates of 70 percent in the 8th and 10th deciles.

Finally the hotels and restaurants sector, unsurprisingly given the average statistics previously presented, shows performing rates below 40 percent below the median exposure, and shares as low as 20 percent is the larger deciles, which points to huge potential as well as realised losses, as shown in Table 6.

5 Conclusions

This note describes the main characteristics of the SME loanbooks of two large Irish banks at the end of 2010. We use the large set of information at the loan level to generate statistics on the geographic and sectoral allocation of loans, exposure sizes and the performance of those loans. The loanbooks show significant losses, both incurred and potential, across all sectors of activity. Losses are highest in the hotels and restaurants, construction and wholesale and retail sectors.

References

[1] Campello, M., Graham, J.R., Harvey, C.R. (2010), The real effects of financial constraints: Evidence from a financial crisis, *Journal of Financial Economics*, 97, 470487.

[2] Central Bank of Ireland (2011a), *Financial Measures Programme Report*.

[3] Central Bank of Ireland (2011a), *Central Bank Quarterly Bulletin*, Quarter 4, 2011.

[4] Lawless, M. and F. McCann (2011), Credit Access for Small and Medium Firms: Survey evidence for Ireland, Central Bank of Ireland Research Technical Paper 11/RT/11.

Table 1: Facility types and number of facilities per borrower

Facilities	%
1	75.49
2	16
3	5.17
4	1.74
5	0.64
6	0.33
7	0.18
8	0.11
9	0.07
10	0.05

Facility type	%
Loan	48.4
Revolving	51.6

Table 2: Performing, Watchlist/Past Due, Default/Impaired, by geographic region

	(1) Performing %	(2) Watchlist/Past Due %	(3) Default/Impaired %
Cork	68.26	23.22	8.52
Dublin	68.66	20.27	11.07
North East	63.35	24.29	12.36
North West / Midlands	72.2	15.32	12.49
South East & Midlands	72.73	17.57	9.7
South Leinster	72.42	17.52	10.07
West	72.19	18.17	9.64
West Munster	70.87	20.14	8.99
Total	70.19	19.66	10.15

Table 3: Geographical definitions

Cork	
Dublin	
North East	Meath, Louth, Cavan, Monaghan
North West / Midlands	Donegal, Sligo, Roscommon, Longford, Westmeath
South East & Midlands	Laois, Offaly, Kilkenny, Tipperary, Waterford
South Leinster	Wicklow, Wexford, Carlow, Kildare
West	Galway, Mayo
West Munster	Kerry, Clare, Limerick

Table 4: Share of loans and exposure by sector of activity

	(1) % Loan Facilities	(2) Share of Total Exposure
Agriculture & Food	24.83	15.20
Construction	8	3.42
Electronic	0.34	0.06
Energy & Mining	0.25	0.95
Financial	7.44	15.91
Hotels & Restaurants	5	15.46
Manufacturing	5.84	6.48
Professional & Real Estate	18.8	11.74
Public, Community & Local	8.46	7.66
Transport & Comms	4.58	3.03
Wholesale & Retail	16.46	20.10
Total	100	100.00

Table 5: Loans in performing, watchlist, default/impaired by sector of activity

	(1) Performing %	(2) Watchlist/Past Due %	(3) Default/Impaired %
Agriculture & food	81.38	13.83	4.79
Construction	65.23	12.75	22.02
Electric	49.63	48.08	2.29
Energy & Mining	53.31	20.78	25.91
Financial	65.79	16.22	17.99
Hotels & Restaurants	48.9	34.82	16.28
Manufacturing	65.9	20.38	13.72
Professional & Real Estate	68.92	20.1	10.98
Public, Community & Local	71.99	19.99	8.01
Transport & Comms	66.26	20.1	13.63
Wholesale & Retail	69.31	17.1	13.6
Total	70.48	18.02	11.5

Table 6: Share of arrears and provisions by sector

	(1) Arrears (%)	(2) Provision (%)
Agri	17.18	7.82
Construction	15.50	9.20
Electric	0.02	0.02
Energy & Mining	3.22	0.80
Financial	4.10	7.73
Hotels & Restaurants	16.82	28.81
Manufacturing	4.60	6.91
Professional & Real Estate	10.66	10.65
Public, Community & Local	6.67	5.93
Transport & Comms	2.95	4.92
Wholesale & Retail	18.28	17.21
Total	100.00	100.00

Figure 1: Share of performing loans across the distribution of exposure

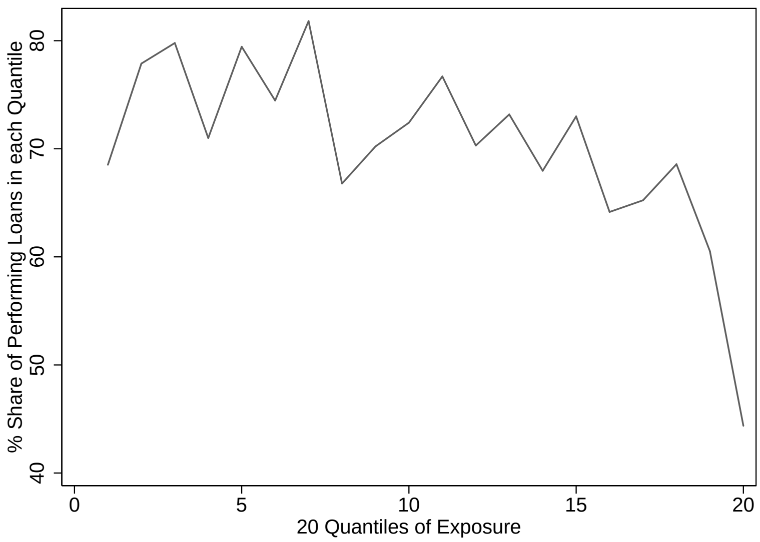

Figure 2: Share of performing loans across the distribution of exposure in Food and Agriculture

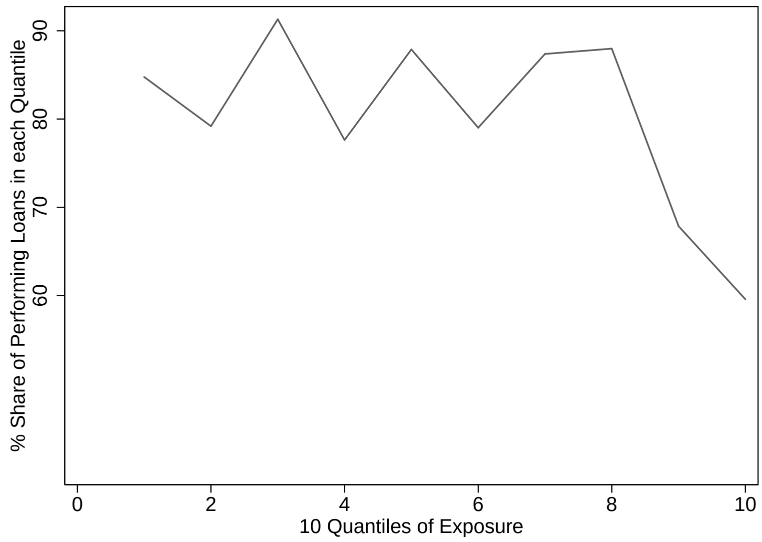

Figure 3: Share of performing loans across the distribution of exposure in Wholesale & Retail

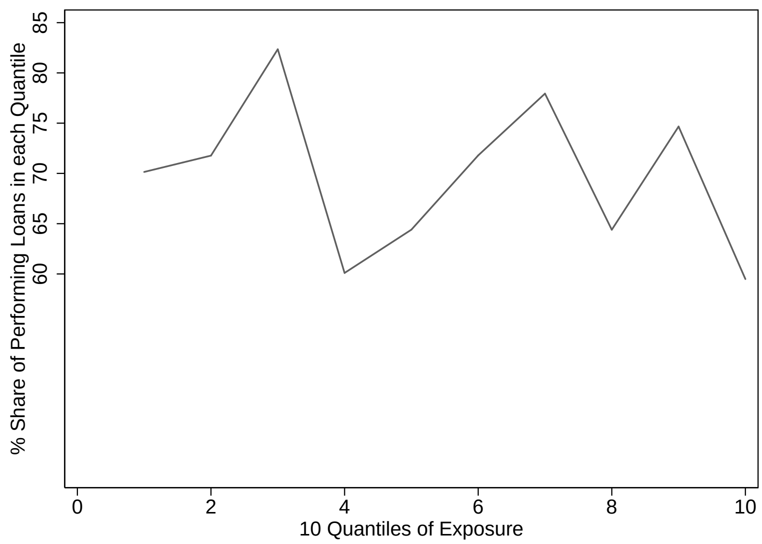

Figure 4: Share of performing loans across the distribution of exposure in Professional & Real Estate

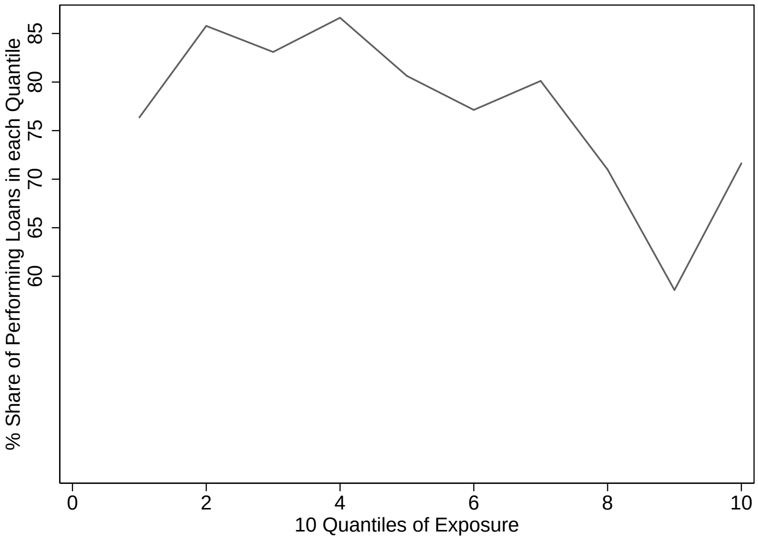

Figure 5: Share of performing loans across the distribution of exposure in Construction

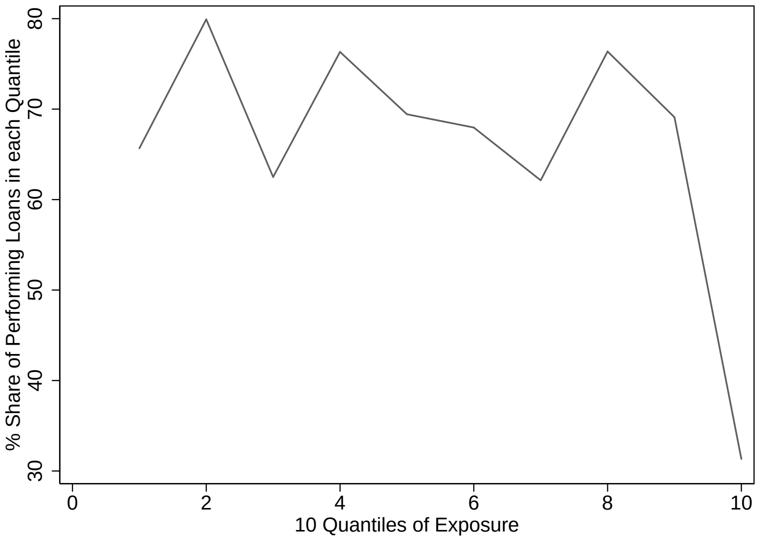

Figure 6: Share of performing loans across the distribution of exposure in Manufacturing

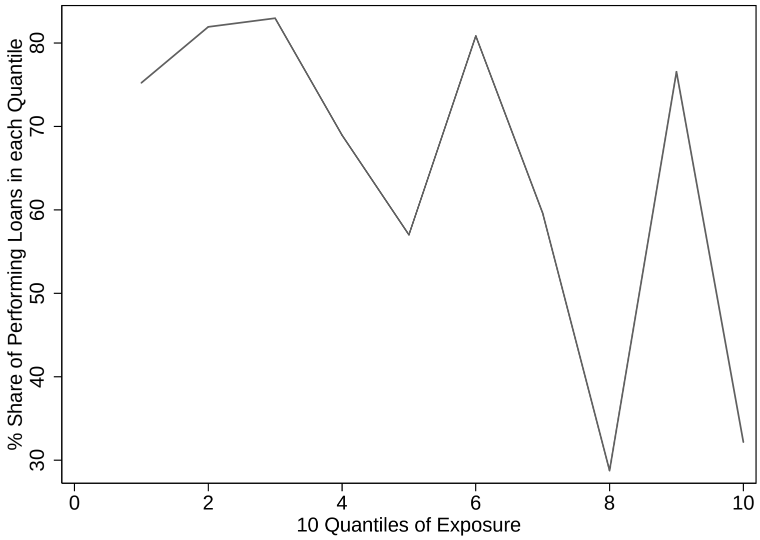

Figure 7: Share of performing loans across the distribution of exposure in Hotels