



Mr Patrick Honohan,
Governor,
Central Bank of Ireland,
Dame Street,
Dublin 2.

9 April 2015

Re: Code of Conduct for Business Lending to Small and Medium Enterprises

Dear Patrick,

I refer to the Central Bank of Ireland Consultation Paper (CP91) on a review of the Code of Conduct for Business Lending to Small and Medium Enterprises.

Please see attached for consideration the comments of the Department of Finance on the proposals as set out in the paper. The Department will of course be available to discuss any aspect of this submission with the Central Bank if required.

Yours sincerely,

Ann Nolan

Second Secretary General

**Department of Finance observations on Central Bank of Ireland's review of the Code of
Conduct for Business Lending to Small and Medium Enterprises**

(Consultation Paper CP91)

Introduction

1. The Government recognises that SMEs are the lifeblood of the economy and play a vital role in the continuing recovery of employment growth in Ireland. SMEs comprise 99.6% of all employer firms and employ approximately 70% of the labour force. 67% of all new job creation in Ireland comes from businesses in the first 5 years of existence. While there is great diversity across SMEs in terms of sector, location, size and turnover, over 90% of SMEs employ less than 10 employees.
2. Government policy since 2011 has focused on ensuring that all viable SMEs have access to an appropriate supply of credit from a diverse range of bank and non-bank sources to support business and foster economic growth and increased employment.
3. Results from the Department of Finance SME Credit Demand survey (October 2014) show stable/increased trading conditions for the majority of SMEs (84%) and an increase in the number of SME credit applications approved (86%, a 5% increase on the previous 6 months). It is important to continue to build on this, protect and create employment, and reinforce the positive results from economic indicators, such as increasing GDP projections, which indicate continuing growth in the Irish economy.
4. The supply of credit to SMEs is a crucial factor in this improvement in trading conditions and the review of the SME Code must also be considered in this context, ensuring that increased regulation in this area does not ultimately negatively impact credit supply to SMEs. It is essential, however, that SMEs are afforded protection when accessing credit or in financial difficulties.
5. The Central Bank's continuing process of assessing financial institutions in their efforts to move distressed SME borrowers onto longer-term sustainable solutions is an important element in assisting SMEs to potentially transition from a distressed to a more sustainable state. Additionally, the Government's enactment of legislation to allow

small companies (as defined by the Companies Acts) to apply to the Circuit Court for examinership and the on-going work of the expanded Credit Review Office are all initiatives that are assisting viable SMEs in addressing their debt situation.

6. Smaller SMEs, with a turnover of up to €3 million, are consumers and are afforded the protection of the Consumer Protection Code 2012. SMEs are also currently afforded the protection of the 2012 Central Bank's Code of Conduct for Business Lending to Small and Medium Enterprises (SME Code) – issued under Section 117 of the Central Bank Act 1989.
7. The Department has noted that the Central Bank now propose to make regulations under Section 48 of the Central Bank (Supervision and Enforcement) Act 2013 to both replace the existing Code and to introduce reforms to strengthen the protections available to SMEs. Recognising the importance of both consumer and SME protection, the Department of Finance broadly welcomes the making of the proposed regulations under Section 48 of the Central Bank (Supervision and Enforcement) Act 2013.

The Department has a number of concerns in relation to the proposed regulations and these are outlined below in this paper. It is vitally important at a time when recovery in the economy will provide growth opportunities for the SME sector that these new regulations should aid rather than inhibit the availability of credit and funding to the SME community. It is also important that provisions of the new regulations are workable, enforceable and are proportionate whilst recognising the dynamics associated with credit in the SME sector.

The Consultation Paper also sets out a number of specific questions and the Department's observations on these are attached.

Finding a balance between providing protections for SMEs without stifling or increasing the cost of lending.

8. The Department is concerned that the correct balance be struck in the new regulations, providing an appropriate level of protection for SMEs without placing such an increase in the administrative burden on lenders in complying with the regulations that it results in lenders tightening their lending policies or passing the increased cost arising from compliance on to their SME customers.

The “one size fits all” nature of the regulations should be re-examined.

9. The Department is concerned about the “one size fits all” approach being taken in the proposed regulations. The current Code provides additional protections to “smaller enterprises” relating to the provision of information and advertisements and applies in the case of credit facilities other than leasing, hire purchase and invoice discounting.

While the Department sees merit in the application of a unified set of regulations across regulated lenders, larger SMEs, with more sophisticated financial needs, may not need the same level of protections as now proposed.

The Department recommends that the Central Bank revisit their proposed approach of one set of regulations to apply irrespective of the size of the SME to ensure that the application of the proposed regulations does not curb the flow of credit to SMEs.

Competition in Banking Sector

10. Competition is essential in the banking sector in Ireland. It is important that the proposed regulations do not serve to discourage competition in the banking sector which would result from overly burdensome regulations.

Credit Application Declines

11. In the case of credit application declines, the requirement to issue more detailed information to the SME is welcome. As well as providing clarity and transparency on the decision made, this may also encourage a learning effect for SMEs, which can inform any subsequent applications for credit. While detailed information on the reasons for the decline of credit could be provided immediately where possible, this may not be practicable in all cases, for example in the case of Online Credit Applications. The accessibility and use of Online Credit Applications is to be encouraged, and the Department understands that this is projected by some lenders to increase by up to 40% in the next three to four years. The Department therefore considers it very important that the requirement for more detailed decline information should not hinder developments in Online Credit Applications. Exceptions could be made, for example in the case of an Online Credit Application, where a detailed decline letter may issue within a reasonable timeframe, for example 15 working days, the precise length of which should be specified in the new regulations.

Consideration should also be given to furthering the work already undertaken through the Banking and Payments Federation of Ireland, whereby credit application decline letters are written in 'plain English', with additional reasons for decline included. While the Department understands that some banks are moving to issue decline letters with more comprehensive explanations on a voluntary basis, proportionate provisions in the revised regulations should support an expansion of this approach and provide a better understanding by SMEs of the reasons for decline. It is important to ensure that the proposals in the regulations on the issue of credit declines do not affect the speed of credit approval and the associated cost of credit.

Improved communication and specification of timeframes is important

12. Improved communication and the specification of timelines which apply to the assessment of an application for credit are also welcome. It is acknowledged that timelines may vary depending on the complexity of the case and the type of credit

sought. The key element is that timelines are explicit and that any delays the lender may have in processing a loan application must be communicated to the SME.

The Department is in agreement with the decision response time of 15 days and looks forward to guidance from the Central Bank on their proposals for enforcing this timeline. While the latest Department of Finance survey of the SME sector indicates improvement of decision timelines, the survey outcomes suggest that more work is required to ensure adherence by financial institutions to the 15 day timeline which was part of the previous Code.

The concept of 'not co-operating' may not be appropriate in an SME context

13. While in principle there may be value in considering the introduction the concept of an SME borrower who is 'Not Co-operating', in line with the Code of Conduct on Mortgage Arrears 2013 (the CCMA), in reality it may be an ineffective measure when applied to SMEs. SMEs often operate in a different environment from consumers and the application to the SME sector of a broad consumer protection measure, such as this, may therefore not be appropriate to businesses. For an SME who is in financial difficulties and 'not co-operating', because of its broader credit relationship with the financial institution through overdraft and other facilities the effect of non-co-operation will most likely become transparent sooner. A detailed impact analysis by the Central Bank on the broad applicability of these consumer protection measures to the SME sector would be required in advance of final decisions on their inclusion in the regulations.

The Department also has concerns as to how the regulations can differentiate between a 'not-co-operating' borrower in a partnership where one partner may be co-operating. The proposed regulations are not clear on this point.

In addition to the above comments, the Department's responses to the 8 questions posed by the Central Bank in their consultation paper is set out below.

Question 1: Do you have comments on the attached draft regulations? In your response, please quote the number of the specific provision(s) which give rise to your concerns and, if possible, suggest alternative drafting or solutions.

Response:

The new Regulations are considerably more detailed than the existing SME Code and in this regard, they may increase the regulatory burden on regulated entities.

It is vitally important at a time when recovery in the economy will provide growth opportunities for the SME sector that these new regulations should aid rather than inhibit the availability of credit and funding to the SME community. It is also important that provisions of the new regulations are workable, enforceable and are proportionate whilst recognising the dynamics associated with credit in the SME sector.

It is crucial that the resulting additional cost incurred by regulated entities is not ultimately to the disadvantage of SMEs seeking credit. The Department would be particularly concerned if the additional requirements being placed on lenders had the effect of reducing the availability or adding to the cost of credit for viable and sustainable business proposals from SMEs. The Central Bank needs to satisfy itself that the measures it proposes to introduce support the availability of credit to the sector at this vital juncture in the recovery of the economy. Placing additional and unnecessary administrative procedures may hamper this recovery. However, the Department recognises that protections for businesses and internationally accepted credit standards on the part of banks need to be a feature of credit availability for the SME sector particularly given the experience of increased and over indebtedness for a significant cohort of the sector through the last decade. A significant challenge for the Central Bank is to determine the appropriate balance to apply in order to ensure that these core principles are adhered to. The impact of increased regulation in this area should therefore be closely monitored, so that appropriate adjustments can be made if the impact has a disproportionate effect on the flow of credit to the SME sector.

Question 2: Are there specific areas that you feel should be expanded on? If so, please provide details and, if possible, drafting suggestions or proposed solutions.

Response:

While it is agreed that detailed decline information should be provided to the SME, it is not necessary that the decline decision and the detailed explanation occur at the same time. The detailed explanation can follow (within a timeframe specified in the regulations e.g. 15 working days). This will ensure that innovative approaches to loan applications and decisions will not be discouraged, for example through Online Credit Applications.

Additionally, as discussed above, it may be useful to set a requirement for all decline letters to issue in ‘plain English’ and with additional and more detailed standard decline reasons, building on the work already undertaken in this area by the Banking and Payments Federation of Ireland. This may strike an appropriate balance between providing further, and comprehensive, detail to SMEs who have been declined credit, without hindering new and more responsive mechanisms by institutions in dealing with credit applications.

Question 3: Do you have any suggestions for further reform, e.g., are there any gaps or areas omitted from the protections proposed? If so, please set out your proposals.

Response:

The Department recommends the following two areas for further consideration:

Partnerships

The regulations would benefit from clarification in relation to a partnership where one borrower is in “financial difficulty”/“not co-operating” and the other partner is co-operating.

Re-instatement of the following paragraph from the existing Code:

The following text from the existing Code of Conduct (2012) should be reinserted into the revised SME Code:

“Nothing in this Code prohibits a regulated entity from acting with all necessary speed:

- a) where in the circumstances of the case it is necessary to initiate a liquidation, receivership, examinership or similar insolvency event or where another regulated entity or other third parties initiate such actions;
- b) where it is necessary in order for a regulated entity to protect its legitimate commercial interests; or
- c) where there is reasonable evidence of fraud, terrorist connections, money laundering and/or misrepresentation,

and the provisions of this Code are without prejudice to a regulated entity's regulatory and/or legal obligations and legal rights to enforce any agreement including any security taken in connection with any agreement."

Question 4: Do you agree that SMEs dealing with credit unions should have the same level of protection as when dealing with other lenders? If you do not agree, please outline the reasons why.

Response:

In principle, the Department is of the view that SMEs dealing with credit unions should have the same level of protection as when dealing with other lenders. However, SME lending does not currently form a huge portion of credit union lending and the Department is concerned that including credit unions in the proposed regulations at this juncture could place a considerable additional administrative burden on individual credit unions in a background where little SME lending is currently taking place. New regulations being introduced for credit unions will allow for more credit unions to provide such lending and their inclusion in the scope of the proposed regulations may be deemed necessary in the future. In the meantime, credit unions must comply with the Consumer Protection Code 2012.

It is therefore recommended that credit unions remain outside the scope of the proposed regulations for business lending at this time but that the matter be kept under review.

Question 5: Do you agree that the 'Smaller Enterprises' provisions in the current SME Code should be extended to all SMEs? If not, please set out the reasons why.

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Response:

As outlined above, the Department is concerned about the “one size fits all” approach being taken in the proposed regulations. The current Code provides additional protections to “smaller enterprises” relating to the provision of information and advertisements and applies in the case of credit facilities other than leasing, hire purchase and invoice discounting. While the Department sees merit in the application of a unified set of regulations across regulated lenders, larger SMEs, with more sophisticated financial needs, may not need the same level of protections as now proposed. Indeed larger enterprises can often have more diverse options in terms of accessing funding beyond the traditional regulated institutions and are often better placed through their own independent advisors to make an assessment of the terms and conditions of the loans being offered by the mainstream lenders compared with other funding options. Care must be taken to ensure that the attractiveness of bank lending is not adversely affected by increased regulatory provision.

The Department recommends that the Central Bank revisit their the ‘Smaller Enterprises’ provisions in the current SME Code and consider whether the provisions should remain applicable only to smaller enterprises as is currently the case.

Question 6: Do you agree that business credit cards should be included in the scope of the regulations that are proposed to replace the SME Code for all SMEs? Please explain why you think this approach is appropriate. If you do not agree, please set out the reasons why.

Response:

The Department has concerns about the proposed extension of the regulations to include credit cards which are not addressed in the consultation paper. For example, should an SME fail to meet business credit card payments, or clear in full, will the SME be categorised as being in financial difficulty and potentially ‘not co-operating’?

SMEs may use business credit cards as a cash flow tool, rather than for credit supply. For this reason, it may be unnecessary to include business credit cards within the scope of the regulations which may unduly increase the administrative burden on banks in complying with

these regulations. Indeed, we understand that the usage of credit cards by SMEs in this manner (for credit supply) is very low.

The Department therefore does not agree that business credit cards should be included in the scope of the proposed regulations at this time.

Question 7: Do you agree that multi-lender credit, including syndicated, club or other multi-lender transactions, and special purpose vehicles should continue to be excluded from the scope of the regulations? If so, please provide the reasons for your view. If you do not agree, please set out the types of multi-lender credit or special purpose vehicles you think should be included and explain why the protections proposed would be appropriate or necessary for these borrowers.

Response:

If an SME is utilising a team of creditors in a multi-lender situation or set up as an SPV, it would, or at least should, be a sophisticated borrower and have access to professional advisors and the resources to access appropriate expertise. In such circumstances, they do not require the same protections as other SMEs.

The Department therefore agrees that multi-lender credit, including syndicated, club or other multi-lender transactions, and special purpose vehicles should continue to be excluded from the scope of the regulations.

Question 8: Do you agree that the introduction of a concept of ‘not co-operating’ is useful in an SME context? If so, do you have any comments on the proposed provisions?

Response:

As highlighted above, this may not be an effective measure when applied to SMEs. SMEs operate in a different environment from consumers and the application of a consumer protection measure such as this may not be appropriate to businesses. For an SME who is in financial difficulties and ‘not co-operating’, because of its broader credit relationship with the financial institution through overdraft and other facilities the effect of non-co-operation will most likely become transparent sooner. A detailed impact analysis by the Central Bank on the

broad applicability of these consumer protection measures to the SME sector would be required in advance of final decisions on their inclusion in the regulations.

The Department also has concerns as to how the regulations provide for lenders differentiating between a borrower who is not co-operating in a partnership where one partner may be co-operating. The proposed regulations are not clear on this point.

The Department therefore does not agree that the introduction of a concept of 'not co-operating' is useful in an SME context.