

SME Market Report

2014 H1



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

The Central Bank of Ireland's *SME Market Report* is compiled by economists in the Financial Stability Division and aims to collate information from a wide range of internal and external sources to give an up-to-date picture of developments in the Irish Small and Medium Enterprise (SME) credit market.¹ The Report will provide information on credit demand, credit access, loan terms and conditions, loan default, interest rates and credit market concentration. It is envisaged that the Report will be released twice yearly. Data used to populate this report come from Central Bank of Ireland *Credit, Money and Banking* and *Retail Interest Rates* aggregate statistics, the Red C *SME Credit Demand Survey*, the European Central Bank (ECB) / European Commission (EC) Survey on the Access to Finance of Small and Medium Enterprises (*SAFE*) and loan-level data collected by the Central Bank of Ireland from the Irish domestic banks participating in the 2011 Financial Measures Program. The data sources are detailed in Appendix 1. The definition of an SME used in each data source is detailed in Appendix 2.

Overview

- The outstanding balance of lending to SMEs has been steadily falling since 2011, with this pattern observable among all the major sectors of the non-financial, non-real-estate economy. Gross new lending flows to these sectors have remained between €450 and €750 million per quarter since 2011 with no discernible upward trend (Section 1).
- SME credit demand is shown to have fallen slightly in the year to March 2014, but to be around the euro area average. Credit demand is shown to be non-expansionary in nature, with demand for working capital and restructuring purposes outstripping that for investment or growth purposes (Sections 2 and 3).
- Credit supply conditions are shown to have eased in the period 2011-2014, with rejection rates on SME credit applications falling from 30 to 20 per cent between March 2011 and March 2014, and a steady increase in the percentage of firms reporting that the size of loan available has increased. In a European context, Irish SME credit conditions remain closer to those of Greece, Italy, Spain and Portugal than to those countries with the most favourable conditions. The share of discouraged borrowers (those not applying for credit due to the expectation that they will be refused) is significantly higher in Ireland and Greece than elsewhere in the euro area (Sections 2 and 3).
- Central Bank of Ireland loan-level data highlight the extent of loan default in the Irish SME market. The default rate is 26 per cent when measured by the number of loans, and 41 per cent when weighted by loan balance. The default rate is highest for SMEs in the Construction, Hotels and Restaurants and Personal (Private Households)² sectors, and is shown to increase among the largest 25 per cent of loans (Section 4).
- For smaller borrowers, both the spread over the Euribor interbank rate and the interest rate premium over larger borrowers have grown since the 2008 crisis (Section 5).
- The SME credit market has become increasingly concentrated between 2011 and end-2013, with the Herfindahl-Hirschman Index of new credit flows increasing from 0.3 to 0.45 over the period (Section 6).
- A Box on a recent policy development, the Strategic Banking Corporation of Ireland, is also included.

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²This sector involves lending for the purposes of house purchase, property investment and consumer lending that is managed in the business banking units of the subject banks.

1 Central Bank of Ireland *Credit, Money and Banking Statistics*

Figure 1 reports the volume of SME credit outstanding using data from the Central Bank of Ireland's *Credit, Money and Banking* statistics. Total credit for the SME market, excluding both the Financial Intermediation and property-related sectors, is shown to have fallen continually since mid-2011. At end-2013 lending to firms in this category accounted for 37 per cent of total SME credit, with the remaining 63 per cent accounted for by lending to firms in the Financial Intermediation and property-related sectors.

Figure 1. Total Outstanding SME Credit, 2010Q1-2013Q4

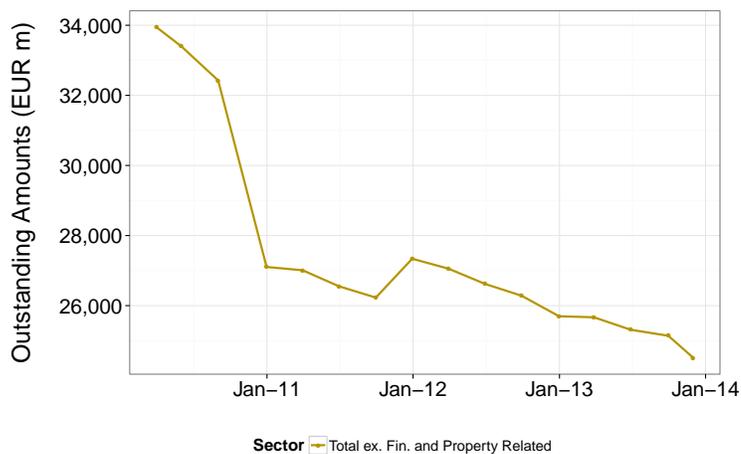


Figure 2. Sector Outstanding SME Credit, 2010Q1-2013Q4

Figure 2 reports the volume of SME credit outstanding for the largest non-financial, non-real estate sectors. The largest sectors are the Wholesale and Retail, Hotels and Restaurants and Primary (Agriculture) sectors. In all cases, as in the aggregate data in Figure 1, a pattern of decreasing credit volumes has been observed since mid-2011.

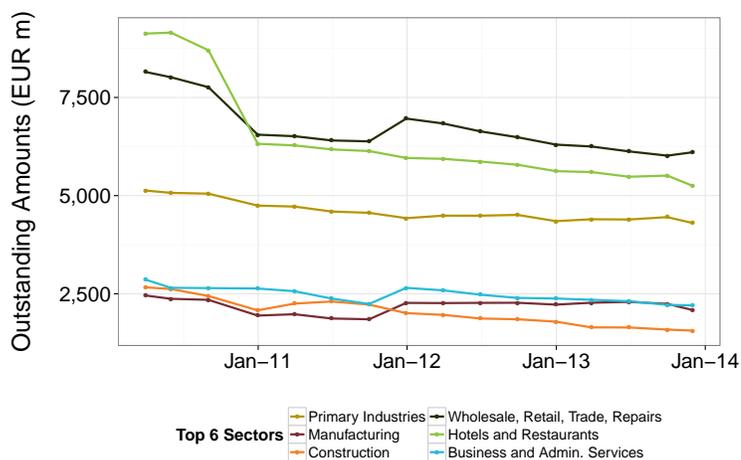
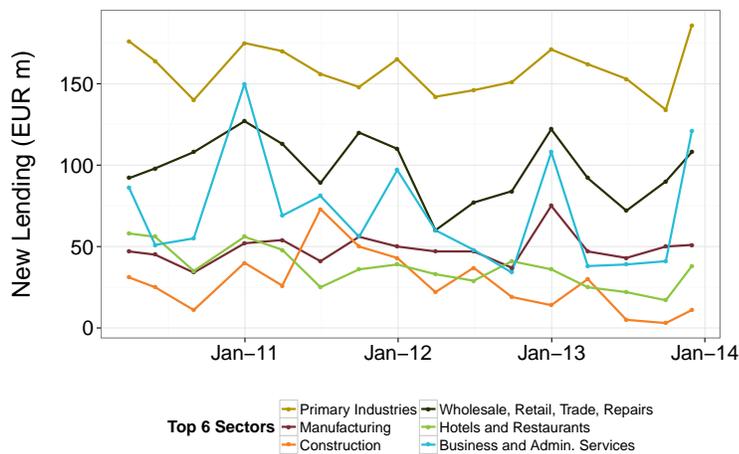


Figure 3. Gross new SME lending, 2010Q1-2013Q4



Gross new lending is defined as the “amount of new credit facilities drawn-down during the quarter by SME counterparties, i.e. where this credit facility was not part of the outstanding amount of credit advanced at the end of the previous quarter”. Figure 3 reports that gross new lending to non-financial, non-property SMEs has remained between €450 and €750 million, with little discernible upward trend over the period 2010Q1 to 2013Q4. A seasonal pattern is observable in the data series, where Q4 figures have been higher than previous quarters in each of the last four years.

Figure 4. Sectoral gross new SME lending, 2010Q1-2013Q4



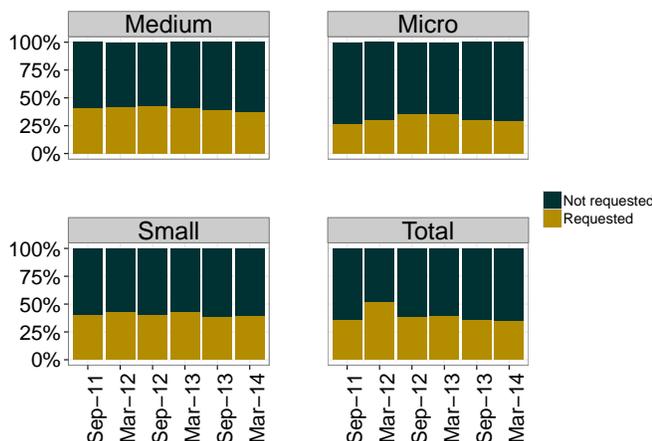
Sector-specific gross new lending figures for the largest sectors within the non-financial, non-real estate sectors are reported in Figure 4. The sector receiving the most gross new lending over the period 2010Q1 to 2013Q4 has consistently been the Primary sector, which includes Agriculture, Forestry and Fishing, followed by the Wholesale and Retail Trade sector. At the sector level, there again appears to be no discernible upward trend in gross new lending for any individual sector.



2 Red C SME Credit Demand Survey

Credit demand is measured by the percentage of respondents applying for bank financing in the previous six months (application rate) as reported by the Red C *SME Credit Demand Survey*, reported in Figure 5. The data show that the application rate has remained stable between 35 and 40 per cent over the period 2011 to 2014. The application rate has decreased from a peak of 40 per cent at March 2013 to 35 per cent at March 2014. Credit demand is higher for Small and Medium firms (40 and 37 per cent in the most recent survey, respectively) than for Micro firms (29 per cent).

Figure 5. Application rate for bank finance 2011-2014



Firms' responses on the type of lending product requested can give an insight into the nature of Irish SME credit demand. Total responses sum to greater than 100 per cent as firms may apply for more than one product in a six-month period. Figure 6 reports that the most common bank lending product requested is the "Renewal or Restructuring of Existing Overdrafts", with 44 per cent of all SMEs seeking credit in the period October 2013 to March 2014 requesting this type of product. While starting from a lower base, it is noteworthy that the percentage of SMEs seeking new loans and new overdrafts has increased in the most recent survey period.

Figure 6. Bank finance products requested, 2011 to 2014

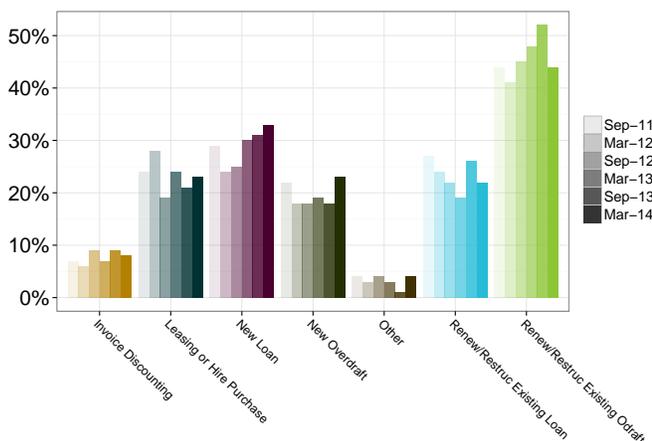


Figure 7. Reasons declared for credit application, October 2013 to March 2014

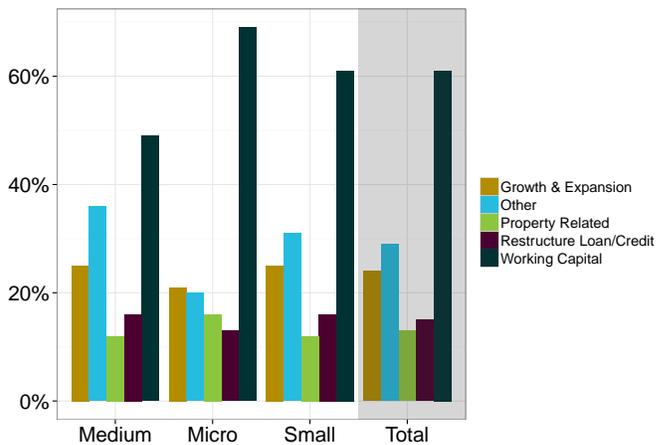
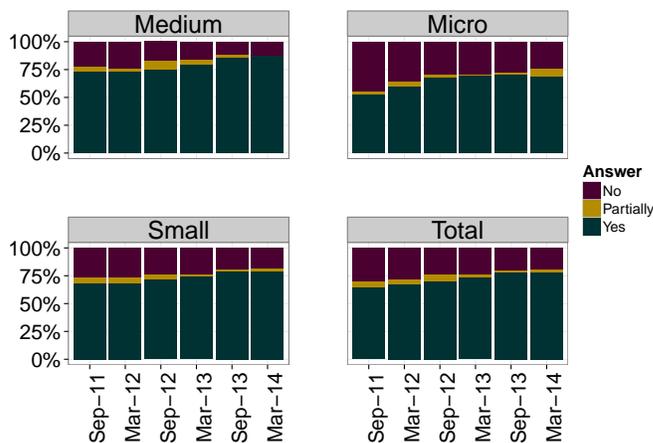


Figure 7 reports the reasons given by SMEs in the period October 2013 to March 2014 for applying for credit. The data show that “Growth and Expansion” is reported as a reason for roughly one quarter of all credit applications, while Working Capital Requirements³ are cited in 61 per cent of cases. Working Capital Requirements and Property-Related Loans are most common among Micro firms. As in Figure 6, totals sum to greater than 100 per cent as firms may respond with multiple reasons for requesting bank finance. The “Other” category here comprises mostly the purchase of vehicles, equipment or other assets.

Figure 8. Outcome of credit applications, 2011 - 2014



Credit conditions are measured in the Red C data by observing the rejection rate on credit applications. The data in Figure 8 suggest a gradual improvement in credit conditions over the three year period under review. The rejection rate among those SMEs applying for credit and having received a decision in the last six months has fallen from 30 per cent in September 2011 to 20 per cent in March 2014. Acceptance rates are highest among Medium-sized firms at 88 per cent, with Small firms and Micro firms being accepted in 79 and 69 per cent of cases respectively.

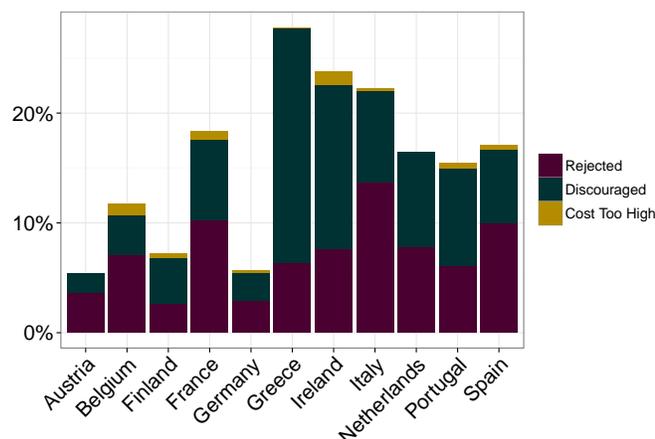
³“Working capital” refers here to requests for the purposes of cash flow management, decline in business revenues, delayed customer payments, increased supplier costs and increased bad debts.



3 ECB/EC SAFE Survey

The credit conditions of Irish SMEs can be placed in a European context using the ECB/EC's *Survey of Access to Finance of Small and Medium Enterprises (SAFE)*. Figure 9 highlights the nature of credit constraints reported across Europe during October 2013 to March 2014. While the percentage of Irish SMEs being rejected is lower than that in Italy, France or Spain, the percentage of discouraged borrowers (those not applying for credit due to expectation that they will be refused) is significantly higher in Ireland and Greece than in other euro area countries.

Figure 9. Nature of credit constraints, October 2013 - March 2014



Changes in the terms and conditions of Irish SME credit can be compared to those across the euro area using the SAFE data. Net percentage changes (percentage of firms reporting increases minus percentage reporting decreases) are reported in Figures 10 to 12. The net percentage of SMEs reporting an increase in interest rates is depicted in Figure 10. Each bar represents a six-monthly survey wave from March 2011 to March 2014. By this measure, Irish credit conditions have remained restrictive and similar to those in Greece, Italy, Portugal and Spain over the three years under review.

Figure 10. Net increases in credit conditions 2011-2014: Interest Rates

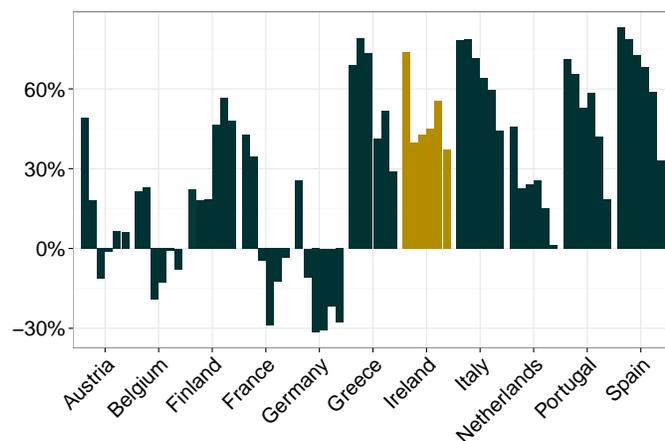


Figure 11. Net increases in credit conditions 2011-2014: Loan Size Availability

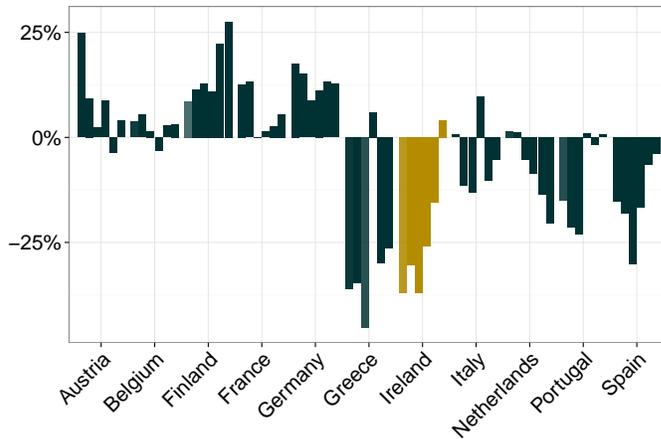


Figure 11 reports the net percentage of firms claiming that the size of loan available had increased in the previous six months. Each bar represents a six-monthly survey wave from March 2011 to March 2014. Through 2011 and 2012, credit conditions in Ireland and Greece were the most restrictive in Europe by this measure. In each of the last four survey periods however the conditions in Ireland have eased, with the net percentage increase turning positive in Ireland for the first time in the period October 2013 to March 2014.

Figure 12. Net increases in credit conditions 2011-2014: Collateral Requirements

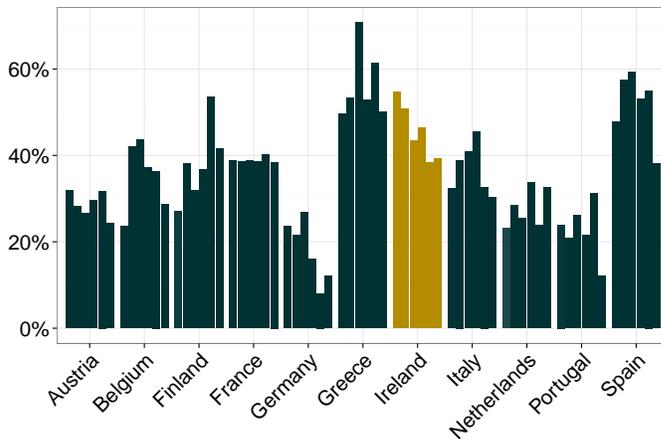


Figure 12 depicts a gradual decline in the net percentage of Irish respondents reporting an increase in collateral requirements. Each bar represents a six-monthly survey wave from March 2011 to March 2014. As in Figures 10 and 11, despite improvement over time, credit conditions in Ireland remain restrictive in a European context.



Changes in credit demand can be observed in the SAFE data through firms' reported increases and decreases in their need for bank loans and bank overdrafts. The percentage of firms reporting an increase in bank loans, minus the percentage reporting a decrease, is shown in Figure 13. Each bar represents a six-monthly survey wave from March 2011 to March 2014. Irish firms have generally been close to the euro area average in the 2011-2014 period by this measure, with a reported growth in credit demand that has been lower than that in Greece, Italy, Portugal and Spain, yet higher than that in Austria, Belgium, Finland and the Netherlands.

Figure 13. Net increases in the demand for bank loans 2011-2014

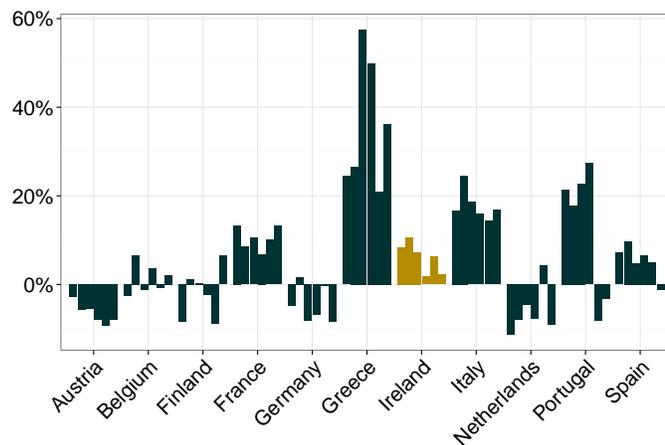


Figure 14. Net increases in the demand for bank overdrafts 2011-2014

Similarly to Figure 13, Figure 14 reports the net percentage increase for firms' demand for bank overdrafts. Each bar represents a six-monthly survey wave from March 2011 to March 2014. Irish SMEs are again placed close to the European average, with demand generally reported to increase to a larger extent than for bank loans. Irish SMEs' emphasis on bank overdrafts as opposed to bank loans suggests that credit demand is skewed towards shorter-term projects since 2011.

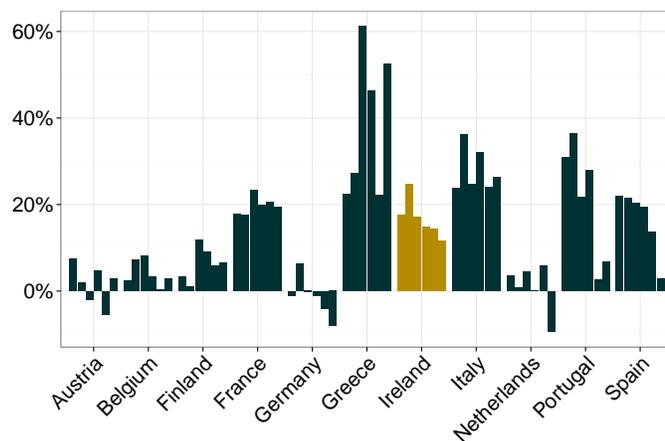
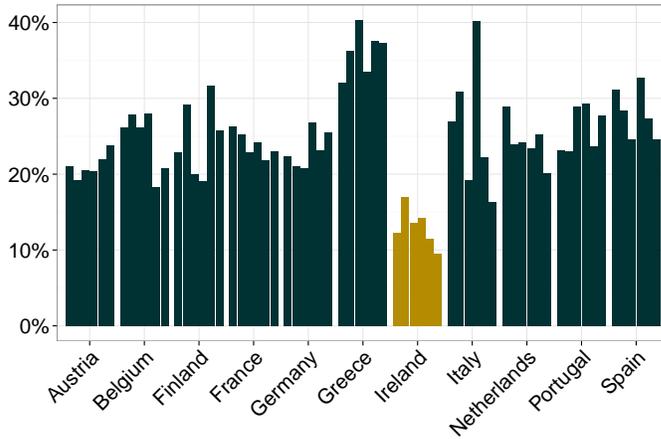


Figure 15. Investment explaining increased demand for credit, percentage increase, 2011-2014



The SAFE data contain information on the drivers of changes in firms’ need for external financing. The non-expansory nature of credit demand in Ireland is confirmed in Figure 15, as Irish firms are found to have the lowest percentage of respondents reporting that investment is the reason behind an increase in demand for external finance. This result is persistent over the period 2011-2014, with each bar representing a six-monthly survey wave from March 2011 to March 2014.

Figure 16. Working capital explaining increased demand for credit, percentage increase, 2011-2014

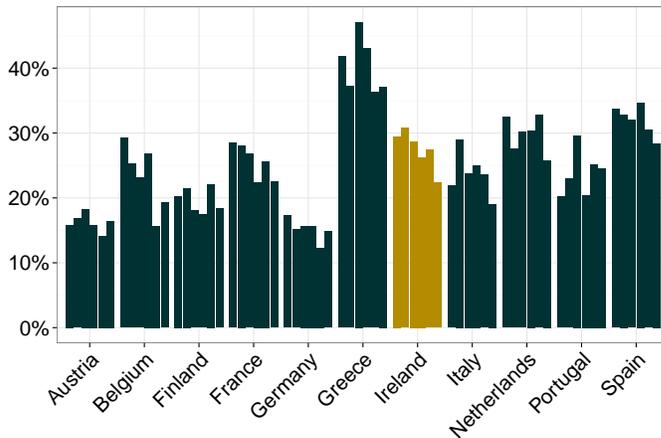


Figure 16 reports that Irish firms have a higher-than-average incidence of working capital as a driver of increases in the demand for external finance. Each bar represents a six-monthly survey wave from March 2011 to March 2014. The nature of Irish credit demand, with an emphasis on working capital rather than investment and expansion, is confirmed in both the Red C (Figures 6 and 7) and SAFE data (Figures 15 and 16).



4 Central Bank of Ireland Loan-Level Data

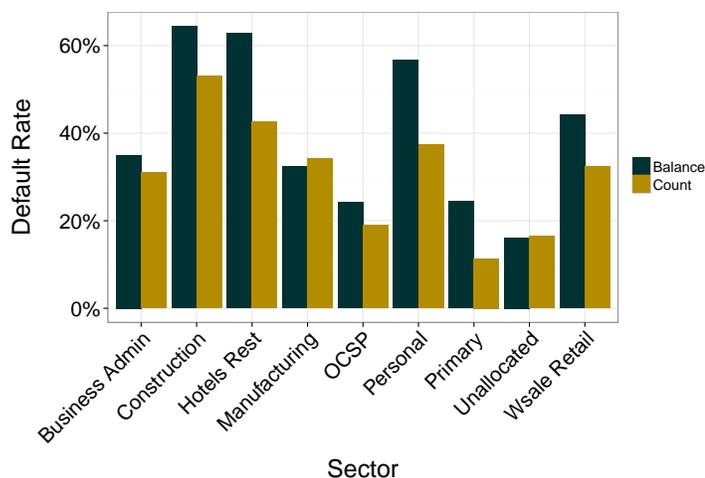
Loan-level data on the population of SME loans held by domestic credit institutions can provide important insight into the loan performance of the existing stock of SME credit in Ireland. Figure 17 reports that there were loans of €21bn in the SME lending data set at December 2013, with an average and median loan size of €71,101 and €9,954, respectively. The default rate in the Irish SME loan books is 26 per cent by loan count and 41 per cent by loan balance, where loan default is defined in accordance with Basel II guidelines.

Figure 18 reports the default rates (by loan count and by outstanding balance) in each sector of economic activity.⁴ In most cases, the balance-weighted default rate is higher than the share of loans in default, indicating a pattern of greater default risk among larger exposures. Balance-weighted default rates in the Construction, Hotels and Restaurants and Personal (Private Households) sectors range between 55 and 65 per cent. The sectors with the lowest default rates are the Other Community, Social and Personal (OCSP) and Primary (Agriculture) sectors, with balance-weighted default rates of between 20 and 25 per cent.

Figure 17. Central Bank SME loan data description, Dec 2013

| | |
|------------------------|--------|
| Total Balance (€M) | 21,041 |
| Average Balance (€) | 71,101 |
| Median Balance | 9,954 |
| Average Interest Rate | 6.41% |
| Default Rate (Count) | 26.05% |
| Default Rate (Balance) | 41.38% |

Figure 18. SME default by Sector, Dec 2013



⁴Sectors with small exposures are subsumed into larger sectors for exposition purposes. The Electricity, Gas, Steam and Air Conditioning Supply, and Water Supply, Sewerage, Waste Management and Remediation Activities sectors are included with the Manufacturing sector; the Transportation and Storage sector is included with Wholesale and Retail; the Human Health and Social Work, and Education sectors are included with the Other Community, Social and Personal sector; the Information and Communication sector is included with Business and Administrative Services.



Figure 19. SME default by NUTS region, Dec 2013

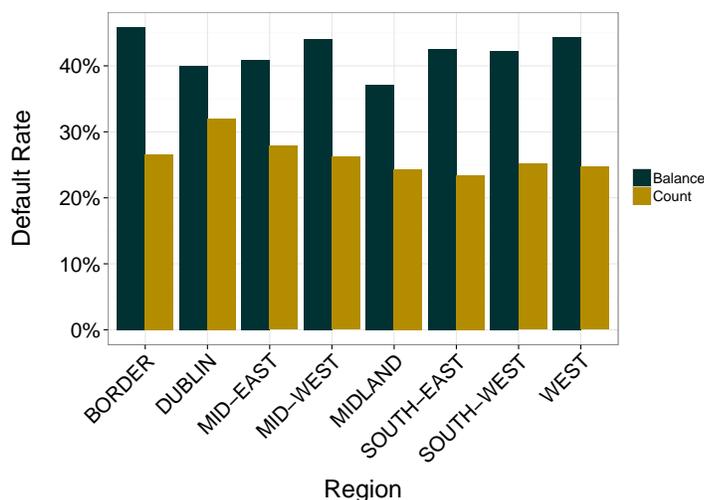
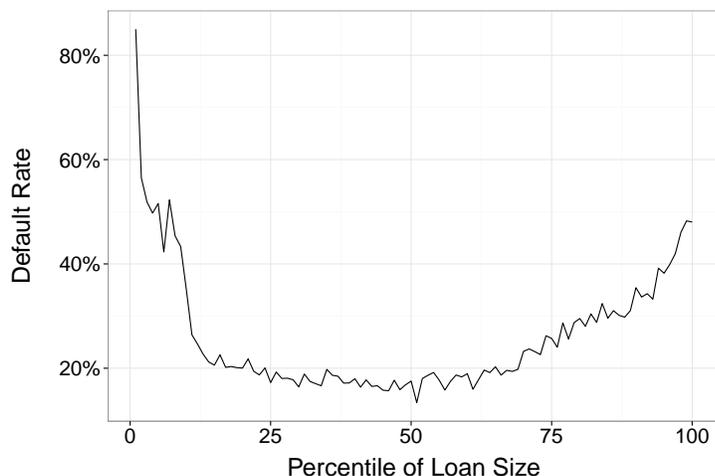


Figure 19 reports the regional breakdown of SME loan default. Default rates across NUTS (Nomenclature of Territorial Units for Statistics) regions are substantially more uniform than across sectors of economic activity. In all cases, balance-weighted default rates range between 35 and 45 per cent. The Border, Mid-West and West regions are those with the highest balance-weighted default rates, with the lowest being in the Midlands. When measured using the number of loans, the highest default rate is in Dublin.

Figure 20. SME default by loan size percentile, Dec 2013



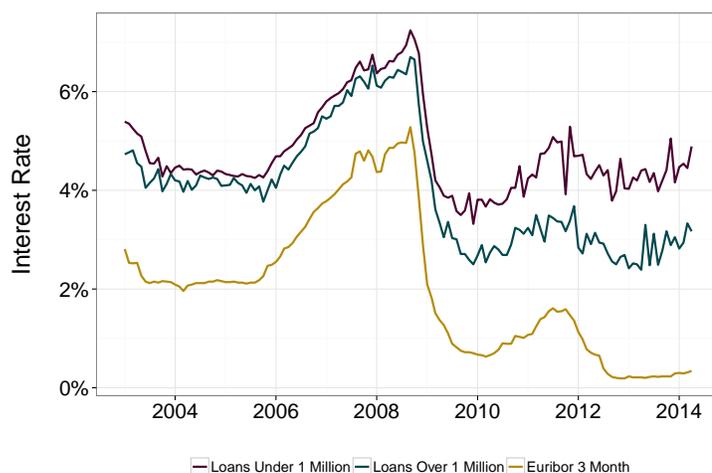
Default risk across the size distribution of SME loans is profiled in Figure 20. The SME book is divided into percentiles of outstanding balance, with the balance-weighted percentage of loans in default plotted for each percentile. The figure exhibits a U-shaped pattern whereby the smallest and the largest loans carry a higher default risk than those in the middle of the size distribution. Among the largest loans, the SME default rate is 48 per cent. The U-shaped relationship between loan size and default holds for both amortising and non-amortising loans.



5 Central Bank of Ireland *Retail Interest Rates Data*

Interest rate data for loans to SMEs is not published by the Central Bank of Ireland. However, interest rates on new loans to non-financial corporations, for loans greater than and less than €1 million, are published in a monthly time series since January 2003, with the rate for loans less than €1 million acting as a proxy for the SME cost of credit. Data are reported here for interest rates on floating rate loans and those fixed for less than one year. The data in Figure 21 show that the spread over the interbank Euribor 3 month rate has widened since the financial crisis, and that the premium paid by SMEs when compared to larger firms has widened since the pre-2008 period.

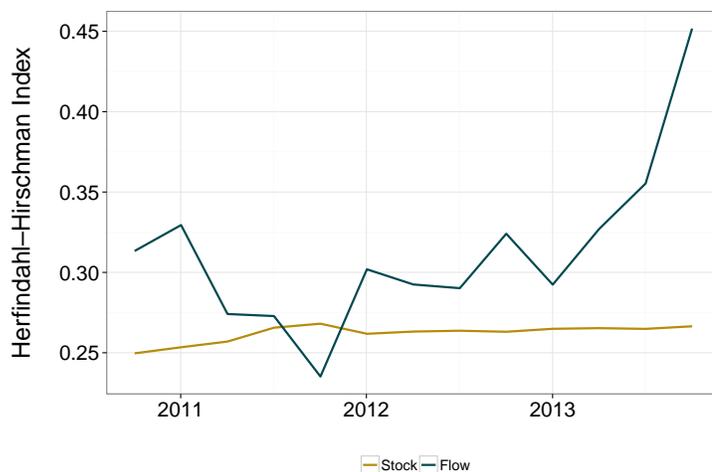
Figure 21. Interest Rates on new lending to non-financial corporations, Jan 2003 - Apr 2014



6 Credit Market Concentration

The concentration of SME lending markets can be measured using bank-level data on SME outstanding balances (“stock”) and gross new lending (“flow”). Figure 22 reports the movement in the Herfindahl-Hirschman Index, a measure that increases in the concentration of the market, for both the stock and flow of non-financial, non-property-related SME credit. Concentration levels in the stock of SME credit have remained close to static between 2010 and 2013Q4, while there has been a marked increase in the concentration of new lending flows during 2013. Recent research⁵ has identified that increased credit market concentration is detrimental to firms’ access to credit.

Figure 22. Herfindahl-Hirschman Index for non-financial, non-property-related SME lending, 2010Q4 - 2013Q4



⁵Ryan, R.M, O’Toole, C.M. and F. McCann (forthcoming), Does bank market power affect SME financing constraints? *Journal of Banking and Finance*; McCann, F. and T. McIndoe-Calder, (2012). Bank Competition Through The Credit Cycle: Implications For SME Financing, *Economic Letters* 04/EL/12, Central Bank of Ireland.



Box 1: Strategic Banking Corporation of Ireland

In late May 2014 the Department of Finance announced the creation of the Strategic Banking Corporation of Ireland (SBCI). The SBCI has pre-committed funds of €500 mln from a number of institutions including the German Promotional Bank KfW, the directed portfolio of the Irish Strategic Investment Fund (ISIF) - formerly the National Pension Reserve Fund - and the European Investment Fund (EIF). The SBCI is intended to fund Irish SMEs through resident institutions (both incumbent banks and potential new entrants will be eligible for SBCI funds) by facilitating 'innovative' loans. It is expected that this innovation will take at least two forms and include both cheaper (KfW in particular has access to lower cost funds than existing resident Irish banks) as well as longer maturity loans for SMEs. The loans will be available to existing SMEs as well as new firms and whilst the majority of the funding will be made through more traditional bank loans, the ISIF will also provide a small amount of equity capital. Whilst banks will benefit from accessing increased and cheaper funding than is currently available, a stipulation of bank involvement will be that all cost savings must be passed onto the borrowing SME. It thus appears that whilst banks will benefit from the lower funding rates KfW, ISIF and EIF have access to, it will be bank credit risk assessment expertise that will determine which SMEs will benefit from this new credit. It remains to be seen whether the implementation of the SBCI will result in more credit access for SMEs, or even how the impact of the SBCI could be evaluated.



Appendix 1: Data Sources

Information from the following sources is used:

- Outstanding balance and gross new lending data from the Central Bank of Ireland aggregate *Credit, Money and Banking* statistics to 2013 Q4.
- Red C SME Credit Demand Survey, April 2011 to March 2014. This nationally representative survey of 1,500 Irish SMEs is carried out on behalf of the Department of Finance on a six-monthly basis, and seeks information on a range of economic and financial factors including firms' demand for credit, their success in applying for credit, their trading performance and their views on Government interventions in the SME credit market.
- European Central Bank (ECB) / European Commission (EC) Survey on the Access to Finance of Small and Medium Enterprises (SAFE), April 2011 to March 2014. The Irish component of this European survey contains information for 500 SMEs. The cross-country nature of the survey allows credit conditions faced by Irish SMEs to be placed in an international context.
- Central Bank of Ireland loan-level data at December 2013. This data set provides information on a wide range of loan characteristics including outstanding balances, sector of activity and loan repayment for the population of enterprise loans outstanding at Allied Irish Banks, Bank of Ireland and Permanent TSB.
- Interest rate data from the Central Bank of Ireland's *Retail Interest Rates* statistical release. Interest rates on floating rate loans and loans with a fixed rate period of under 1 year are used.
- Herfindahl-Hirschman Indices are calculated using the bank-level lending data used to compile the Central Bank of Ireland's quarterly *Credit, Money and Banking* statistics.

Appendix 2: Classification of SMEs

For the purposes of the Central Bank of Ireland aggregate statistical series and the Red C survey data, an SME counterparty is defined as any entity engaged in an economic activity, irrespective of legal form (i.e. corporation, partnership, sole-trader, etc.), which employs fewer than 250 persons and whose annual turnover does not exceed €50 million or whose annual balance sheet does not exceed €43 million. This is the standard EU definition of an SME, and is consistent with that applied in the Code of Conduct on SME Lending and by the Credit Review Office.

In the SAFE survey data, SMEs are defined solely by their employment size. Three categories of SME are analysed: Micro firms, with less than 10 employees, Small firms with 10 to 49 employees, while Medium firms are those with 50 to 249 employees. All firms with more than 250 employees are considered to be Large firms and are removed from the analysis.

The Central Bank of Ireland loan-level data do not contain the relevant information on borrowing firms to define SMEs in a similar fashion. Rather, SMEs are separated from Large borrowers in the data in a manner similar to that used by the current EBA/SSM Asset Quality Review. All firms whose exposures are managed in retail and business banking units of the subject banks are modelled as SMEs, while all exposures managed in corporate banking divisions are considered to be Large firms and excluded from the analysis.

