SME Market Report

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2016 H2

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 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 provides information on credit demand, credit access, loan terms and conditions, loan default, interest rates and credit market concentration. The report is released twice yearly. The data sources are detailed in Appendix 1 and the SME definition adopted in each data source is defined in Appendix 2.

Overview

- Gross new lending to SMEs is currently high relative to the average since 2010. Annualised quarterly new lending in Q3 2016 is 5.1 per cent higher than Q3 2015. Lending growth between these dates is highest in the Manufacturing, Hotels/Restaurants and Construction sectors, but declines are observed in the Wholesale/Retail and Services sectors. Analysis of euro area data show that non-financial corporation lending flows are low compared to pre-crisis levels and compared to other European countries.
- SME outstanding loan balances continue to decline. Since the last report, a decrease of 2.9 per cent is observed.
- The SME lending market remains highly concentrated. The combined market share of the three main lenders in gross new lending flows is currently 93 per cent.
- Bank finance applications continue to decline. Declines are driven by relatively larger falls in applications for renewed/restructured products, with applications for new loans and leasing/hire-purchasing more stable through time. Analysis of euro area data shows that Irish demand for credit is relatively low in a cross-country context.
- Rejection rates have increased since the last report. Across all finance products, the rejection rate in the latest survey is 16 per cent (11 per cent in the previous survey). However, rejection rates are lower than in earlier surveys and loan/overdraft rejection rates are in line with euro area averages.
- Loan performance is improving. The latest Central Bank of Ireland loan-level data (June 2016) show that 24 per cent of SME outstanding balances are in default, down from 41 per cent in 2013. The share of performing loans transitioning to default in the preceding six months has also declined since 2013 and is currently at 1.7 per cent.
- SME interest rates are higher than euro area averages, using non-financial corporation rates on loans up to €250,000 as a proxy for SME lending rates. Since the last report, the average interest rate has declined from 5.9 per cent to 5.5 per cent.
- Box 1 reviews SME lending and investment activity by the Ireland Strategic Investment Fund to date. Box 2 presents a cross-country comparison of SME default rates in Europe. Box 3 describes Central Bank of Ireland regulations and protections related to SME lending.

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

Figure 1 presents annualised gross new lending to non-financial, non-real estate SMEs since 2010.[2] Annualised lending in Q3 2016 totalled €3 billion. New lending is now 5.1 per cent higher than in Q3 2015 and 28 per cent higher than in Q3 2014.

Figure 1. New SME lending (Sum of previous four quarters, by quarter), Q4 2010 - Q3 2016

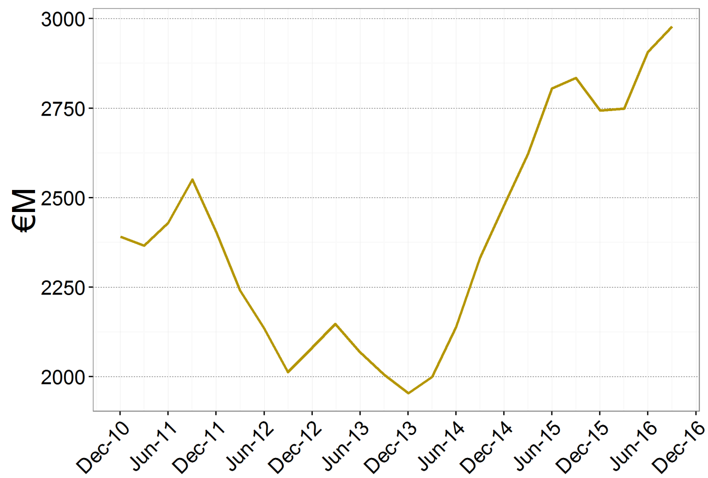
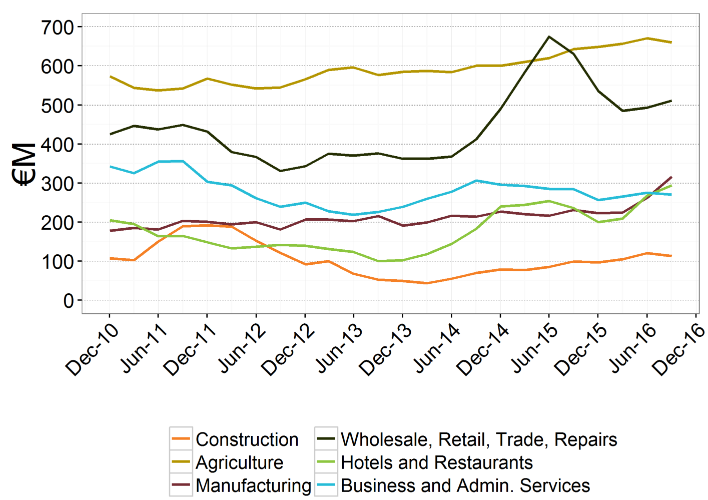


Figure 2 presents annualised gross new lending trends for the six main non-financial, non-real estate sectors. The Agriculture and Wholesale/Retail sectors consistently have the highest shares of new lending. Compared to Q3 2015, annualised new lending in Q3 2016 has increased in Manufacturing by 37 per cent, in Hotels/Restaurants by 25 per cent, in Construction by 14 per cent and in Agriculture by 2.6 per cent, but declined in Wholesale/Retail and Business and Administrative Services by -19 per cent and -4.9 per cent, respectively.

Figure 2. New SME lending, by sector (Sum of previous four quarters, by quarter), Q4 2010 - Q3 2016



[2]Annualised data are a rolling summation over the previous four quarters. 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'. These data exclude renegotiations. Construction lending is included in these data but real estate activities are excluded.

Figure 3. Credit outstanding to SMEs, Q1 2010 - Q3 2016

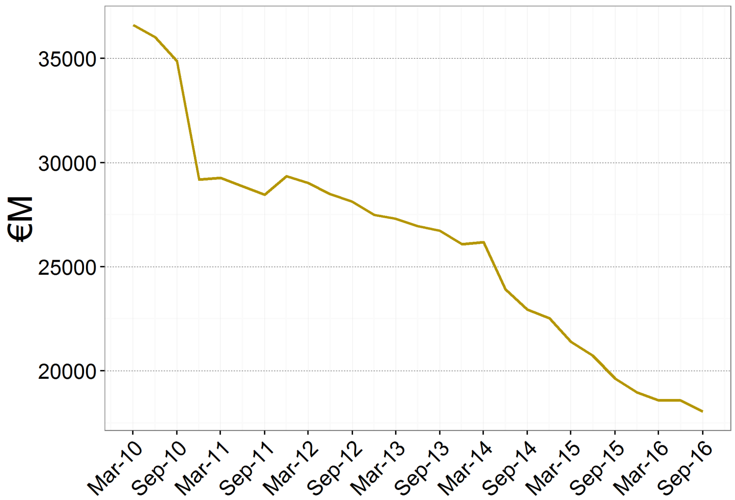


Figure 3 presents the value of outstanding credit to non-financial, non-real-estate SMEs. Stocks have declined by 51 per cent since Q1 2010.[3] Since the last report (Q3 2016 versus Q1 2016), stocks have declined by a further 2.9 per cent.

Figure 4. Credit outstanding to SMEs by sector, Q1 2010 - Q3 2016

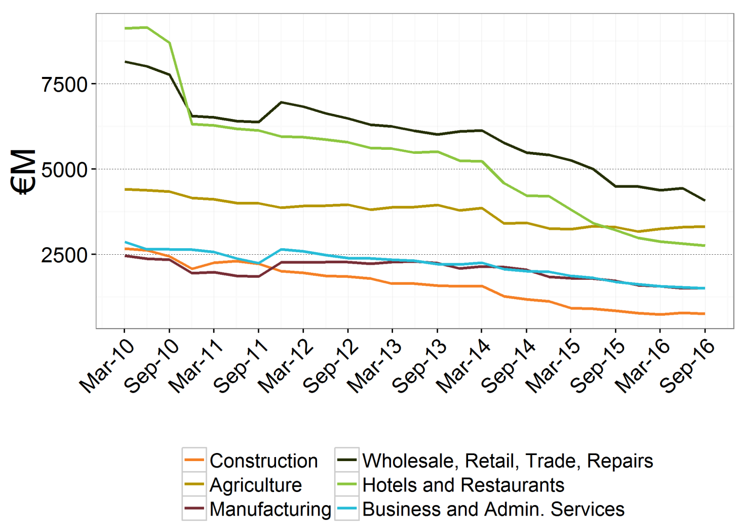
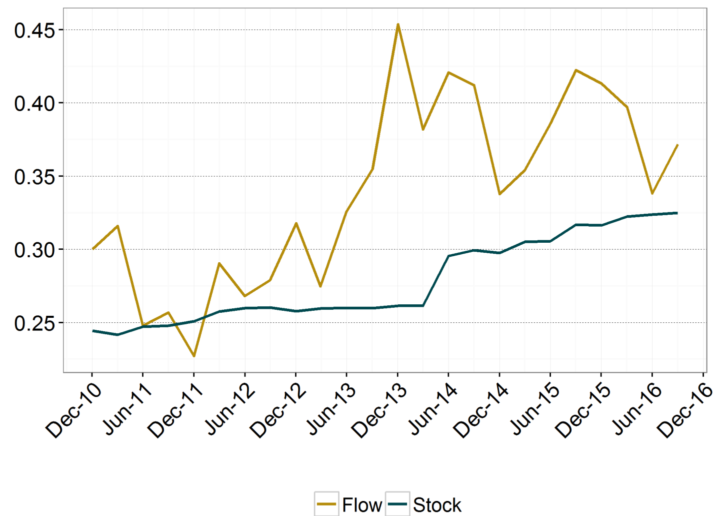


Figure 4 presents trends in outstanding credit for the six main non-financial, non-real estate SME sectors. Since the last report (Q3 2016 versus Q1 2016), stocks have increased in the Construction (2.6 per cent) and Agriculture (2.1 per cent) sectors but declined in the Wholesale/Retail (-6.9 per cent), Hotels/Restaurants (-4.1 per cent), Services (-3.9 per cent) and Manufacturing (-3.4 per cent) sectors.

[3]Declines in outstanding credit are due to a number of factors, including repayments outstripping new lending, revaluations (includes write-offs), loan sales and bank exits.

Figure 5 reports the Herfindahl-Hirschman index, which measures the concentration of lending 'stocks' (outstanding balance) and 'flows' (gross new lending) for non-financial, non-real estate SME lending of all domestic banks.[4] The SME lending market has generally become more concentrated since 2010. In Q3 2016, the combined market share (flow) of the three main lenders was 93 per cent.

Figure 5. Herfindahl-Hirschman index for non-financial, non-real estate SME lending, Q4 2010 - Q3 2016



Box 1: The Ireland Strategic Investment Fund [a]

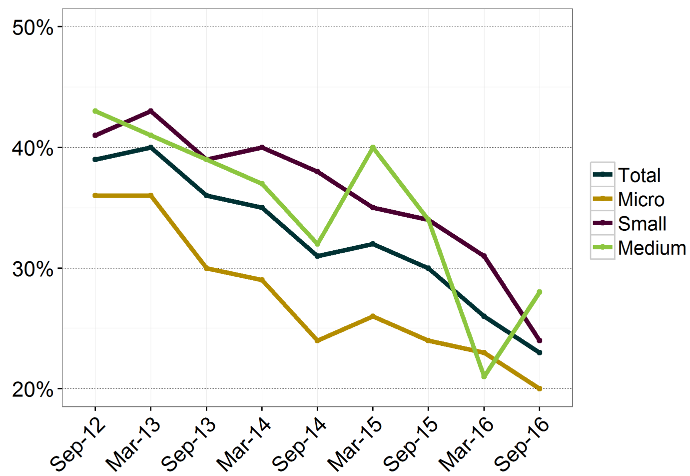
The Ireland Strategic Investment Fund, managed and controlled by the National Treasury Management Agency (NTMA), is a sovereign development fund with a statutory mandate to invest on a commercial basis in a manner designed to support economic activity and employment in Ireland. The Fund's predecessor was the National Pensions Reserve Fund (NPRF). ISIF began investing in the Irish economy in December 2014. The fund is comprised of a "Directed" portfolio (public policy investments in Allied Irish Banks, Bank of Ireland and the Strategic Banking Corporation of Ireland) valued at €13.5bn, and a discretionary portfolio valued at €8.1bn (figures valid on 31 December 2016).

SME Financing is a sector of interest for the Discretionary portfolio and ISIF had committed €385m to the sector at 31 December 2016. ISIF has committed €200m to Bluebay Ireland Corporate Credit Ltd which is investing €450m in senior secured and "uni-tranche" loans to Irish SMEs. ISIF has also committed €125m to a €292m fund managed by Carlyle Cardinal Ireland which provides equity to Irish SMEs. The latter two platforms both target investments of between €5m and €45 to 50m. BMS Finance Ireland, to which ISIF has committed €15m, provides a venture debt product to Irish SMEs targeting loans of €500k to €5m while Causeway Capital partners, to which ISIF has committed €15m, targets equity investments of €2.5m to €10m. ISIF has invested €30m in the equity of Finance Ireland to support the growth of its asset based finance business which targets the SME and Agri sectors. Both the Food and Agriculture sectors are also targeted via a commitment of €45m to the €100m Glanbia Milkflex Fund which provides growth loans to dairy farmers. Furthermore, ISIF has invested in a large number of venture capital funds with total commitments of €504m.

[a] Box author: James Carroll.

2 Department of Finance SME Credit Demand Survey

Figure 6. Application rate for bank finance, September 2012 - September 2016



The latest Department of Finance *SME Credit Demand Survey* shows continued decline in the demand for bank financing.[5] Figure 6 presents the share of SMEs that applied for any bank finance facility (loans, overdrafts, leasing, hire-purchasing and invoice discounting). In the latest survey, 23 per cent of firms applied for bank finance, down from 26 per cent in the previous survey. While Medium firms show an increase over the last six months, this follows a large decline in the previous survey.

Figure 7. Application rate by product, September 2012 - September 2016

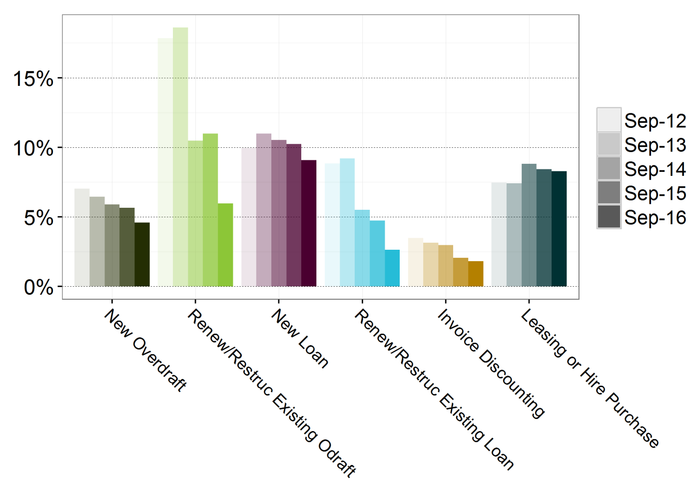


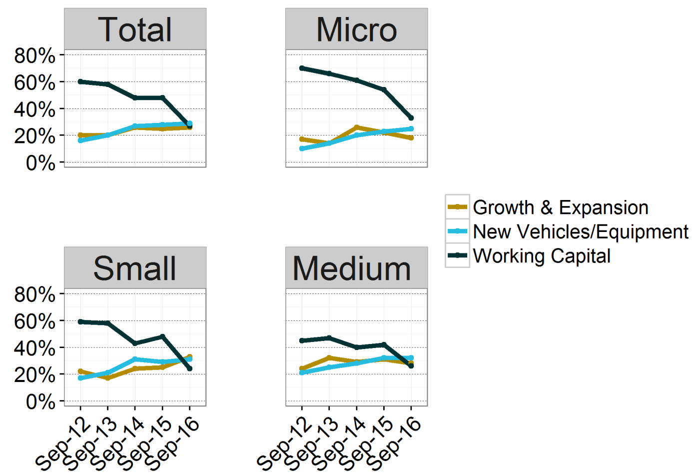
Figure 7 presents application rates for each product. The most common products requested in the latest survey are leasing/hire-purchasing and new loans. Demand for these products is also more stable through time. Declining application rates are generally observed for the remaining products, particularly for renewed loans/overdrafts.

[4] The Herfindahl-Hirschman index is calculated as the sum of the squared market shares. Higher values indicate higher market concentration or lower levels of competition. The index is created using data from 17 banks.

[5] The survey is conducted twice yearly: October to March (labelled 'March' in this report) and April to September (labelled 'September'). This nationally representative survey collects information on a range of economic and financial factors including firms' demand for credit, their success in applying for credit and their trading performance. 'Micro' firms have 1-9 employees and turnover or balance sheet value up to €2 million. 'Small' firms have 10-49 employees and turnover or balance sheet value up to €10 million. 'Medium' firms have 50-250 employees and turnover up to €50 million or balance sheet value up to €43 million.

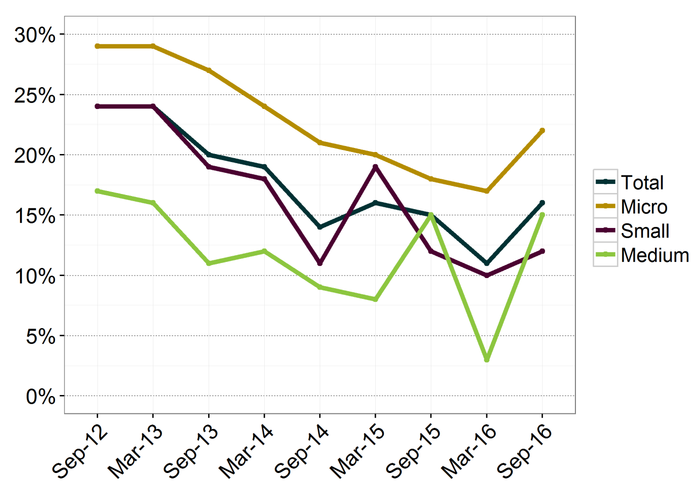
Figure 8 describes the changing purpose of SME credit applications. The share of applications for working capital has decreased since 2012 while the share of applications for new vehicles/equipment and growth/expansion has increased slightly.[6] These trends are generally observed across all SME size categories, except among growth/expansion for Micro firms.

Figure 8. Purpose of credit application, September 2012 - September 2016



After declines in the previous report, the latest survey shows an increase in rejection rates. Across all SME size categories and finance products, the rejection rate has increased to 16 per cent, having been at 11 per cent in the previous survey.[7] The increase in rejection rates in the latest survey is observed across all SME sizes but is particularly large for Medium firms. As with previous reports, Micro firms show the highest rates of rejection.

Figure 9. Bank finance rejection rates, September 2012 - September 2016



[6] 'Working capital' refers to requests for the purposes of cash flow management, decline in business revenues, delayed customer payments, increased supplier costs and increased bad debts. Totals may sum to less than 100 per cent because finance applications for property-related reasons and loan restructuring are excluded from the graph. Totals may sum to greater than 100 per cent as firms may respond with multiple reasons for requesting bank finance

[7] Rejection rates are for those SMEs applying for credit and having received a decision in the last six months. These rates are for all finance types (loans, overdrafts, leasing, hire-purchasing and invoice discounting)

Figure 10. Median debt-to-turnover ratio, September 2013 - September 2016

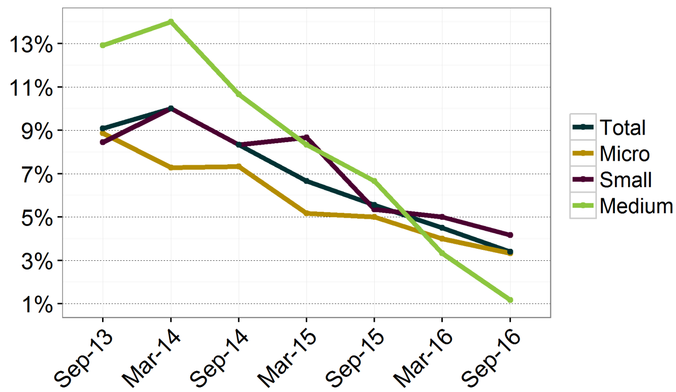


Figure 10 shows that SME indebtedness has been decreasing over time, consistent with the pattern presented in Figure 3.[8] The median debt-to-turnover ratio peaked at 10 per cent in March 2014. Since then, it has declined in each survey and the ratio is currently 3.4 per cent (September 2016). This declining trend is generally observed across all SME sizes, but is particularly evident for Medium firms. Furthermore, the share of firms with no debt has increased considerably, from 23 per cent in September 2013 to 50 per cent in the latest survey.

[8]The debt-to-turnover ratio is calculated using a significantly reduced sample. This is the result of missing debt and turnover information (18 per cent and 33 per cent of firms respectively), leading to a missing debt-to-turnover ratio for 41 per cent of firms.

3 Central Bank of Ireland Loan-Level Data

Loan-level data from Allied Irish Banks, Bank of Ireland and Permanent TSB are employed to describe loan performance.[9] SME default rates have consistently fallen over the sample period. By share of outstanding balances, the default rate has declined from 41 per cent in 2013 to 24 per cent in June 2016. This decline in the default rate can be driven both by improvements in the performance of individual loans (as documented in Figure 14) as well as the exit of defaulted loans from the loan book through loan sales, the repossession of collateral, company liquidations and insolvencies.

Figure 11. SME default rates, December 2013 - June 2016

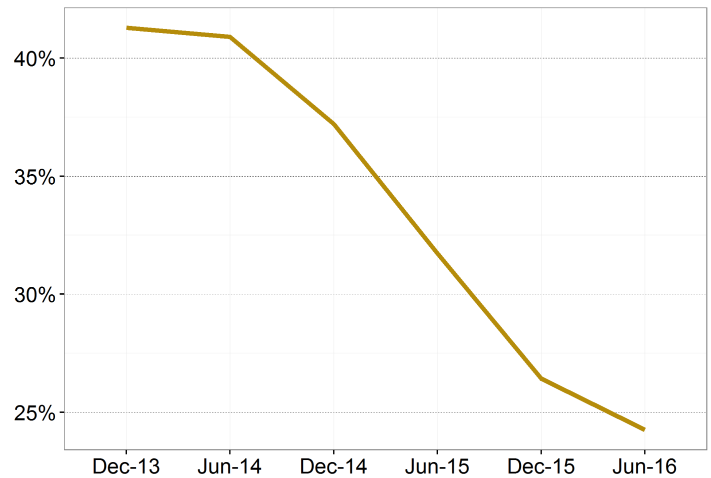
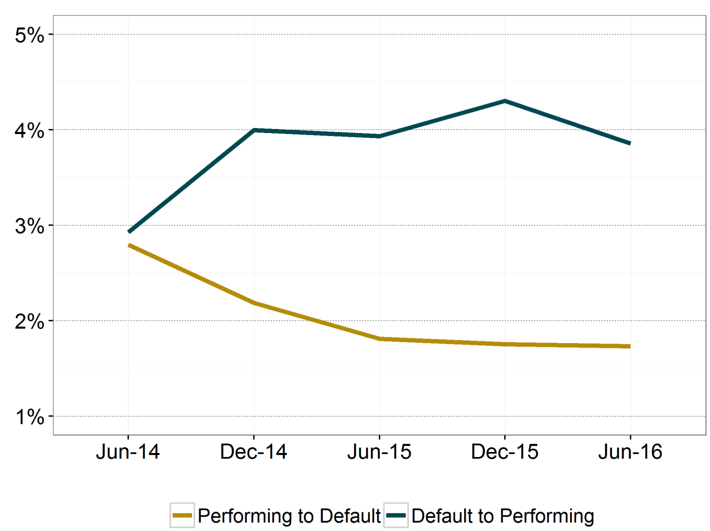


Figure 12 presents the share of SME loans that transitioned between performing and default status in each period (six-monthly transitions, weighted by loan outstanding balance). The share of performing loans transitioning to default has generally declined since 2014, and is currently at 1.7 per cent. While the share of defaulted loans transitioning to performing increased between June and December 2014, the share has been stable since, at approximately 4 per cent.

Figure 12. Share of loans switching performance status (six-monthly transitions), June 2014 - June 2016



[9]These data are collected every six months with the latest data from June 2016. The finance types are predominantly comprised of loans, overdrafts, hire-purchasing and leasing. ‘Default’ is defined as loans in arrears of greater than 90 days past due or deemed unlikely to repay without giving up collateral.

Figure 13 provides additional detail on the default transition statistics presented in Figure 12 for the six largest sectors in the loan-level data.[10] In all cases a reduction in the share of performing flows entering default (weighted by the balance outstanding on each loan) on a six-monthly basis is recorded. As of June 2016, default flows are largest in the Hotels and Restaurants (HR) sector, where roughly 3.5 per cent of performing loans entered default over the preceding six months. The sector with the lowest share of performing loans transitioning to default has consistently been the Primary (PRI) sector, composed mostly of agricultural loans, where roughly one per cent of performing loans enters default each six months.[11]

Figure 13. Share of loans switching from performing to default by sector (six-monthly transitions), June 2014 - June 2016

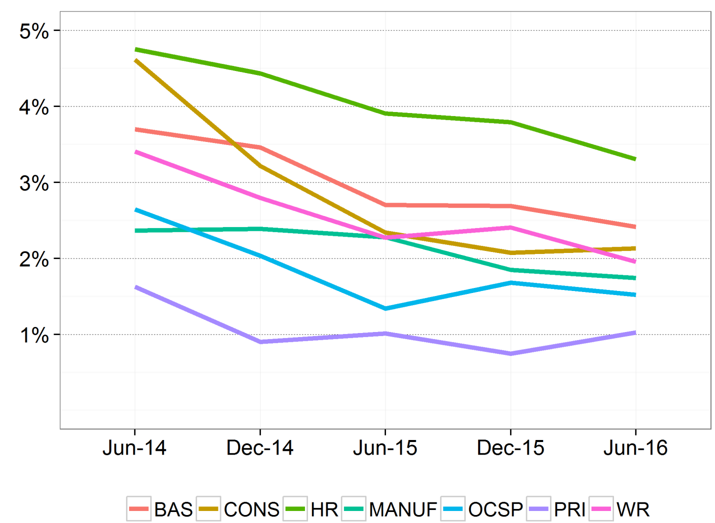
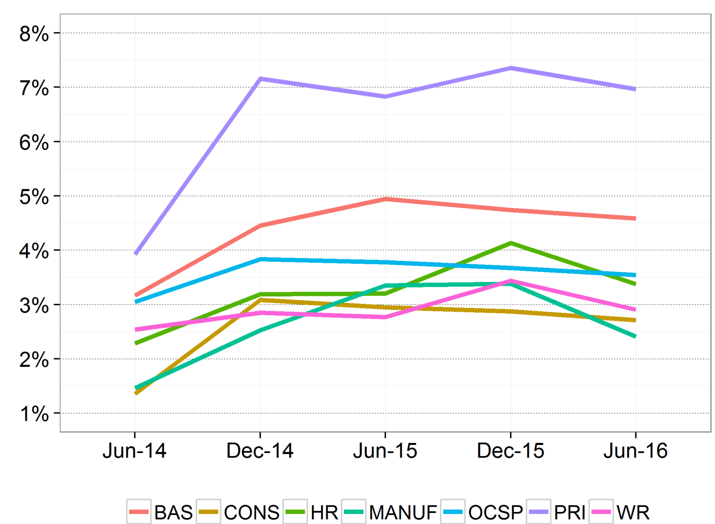


Figure 14 presents the share of defaulted loans flowing back to performing status for each of the sectors reported in Figure 13. Analogously to the low default rates presented above, the Primary sector is also shown to have the highest share of defaulted loans transitioning back to performing status (7 per cent in the most recent period). The Business and Administrative Services sector has the next most favourable transition rate at close to 5 per cent, while transition rates in the other four sectors range between 2.5 and 3.5 per cent, which in all cases represents an improvement relative to the beginning of the sample.

Figure 14. Share of loans switching from default to performing by sector (six-monthly transitions)



[10] The sectors referenced in the chart are Business and Administrative Services (BAS), Construction (CONS), Hotels and Restaurants (HR), Manufacturing (MANUF), Other Community, Social and Personal Services (OCSP), Primary (PRI) and Wholesale and Retail (WR).

[11] Sectors 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 (OCSP) sector; the Information and Communication sector is included in Services.

Figure 15. SME default rates by sector, December 2015 and June 2016

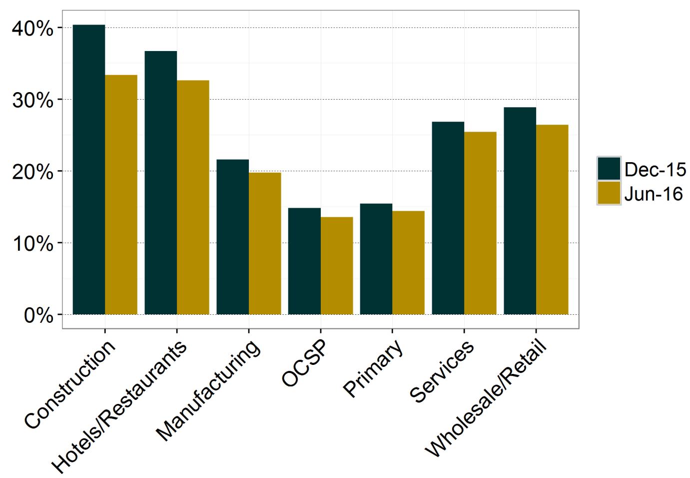
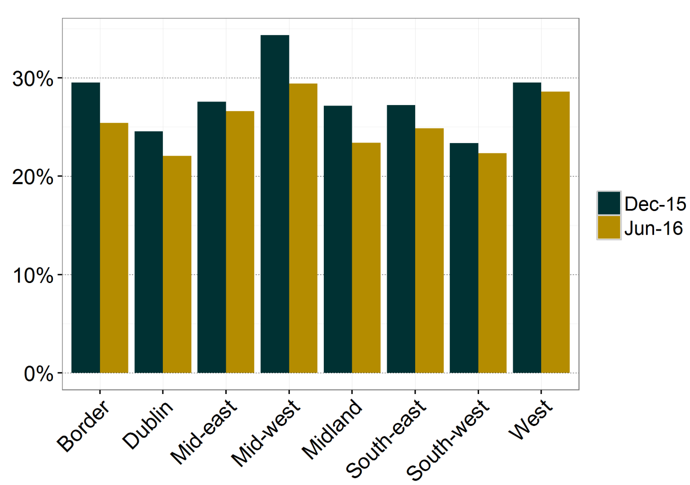


Figure 15 presents the share of outstanding balances in default across the main economic sectors in the latest two loan-level datasets.[11] While the Construction and Hotels/Restaurants sectors have the highest default rates, reductions in default rates are relatively larger in these sectors.[12]

Figure 16. SME default rates by region, December 2015 and June 2016



Default rates are similar across regions.[13] In the latest data (June 2016), default rates are highest in the Mid-West, West (both 29 per cent) and the Mid-East (27 per cent). Since the last report, improvements are observed in all regions but are relatively larger in the Border, Mid-West and Midland regions.

[12]The reader should note that the relatively large decline in default rates for the Construction sector between December 2015 and June 2016 is partly due to a reduction in Construction balances (11 per cent). This is driven by a change in classification for some Construction loans (from Construction to Commercial Real Estate) between these dates.

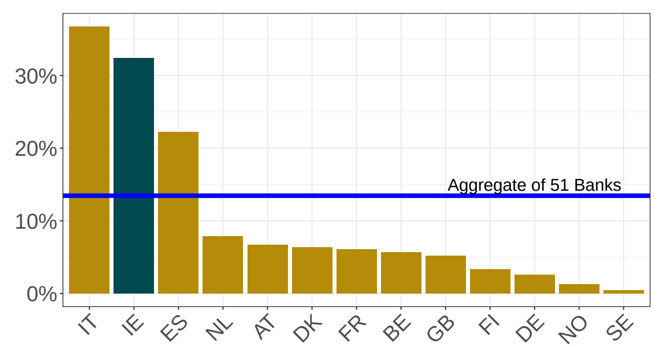
[13]Nomenclature of Territorial Units for Statistics (NUTS) regions - 'Border': Cavan, Donegal, Leitrim, Louth, Monaghan, Sligo; 'Mid-East': Kildare, Meath, Wicklow; 'Mid-West': Clare, Limerick; 'Midlands': Laois, Longford, Offaly, Westmeath; 'South-East': Carlow, Kilkenny, Tipperary, Waterford, Wexford; 'South-West': Cork, Kerry, 'West': Galway, Mayo, Roscommon.

Box 2: SME Default – A European Comparison[a]

In 2016, the EBA, in cooperation with the ECB, ESRB, EC, and the competent authorities from all relevant national jurisdictions, carried out a stress test of 51 EU and EEA banks. The stress test was designed to assess the resilience of the EU banking sector in a consistent way. The sample of banks included in the stress test covered 70 per cent of the banking sector in the EU but included only large banks. Similarly to previous EBA exercises, the stress test yielded substantial data on the 51 banks.

The chart below compares the aggregated SME default rate[b] of all Irish lending portfolios by any of the 51 banks with similar portfolios in the other EU countries. The Irish SME lending portfolio default rate at end-2015 was the second highest compared to selected other European countries, Italy being the highest. It must be noted, however, that due to the sample selection process, certain countries were not part of EBA stress test.

SME Default Rate (per cent) by Country, December 2015



Using data released on the same 51 banks as part of the EBA's 2014 stress test, the table below highlights the evolution of the default rate, coverage ratio on the default stock and share of SME lending over the two year period.[c]. The Irish lending portfolios' end-2015 aggregate default rate decreased significantly compared to the aggregate default ratio at end-2013 (-15.6 percentage points) The coverage ratio (loan loss provisions expressed relative to the size of defaulted loans) on the default stock remains one of the highest in the sample (63 per cent), but this has decreased compared to end-2013. Further, SME lending as a percentage of total lending increased since 2013 and now represents 19 per cent.

Comparison of SME Portfolios by Country, Dec. 2015 and change vs. Dec. 2013 ($\triangle$)

Country	AT	BE	DE	DK	ES	FI	FR	GB	HU	IE	IT	NL	NO
Default Rate '15	6.7%	5.6%	2.6%	6.4%	22.2%	3.3%	6.1%	5.2%	9.4%	32.4%	36.7%	7.8%	1.2%
$\triangle$ [%p]	-0.8%	-0.6%	-1.2%	-0.7%	-5.6%	-0.3%	-0.1%	-2.5%	-7.8%	-15.6%	7.4%	0.3%	-0.6%
Coverage Ratio '15	59.6%	42.5%	49.0%	31.7%	49.0%	44.6%	56.1%	35.8%	108.0%	63.3%	51.2%	43.7%	38.1%
$\triangle$ [%p]	-8.5%	-0.5%	4.6%	3.2%	0.2%	1.8%	-6.1%	-9.6%	27.7%	-24.5%	2.8%	-5.3%	6.0%
Share of Lending '15	23.2%	28.2%	13.0%	21.6%	22.0%	16.3%	20.2%	8.2%	22.8%	19.4%	38.2%	15.7%	18.2%
$\triangle$ [%p]	0.9%	-0.4%	1.6%	-1.2%	0.8%	0.4%	3.2%	0.1%	7.7%	2.0%	2.8%	-4.0%	-0.7%

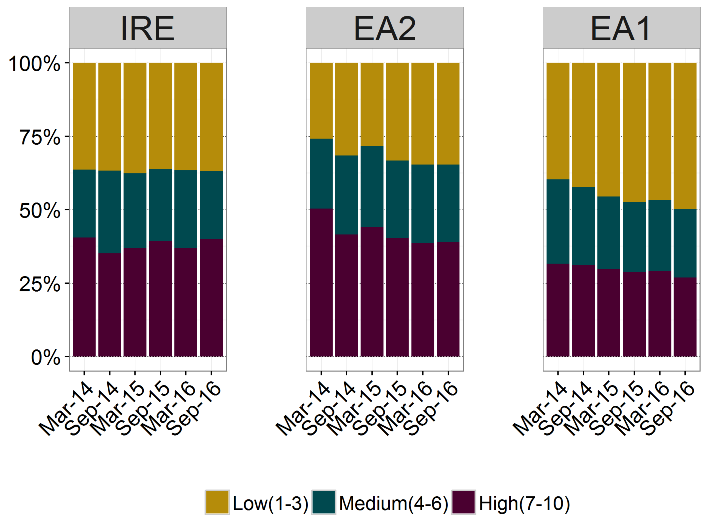
[a]Box authors: Paul Lyons and Thore Kockerols. Email: paul.lyons@centralbank.ie

[b]The default rate is defined as default stock divided by default stock plus non-default stock. SME portfolios correspond to the EBA exposure classes: 3200 (Corporates-SME); 4110 (Retail - secured by real estate property - SME); 4310 (Retail - other - SME); 4500 (retail -SME) and 5100 (secured by mortgages on immovable property SME). For details see: http://www.eba.europa.eu/documents/10180/1519986/Metadata-for-the-website.xlsx

[c]SME lending is expressed as a share of total lending, where we define total lending as EBA exposure classes: 4120+5000-5100+3200+4110+4310+3000-3200+4200+4320

4 ECB/EC SAFE Survey

Figure 17. Concerns on access to finance, March 2014 - September 2016



The ECB/EC *Survey on the Access to Finance of Enterprises* (SAFE) is used to compare credit conditions in Ireland to those of the euro area.[14] Figure 17 describes how firms' perception of access to finance as a concern has changed over the last six surveys.[15] While credit access concerns are declining in EA1 and EA2, they have remained relatively more stable in Ireland. In the latest survey, the share of Irish SMEs stating a 'high' concern (40 per cent) is similar to EA2 (39 per cent) but higher than EA1 (27 per cent).

Figure 18. SME perceptions of bank willingness to provide credit, March 2014 - September 2016

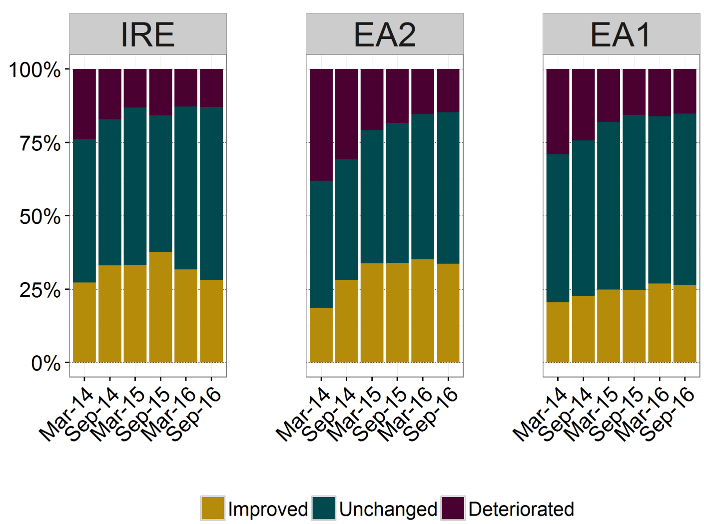


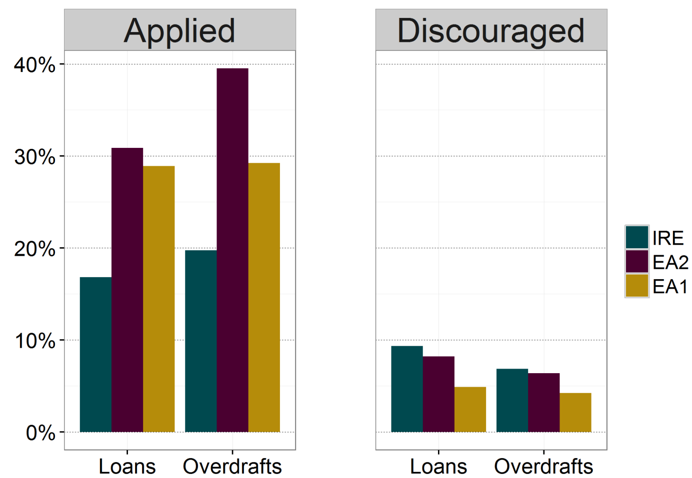
Figure 18 describes SME perceptions on bank willingness to provide credit. The share of SMEs stating a 'deterioration' has declined in Ireland and the euro area. In the latest survey, the net improvement (share of improvements minus the share of deteriorations) in Ireland is 15 per cent, which is lower than EA2 (19 per cent) but higher than EA1 (11 per cent).

[14]The survey is conducted twice yearly with the most recent survey covering the period from April 2016 to September 2016. Ireland is compared to two groups of countries: EA1 which comprises of Austria, Belgium, Germany, Finland, The Netherlands and France, and EA2 which comprises of Portugal, Italy, Spain and Greece.

[15]Responses range from 10 ('extremely pressing') to 1 ('not at all pressing') and finance includes bank loans, trade credit, equity, debt securities and other external financing.

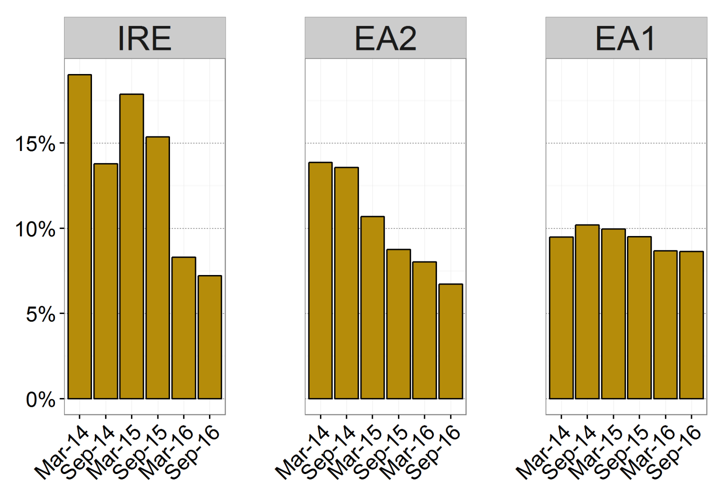
In the latest survey, loan and overdraft application rates are considerably lower than euro area averages.[16] For example, the loan application rate in Ireland, EA2 and EA1 is 17 per cent, 29 per cent and 31 per cent respectively. Ireland and EA2 show a higher share of discouraged borrowers (i.e. SMEs that did not apply because of fear of rejection) than EA1.

Figure 19. Application and discouraged borrower rates for loans and overdrafts, September 2016



After declining significantly in the previous report, rejection rates on loan/overdraft applications remain low in Ireland and are similar to euro area averages. The latest rejection rate in Ireland (7.2 per cent) is slightly higher than EA2 (6.7 per cent) but slightly lower than EA1 (8.6 per cent).[17]

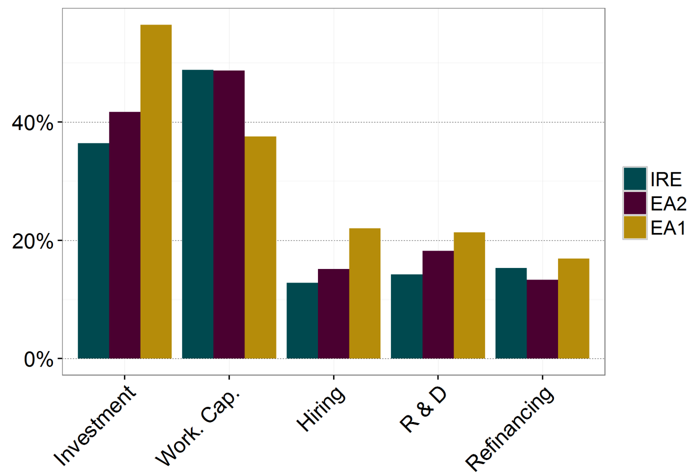
Figure 20. Rejection rates for loan and/or overdraft applications, March 2014 - September 2016



[16]Following the SAFE reports, Figure 19 only includes SMEs for which bank loans and overdrafts are relevant.

[17]SMEs that applied for both a loan and an overdraft but received a rejection for either are treated as rejected for Figure 20. SMEs whose applications are "still pending" or "don't know" are excluded from calculations.

Figure 21. Purpose of financing, September 2016



For SMEs that used financing in the previous six months, Figure 21 describes the purpose of these funds.[18] While the largest share is accounted for by 'working capital' in Ireland and EA2, 'fixed investment' is the main purpose in EA1. The 'fixed investment' share in Ireland has declined since the last report (from 43 per cent to 36 per cent) and is below euro area averages.

Figure 22. Change in interest rates, March 2014 - September 2016

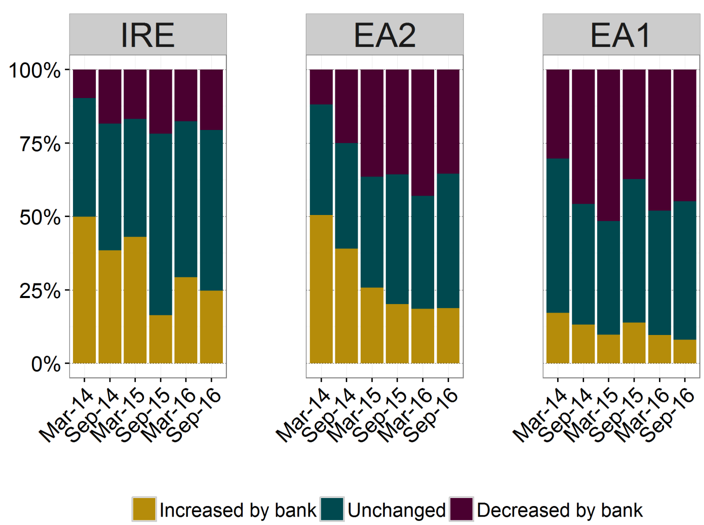


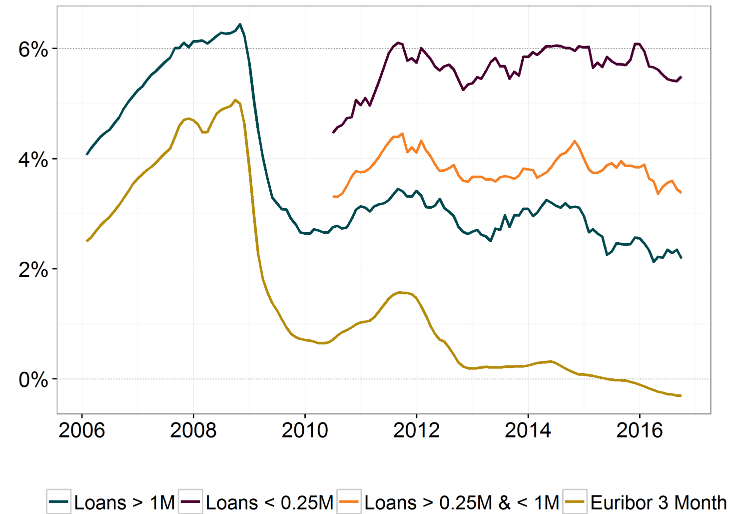
Figure 22 describes the share of SMEs that reported increased, decreased or unchanged interest rates (as reported by SMEs that applied for a new loan and/or overdraft in each survey). While the share of increases is slightly higher than the share of decreases in Ireland, most Irish SMEs currently report an unchanged situation. This is contrary to the situation in the euro area as a whole where significantly more SMEs reported decreases than increases in the latest survey.

[18]In SAFE, financing refers to 'external sources or from funds generated by your enterprise'. In Figure 21, 'Investment' refers to investment in property, plant, machinery or equipment, 'Work. Cap.' refers to inventory or working capital, 'Hiring' refers to hiring and training of employees, 'R & D' refers to developing and launching new products or services and 'Refinancing' refers to refinancing or paying off obligations. The shares presented exclude SMEs which responded with 'don't know' or 'not applicable'.

5 ECB Monetary and Financial Statistics

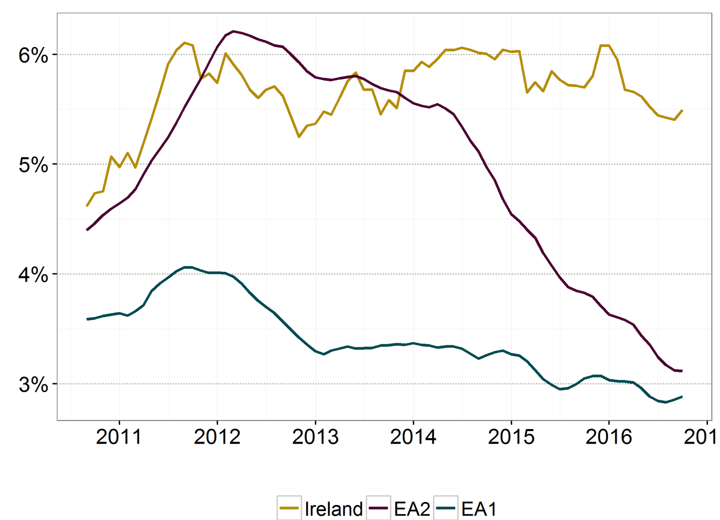
Figure 23 presents interest rates on Irish non-financial corporation (NFCs) loans of varying originating balances.[19] We use rates on loans under €0.25 million as a proxy for SME cost of credit. Interest rates are higher for smaller loans – the average interest rate for SMEs in the latest six months of data (April to September) is 5.5 per cent, which is 3.2 percentage points higher than that for loans above €1 million and 2 percentage points higher than that for loans between €0.25 million and €1 million. The average SME interest rate is lower than in the previous report (5.9 per cent – October to March).

Figure 23. Interest rates on NFC loans (3-month moving average), Ireland, January 2006 - September 2016



Interest rates on new NFC loans below €0.25 million in Ireland, EA1 and EA2 are presented in Figure 24 (see Appendix 2 for country groupings).[20] As shown in previous reports, interest rates in Ireland are above euro area averages. The average interest rate in Ireland over the latest six months is 2.3 percentage points higher than EA2 and 2.6 percentage points higher than EA1. Central Bank of Ireland research on cross-country interest rate variation (Carroll and McCann, 2016)[21] has shown that across Europe, SME interest rates are higher where SME default rates are high, where bank competition is weak, where bank funding pressures are more pronounced and where the macroeconomy is weaker.

Figure 24. Interest rates on NFC loans under €0.25 million (3-month moving average), euro area, August 2010 - September 2016



[19] In this section, interest rates and lending volumes are for 'new business' lending to NFCs. This data excludes revolving loans and overdrafts, convenience and extended credit card debt.'New business' is defined as any new agreement between the customer and the credit institution. This agreement covers all financial contracts that specify, for the first time, the interest rate of the loan, *including any renegotiation of existing loans*.

[20] This figure is created by first calculating the three-month moving average in each country. For the comparison country groupings (EA1 and EA2), a direct unweighted average is then used. This figure excludes Belgium and Greece due to missing data.

[21] Carroll, James and McCann, Fergal, 2016. "Understanding SME interest rate variation across Europe," Quarterly Bulletin Articles, Central Bank of Ireland, pages 60-76, March.

Figure 25. Difference between interest rates on small and large NFC loans (3-month moving average), August 2010 - September 2016

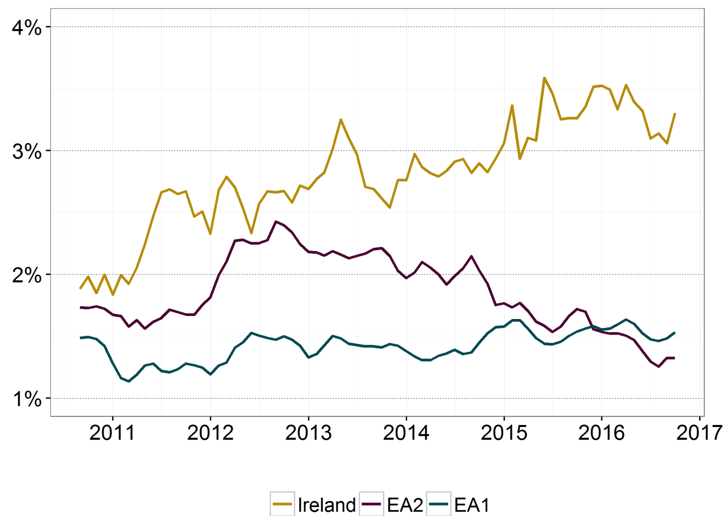


Figure 25 displays the difference in interest rates between small loans (below €0.25 million) and large loans (above €1 million).[22] This interest rate gap in Ireland is above 3 percentage points in all months in 2015 and 2016. Central Bank of Ireland research from Holton and McCann (2016) shows that this differential is higher where banks have greater market power and greater balance sheet weakness, and these these effects are exacerbated in periods of weak macroeconomic performance.[23]

Figure 26. New lending to NFCs (loans up to and including €1 million) as a proportion of domestic demand, Q1 2003 - Q2 2016

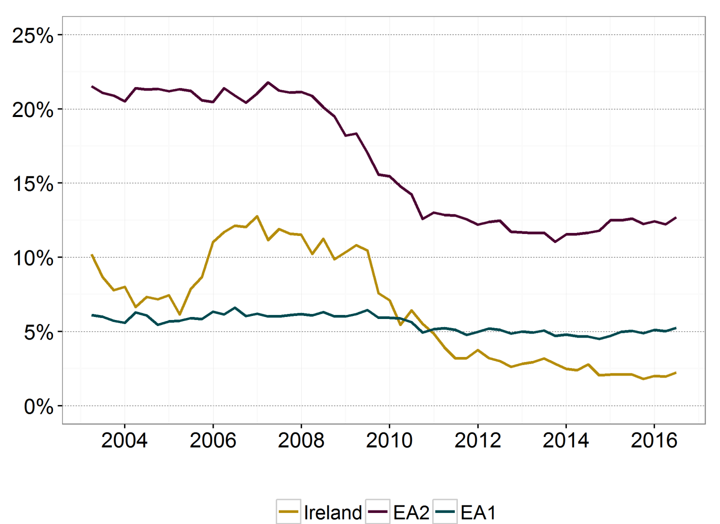


Figure 26 presents the ratio of NFC lending to domestic demand, to anchor the size of SME lending flows relative to economic activity. Lending flow data are for loans on amounts up to and including €1 million.[24] The ratio in Ireland is currently higher than at the time of the last report (2.1 versus 1.9 per cent) but below EA1 (5.1 per cent) and EA2 (12.4 per cent) averages. Other Member States with ratios less than 5 per cent are the Netherlands (2.4 per cent), Austria (3.5 per cent), Finland (4.3 per cent), France (4.3 per cent), and Germany (4.7 per cent).

[22]This figure is created by first calculating the three-month moving average for the two interest rate series in each country. The data presented is then the difference between these two moving averages, by month. For the comparison country groupings (EA1 and EA2), a direct unweighted average is used. These averages exclude Belgium and Greece due to missing data.

[23]Sarah Holton and Fergal McCann, "Sources of the Small Firm Financing Premium: Evidence from euro area banks." Central Bank of Ireland Research Technical Paper 09RT16.

[24]This higher loan threshold is chosen as lending data for loans on amounts up to €0.25 million are not available pre-2010. Euro area (excluding Ireland) quarterly domestic demand data (final consumption expenditure and gross capital formation) are from *Eurostat*. Irish domestic demand data are from the Central Statistics Office and exclude "Intangible Assets" and "Machinery and Equipment of which: Other Transport". All data are at current market prices and are non-seasonally adjusted. Monthly new lending data are aggregated to quarterly for comparison. EA2 excludes Greece due to missing data.

Box 3: SME Lending Regulations [a]

In December 2015, the Central Bank of Ireland published the 'Central Bank (Supervision and Enforcement) Act 2013 (Section 48) (Lending to Small and Medium-Sized Enterprises) Regulations 2015'.[b] The Regulations build on the protections for SME borrowers under the Central Bank's 'Code of Conduct for Business Lending to Small and Medium Enterprises 2012',[c] which the Regulations replaced. Some technical amendments were made by way of Amendment Regulations in May 2016. The Regulations came into effect and applied to regulated entities, except credit unions, from 1 July 2016. For credit unions lending to SMEs, the Regulations took effect on 1 January 2017.

For the purposes of the Regulation, a "regulated entity" means a regulated financial service provider carrying out relevant activities (as defined in the Regulations); the Regulations therefore apply to both regulated lenders and credit servicing firms.

The Regulations place the following key requirements on regulated entities:

- Appropriate on-going training of staff;
- Annual meetings and credit reviews for borrowers;
- Greater transparency for borrowers around the application process;
- Reasons for decline in writing and specific to the borrower's application;
- Signposting of the appeals and complaints processes, the Financial Services Ombudsman, the Credit Review Office and Government supports at relevant times;
- Greater protections for guarantors to include prescribed warning statements and keeping guarantors informed at crucial times during the lending relationship;
- Engagement with borrowers in arrears and financial difficulties; and
- Expanded grounds for appeals and an internal Appeals Panel comprising of at least two decision makers not involved in the borrower's case previously and with sufficient knowledge and experience to conduct the appeal.

On 3 June 2016, the Central Bank published a short 'Guide for Micro and Small Enterprises and Guarantors',[d] highlighting the protections available to them.

[a] For further information please contact staff in the Consumer Protection – Policy and Authorisation division. Email: code@centralbank.ie

[b] Available from here

[c] Available from here

[d] Available from here

Appendix 1: Data Sources

- Central Bank of Ireland *Credit, Money and Banking* statistics, Q1 2010 to Q1 2016. This source contains lending stocks and flows by quarter and sector for all Irish banks.
- Department of Finance *SME Credit Demand Survey*, September 2012 to September 2016. This nationally representative survey of 1,500 Irish SMEs is carried out on a six-monthly basis, and collects 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 Enterprises* (SAFE), October 2012 to September 2016. 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. In this report, Ireland is compared to two groups of EU countries: EA2 is comprised of Portugal, Spain, Italy and Greece while EA1 is comprised of Austria, Germany, Belgium, Finland, The Netherlands and France.
- Central Bank of Ireland loan-level data, December 2013, June 2014, December 2014, June 2015, December 2015, June 2016. This dataset 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. 'Default' is defined as loans greater than 90 days past due, or deemed unlikely to repay without giving up collateral, in line with the definition specified under Basel II.
- Monthly euro area interest rates and new lending data to non-financial corporations are based on the ECB's *Monetary and Financial Statistics* (MFI interest rates). These data are for loans other than revolving loans and overdrafts, convenience and extended credit card debt (all maturities), and include renegotiations.

Appendix 2: Classification of SMEs

For the purposes of the Central Bank of Ireland aggregate statistical series and the Department of Finance *SME Credit Demand Survey*, 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 consistent with the SME definition in the Central Bank's SME Lending Regulation and used by the Credit Review Office.

In the SAFE survey, 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 larger corporate borrowers in the data in a manner similar to that used by regulatory stress testing exercises. All firms whose exposures are managed in retail and business banking units of the subject banks are modeled as SMEs, while all exposures managed in corporate banking divisions are considered to be large firms and excluded from the analysis in this report.