Organisation Science & Public Policy

Report on *Credit Lending to SMEs* Event

held at

Kemmy Business School, University of Limerick

on 22 May 2012

Report compiled by John Heneghan and Dr. Helena Lenihan

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Organisers' Contact Details
John Heneghan, Lecturer in Accounting and Corporate Governance, Department of Accounting and Finance, Kemmy Business School, UL
E-mail: John.Henghan@ul.ie

Dr. Helena Lenihan, Assistant Dean, Research and Senior Lecturer in Economics, Kemmy Business School, UL
E-mail: Helena.Lenihan@ul.ie

Robert Grealis, Interim CEO, Limerick Chamber
E-mail: ceo@limerickchamber.ie

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Introduction

Jointly sponsored by the Kemmy Business School (KBS) at the University of Limerick (UL) and the Limerick Chamber, an event entitled *Credit Lending to SMEs* was held at UL on 22 May 2012. The event, at the suggestion of John Moran, Secretary General of the Department of Finance was a reconvening of participants from a meeting on the same topic organised by the Department of Finance and held at the Strand Hotel, Limerick on 2 April 2012.

The two-hour event was moderated by John Heneghan, Lecturer in Accounting and Corporate Governance at the KBS.

Aims

The aims of the event were to:

- Explore the disparity between the level of information required by lenders and the ability of SMEs to supply it
- Gain insights from the Credit Review Office (CRO) from its experience as an independent reviewer of lending decisions by banks that turn down loan requests from SMEs
- Facilitate an exchange of views between SMEs, lenders and SME advisors, which might lead to overcoming barriers to credit access

Structure

The evening's proceedings were structured as follows:

1. **Plenary session** (55 mins):
   - Welcome by Dr. Philip O'Regan, Dean of the KBS, and Robert Grealis, Interim CEO, Limerick Chamber
   - Address by John Perry T.D., Minister for Small Business at the Department of Enterprise, Jobs and Innovation
   - Presentation 1: Translational Research at the KBS
   - Presentation 2: Credit Lending to SMEs: Financial Data and Roles of Key Players
   - Presentation 3: Insights from the CRO
   - Agreement on themes for the break-out sessions
2. **Break-out sessions** (30 mins): Three break-out groups each explored one of the following themes (see Appendix 1 for details):
   - Expectations gap between banks and SMEs
   - The loan-processing encounter
   - Procurement, loan guarantee scheme, doing business locally
3. **Return to plenary** (35 mins): Discussion and closing remarks

Minister's Address

John Perry, TD, Minister for Small Business at the Department of Enterprise, Jobs and Innovation

The Minister addressed the urgent need to remove barriers faced by SMEs in accessing credit. According to Minister Perry, "Now more than ever we need ambitious and energetic business owners, entrepreneurs and managers who can play a real part in driving a positive uplift in the economy." The Minister described these people as job creators and innovators and stressed the need to encourage and support them in making their mark and building a better future for themselves and this country. With a view to making the financial landscape more effective in meeting the needs of Irish businesses, the Minister stated the importance of adopting a solution-focused approach in delivering a practical programme of actions. He concluded by stating that "We *must* dismantle unnecessary barriers that stymie growth and hold back investment."

Presentation 1: Translational Research at the KBS

Dr. Helena Lenihan, Assistant Dean, Research, KBS

Dr. Lenihan outlined the KBS research strategy. Amongst other things, the strategy focuses on 'translational research', i.e., research that has a real impact on practice and implications for policy. Dr. Lenihan shared with participants a series of KBS monthly research bulletins, which were developed to demonstrate the significance and relevance beyond academia of excellent KBS research. Under the umbrella theme of 'Organisation Science and Public Policy', the monthly bulletins demonstrate to policymakers and organisations alike how research conducted at the KBS can have an impact on the economy, organisational change initiatives and public policy. Issues of the bulletin can be accessed at www.ul.ie/business/kbs-research-bulletin.

Dr. Lenihan then introduced John Heneghan by stating that his work in the area of SME research is an excellent example of translational research, given the potentially significant impact of its practical applications on public policy.

Presentation 2: Credit Lending to SMEs: Insights into the Use of Financial Data and the Roles of Key Players

John Heneghan, KBS

This presentation presented the findings of a survey, conducted by the presenter, of 78 small firms in relation to interactions with their lenders and accountants. This and the next presentation (from a senior reviewer at the CRO) were designed to provide insights to participants in preparation for their deliberations during the break-out sessions.

John Heneghan described lending to SMEs in Ireland as "a double-edged problem" and noted that while there is a refusal rate of 23% (Mazars report Nov 2011), some 60% of SMEs have chosen *not* to apply for credit. According to Mr. Heneghan, "This is a threat to growth. Furthermore, the main demand has been for working capital and cash flow rather than capital and long-term investment. This is a threat to these firms specifically and the economy generally."

The speaker referred to three significant observations (the first of which formed a key theme of the evening's event) made by the CRO from its 5th quarterly report (November 2011):

1. The disparity between level of information required by banks and some SMEs' ability to supply it
2. Financial accounts produced only for tax computation and cashflow forecasts produced at the bank's request
3. Many cases (loan requests) turned down because of "overly rigid lending policies"

Presenting evidence from his research of 78 small firms (albeit a convenience sample), the speaker noted that 40 firms had experienced growth since September 2008. Although 36 firms (46%) chose not to apply for credit, 80% of those that had applied were successful. The research findings indicated a level of sophistication with regard to how the firms prepared and used financial information in their businesses. Specifically:

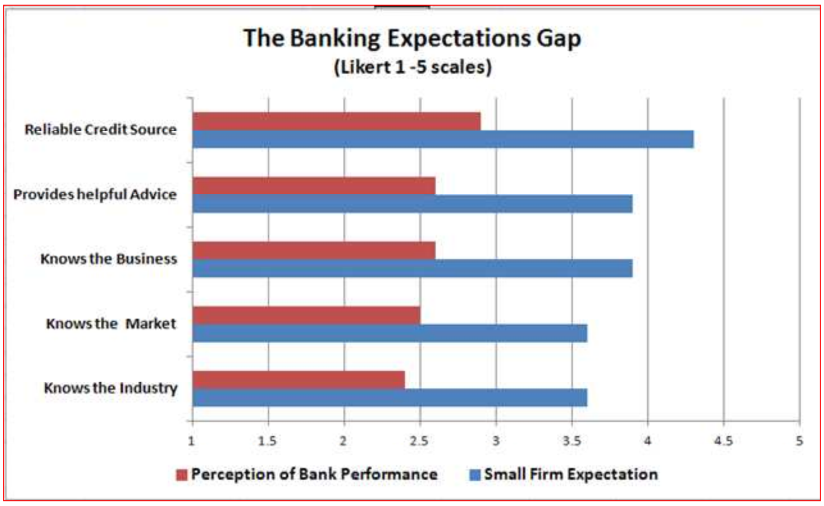
- 76 have their accounts audited
- 69 prepare their management reports on an accrual basis: SALES, P&L, cash flows
- All firms use brand-name accounting software

The speaker suggested that when the above statistics are considered in the context of the average duration of the banking relationship (i.e. 19 years), this may be an appropriate place to begin seeking a solution to the barrier to credit. There is a "latent or dormant power that exists in the SME that has not been harnessed" by the triangular relationship of SMEs, accountants and lenders.

Making it clear that the presentation was intended to provide insights and not demonise banks, accountants or the government, the speaker reflected on the gap between what the 78 firms expected from their lender and their perceptions of the banks' performance (referred to as the "expectations gap"). The research findings in this regard are presented below.

The Small Firm – Banking "Expectations Gap"

Averaging: Expectation of 3.8 contrasts with Perception of 2.6.



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The survey looked at five lender attributes: *reliable credit source*, *provides helpful advice*, *knows the business*, *knows the market* and *knows the industry*. With respect to all five attributes on a scale of 1 to 5, the average expectation of surveyed SMEs was 3.8 while the average perception was 2.8.

Regarding the specific attribute of providing helpful advice, the speaker commented that the gap between the expectation of 3.9 and the perception of 2.6 "is disappointing and could possibly be as debilitating as curtailing credit to SMEs". This particular expectation gap may be explained to some extent by the fact that while 64 firms were asked by their bank to supply audited accounts, only 34 had the opportunity to discuss such accounts with the bank. The speaker asked if banks "could be doing more to seek and peruse financial information from their clients?" and "to what extent do banks believe or rely on their clients' financial reports?"

The presentation looked at the role of the accountant and, as noted above, 76 of the 78 firms had their accounts audited. However, while 26 received advice on the type of finance required for the firm, only 6 firms used their external accountant to access finance. According to the speaker, the fact that only 16 firms got advice on the effective rate of interest "might perhaps suggest lazy servicing by some accountants".

Presentation 3: Insights from the Credit Review Office

Paul Kerr, Senior Reviewer at the CRO

This presentation centred on two case studies involving SMEs that availed of the CRO's appeal process after they were refused credit from banks. In one case, the CRO supported the firm's application for credit and overturned the bank's decision to decline credit. In the second case, the CRO supported the bank's decision to decline. In over 50% of cases reviewed through its appeal process, the CRO overturns the lender's decision not to provide credit to SMEs. In this context and in light of the fact that the CRO's Helpline advice service can resolve issues without a formal process, there can be no doubting the CRO's influence in the credit-lending debate.

The CRO's note of caution to SMEs – "Fail to prepare, prepare to fail" – underlines the importance of business planning and forecasting. The CRO has advised banks that they "need to work on deal-making". Indeed, the CRO's "watchdog" function has banks looking more closely at their lending decisions.

Coda

The event produced an atmosphere of engagement that was rarely experienced before by many of the participants (bankers and SMEs alike). For that reason and for the issues generated in the sessions, the suggestion for a follow-up event was strongly supported and warmly welcomed.

The organisers would like to express a word of THANKS to Tom Collins, Director of the National Centre for Taxation Studies at the KBS, who along with Dr. Lenihan and Robert Grealis, acted as a rapporteur in the break-out session.

Appendix 1: Break-out Sessions

Group 1 Theme – Expectation Gap

Banks and the SME Sector

1. SME – over-reliance on asset-driven banking decisions rather than capacity to finance. A culture pervades of “what do you own” rather than focusing of the borrowers’ repayment capacity.
2. Tendency for clients to follow the “good banker”, with whom they have established a good working relationship. The benefit of a local “good banker” is being diluted by delayed or overdue decisions.
3. Tensions arise by slow or a seeming incapacity to make decisions at “local” branch level and may reflect certain deficiencies in skill sets by bankers. This was acknowledged by banking participants. This aspect was countered by a participant working with a German bank based in Cork, who stated that decisions up to €50k are made at a local level within 24 hours.
4. The current economic climate has perhaps led to an over-correction in lending policy conservatism and that in the height of the Celtic tiger, the standard of lending decisions was deficient.
5. There was a fear factor on the part of SMEs to use the Credit Review Office (CRO), specifically the fear is that “going over the head” of the bank may prejudice future credit applications.
6. Whilst the CRO representative highlighted the creation of standardised loan application forms, the success or otherwise of this was not evident from the discussions.
7. Whilst noting the important role played by accountants in preparing loan applications, the cost of this assistance can be prohibitive for the SME.

Recommendations

- The “old chestnut” of personal guarantees needs to be addressed – the banks counter this by arguing that they are not a venture capital house.
- Address the art of lending through courses and/or executive programmes by availing of the expertise of universities such as UL?
- Look at the feasibility of having workshops between banks and accountants (and other financial intermediaries) to expedite the bank loan application process.
- Address the protracted requests for information, etc.

Group 2 Theme – The Loan-processing Encounter

The Loan Application Burden

1. The process of making a loan application is particularly onerous on small business, and the costs associated with certain loan applications can be significant and sometimes amount to a material percentage of the overall loan value.
2. There were also concerns expressed by SMEs that the terminology used can be difficult to understand.
3. It appears that the loan application process and level of information required is established based on regulatory requirements.

Recommendations

- Implement a simplified loan application process with a *tiered* system that minimises the level of detail required based on the type and size of the loan.
- Reduce the cost burden on SMEs by asking banks to pay their own legal fees where this is required as part of the loan application.
- Implement a "Plain English" policy for all bank communications and documentation.

Payment Terms

1. The culture of payment in Ireland is detrimental to the financial health of the SME sector in particular. Public bodies, which are legally required to pay within 30 days, can consistently defer payment out to 60-70 days, which is having a significant negative impact on SME cash flow.
2. Views from bank representatives suggest that up to 60% of SMEs in certain sectors are financially challenged because of late payments, especially from the public sector.

Recommendations

- Impose a 30-day payment term on all government, semi-state and public body organisations and ensure this is policed with significant penalties for late payment.
- Review the potential to establish regulated payment terms in additional sectors, including the private sector.

Communications

1. There are perceptions across all stakeholders that are not borne out by the facts, and there is a clear lack of understanding of the factors impacting on business and on the banks.
2. SMEs and banks are less likely to have a proactive relationship until such time as their cash flows dictate and the sharing of business information is minimal.
3. Professional advisors to SMEs, especially auditors, are less likely to proactively review and advise on the financial information of the business outside of the annual audit and tax returns.

Recommendations

- There is a need to develop more proactive communications between all parties (owner, banker, advisor).
- There is a need to change the perception that banks are not open for business.

Personal Guarantees

1. The requirement to provide personal guarantees is a barrier for SMEs making loan applications. This is stifling business development and job creation as well as the ability of SMEs to implement plans to survive.

Recommendations

- Reduce the personal guarantee burden on SMEs for loans where the business clearly demonstrates the ability to repay and/or has an asset base that provides security for the bank.
- Eliminate the personal guarantee burden for viable SMEs for small loan and overdraft amounts.
- Review how the new loan guarantee scheme can be used to affect this change.

Group 3 Theme(s) – Loan Guarantee Scheme, Procurement, Doing Business Locally

Loan Guarantee Scheme

1. Has the potential to invoke confidence in an economy, which is very much in need of such confidence.
2. Must learn from the mistakes experienced in other countries, such as an overly complicated application process in the case of the UK scheme, for example.

Recommendations

- Commercial reality should drive decision-making, *not* politics.
- The scheme should not be administered in the same fashion as similar schemes administed by government agencies in the 1970s.
- Putting money into "dead" businesses must be avoided.
- Examine evidence from other countries where schemes similar to those of the loan guarantee scheme have been introduced and derive transferable lessons (good and bad).

Procurement

1. Government procurement should support SMEs.
2. One participant of the session shared the following statistic: The Irish government is 17 times more likely than the French government *not* to support its own firms.

Recommendations

- Develop procedures or legislation that will enable micro and small entities to successfully pursue business in their local areas. Success in local businesses will, in turn, drive economic activity at the level of the national economy.
- Organise follow-up seminar dedicated to procurement (Minister Perry stated that he would attend).

Doing Business Locally

1. Lots of business engagement and exchanges are best done locally.
2. Local business engaging with national government encourages local decision-making.

Recommendations

- Address information needs (information asymmetry) of local SMEs.
- Procurement should facilitate, or be tied to, helping SMEs to employ locally.

Group 3 commented positively on the presence of the Minsister and his willingness to engage in key issues affecting the SME (largely indigenous) sector of the Irish economy.