Philip R Lane: SMEs and the macro-financial environment

Address by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the Irish Small and Medium Enterprises Association Annual Conference 2016, Royal Dublin Society, Dublin, 11 November 2016.

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Introduction

Good afternoon. I would like to thank ISME for inviting me to address your annual conference. The theme "Challenging Times – New Opportunities" is certainly timely, especially as Ireland adapts to the implications of Brexit in the coming months and years. The SME sector is central to the work of the Central Bank. At the macroeconomic level, the economic performance of Ireland critically depends on the SME sector. In relation to our financial stability mandate, the financial health of the SME sector is of primary importance.

The format of my talk today has four parts. First, I will provide an overview of the analysis of the SME sector that has been undertaken by our economics team in the Central Bank. Second, I will discuss the financial environment facing the SME sector. Third, I will turn to the implications of Brexit. Fourth, I will offer some reflections on the relevance to the SME sector of the Central Bank's mandate to safeguard financial stability and protect consumers.

The role of the SME sector in the Irish economy

The importance of SMEs to the Irish economy is well known: SMEs account for nearly all active enterprises and employ about two thirds of the total workforce. The vast majority of these firms have been created in Ireland and many are run by owner-managers. The SME sector is highly dynamic, with smaller firms having the highest rates of both job creation and job destruction. The smallest firms account for nearly half of all net job creation in Ireland, with the largest contribution coming from young, small, domestically-owned enterprises[1].

An important characteristic of the SME sector is that it is highly interconnected to other sectors in the economy. The output of SMEs can be sold to one of five broad groups: enterprises in the same sector, enterprises in other sectors, domestic consumers, export markets and the public sector. The varying reliance of individual SME firms on these revenue sources (for example, the extent to which a firm is business-facing or consumer-facing), has important implications in relation to how economic shocks are transmitted to and from the SME sector.

While granular data on SME reliance on each of these revenue sources are not available, much can be inferred from economy-wide input-output tables. For example, the latest CSO data show that manufacturing and business services sectors are the most export orientated, while construction and distribution sectors have the highest shares of direct consumer sales. Domestic business-to-business sales are most relevant to agriculture, business services and distribution sectors. A full understanding of the different sectoral interlinkages is of paramount importance in identifying the risks facing the SME sector.

The experience of the SME sector since 2008 illustrates the importance of understanding the differences in inter-sectoral linkages across individual firms within the sector.

Between 2008 and 2012, SME employment levels declined by almost a fifth, which is about double the decline experienced by larger firms during the crisis. While employment fell in nearly

all SME sub-sectors, industry and construction were most affected. Most severely, the reversal in the construction sector saw a 50 percent decline in employment. By 2014, employment in larger firms was just 5 per cent lower than 2008 levels, while still 15 per cent lower for SMEs. There are many factors which determined the magnitude of the economic shock faced by SMEs. One striking example is the difference in experience for those retail firms selling durable and non-durable goods. In the case of durables (such as motors, furniture, hardware and electrical goods), sales fell by 40 to 50 per cent during the crisis. In contrast, food sales in 2012 and 2013 were close to identical to those on the eve of the recession.

The recovery in Ireland in recent year has included a substantial contribution from the SME sector. The share of SMEs reporting increased sales almost doubled between 2013 and 2016, with rising activity levels in all the main business sectors. While we see expansion across all SME size categories (Micro, Small and Medium), the recovery has been weakest for smaller, non-exporting SMEs. We observe similar patterns in the data on firm profitability. Surveys carried out by the ECB also point to a relatively strong recovery in Ireland: growth in turnover and profitability has been stronger here than in most other countries in the euro area in recent years.

SME investment is also showing signs of recovery. Recent research from the Central Bank of Ireland shows that the share of SMEs investing has increased steadily since 2012, and currently about one third of SMEs are investing, with larger firms, exporters and innovators most likely to invest[2]. Investment is also strong by European levels – the share of Irish SMEs reporting investment increases is among the highest in the euro area.

The financing of the SME sector

Let me now turn to the financing environment facing the SME sector.

Currently, new investments in the SME sector are primarily funded by retained earnings, with bank financing and leasing together accounting for less than twenty per cent of investment expenditure. This is consistent with the post-crisis situation in many advanced economies and reflects a combination of deleveraging factors and still-low investment levels.

Even in good times, SMEs face a tougher financing environment compared to larger corporates, due to higher investment risks and limited firm-level information available to providers of debt and equity finance. The legacy of the crisis has further strained this relation: Ireland has among the highest shares of non-performing SME loans in the EU, with many property-related loans secured on SME businesses during the boom. However, relative to the peak, the stock of outstanding balances in default has declined, with fewer SMEs entering default and more SMEs returning to performing loan status. More generally, the SME sector has undergone substantial deleveraging: the stock of loans to SMEs in 2016 is about half that in 2010. Survey evidence shows that debt-to-turnover ratios are declining and the share of SMEs with no debt is increasing.

While there was a sharp tightening in credit conditions for the SME sector during the crisis, there has been a significant turnaround over the last three years – rejection rates have been declining steadily and are now in line with euro area averages, and new SME lending has been growing strongly since 2014. Improvements in SME fundamentals, driven by the improving economy, have played a role in these improved acceptance rates for SMEs. While surveys show that access to finance is still a high concern for about one third of Irish SMEs, a growing share of firms are reporting that the willingness of banks to provide credit is improving. Across the euro area, an easing in credit conditions has been supported by the accommodative monetary stance of the ECB, which has been reinforced by the range of non-standard measures that have been implemented since Summer 2014.

The composition of lending to the SME sector is also shifting towards a more pro-growth orientation. During the crisis, SMEs were seeking loans to cover the deterioration in trading

conditions and support balance sheet restructuring. In 2012, 40 per cent of credit applications from Micro-SMEs were for “stressed” reasons, which include revenue declines, increased bad debts, or a slowdown in debtor collection. By 2016, this figure had dropped to 13 per cent. We are also seeing that the share of credit applications for investment purposes is rising while the share for working capital is declining, which is again likely a symptom of improving outlook and sentiment.

One aspect of SME financing that has received much attention is the cost of credit. Indeed, the Central Bank of Ireland’s SME Market Report has regularly shown that interest rates on smaller company loans are higher than the euro area average[3]. Furthermore, while rates in other vulnerable countries have declined since 2014, they have remained high in Ireland. Understanding these differentials has been the focus of a research project at the Central Bank. This research shows that macro-financial factors rather than differences in SME characteristics are the primary explanation for cross-country interest rate differentials. For example, interest rates tend to be higher in countries in which there is a higher share of non-performing loans, unemployment is atypically high, banks are under stress and the banking system is more concentrated. From these results, we can expect that further improvements in the health of the Irish banking system (which in turn may trigger the entry of new lenders) and continued macroeconomic improvement will help to narrow cross-country interest rate differentials.

Let me briefly turn to the current Capital Markets Union (CMU) initiative. The aims of CMU are to improve access to finance for all businesses across Europe including SMEs, increase and diversify funding sources for the real economy and make capital markets in Europe more efficient and effective. For SMEs, there are two ways in which CMU could help. First, the development of deep and liquid securitisation markets for SME loans would improve the ability of banks to source financing for new SME lending. Second, if CMU delivers alternative financing sources for enterprises, this can help reduce the dependence of SMEs on banks for credit intermediation.

Funding diversification also matters generally for enterprise development when viewed through the lens of the enterprise financing lifecycle. As enterprises grow, their funding requirements change and develop. For example, early in the lifecycle, companies rely on informal financing, insider funding or business angel equity. If the firm has adequate scale and growth prospects, they may have access to other private equity such as venture capital or mezzanine finance, and the largest firms have access to public debt and equity markets. By facilitating the introduction of targeted policies to improve the supply of alternative financing across the lifecycles of firms, CMU can contribute positively to the funding environment for SMEs.

Other recent interventions in the Irish SME landscape are the Strategic Banking Corporation of Ireland and the Ireland Strategic Investment Fund. The SBCI began “on-lending” through a number of bank and non-bank partners in March 2015 with the goal of promoting competition in the SME lending market and reducing the cost of credit for SMEs. The SBCI has made a significant impact since its launch with over 8500 loans issued, representing €347 million in new lending. We estimate that SBCI lending in 2015 equates to a sizable 9 per cent of total new lending to SMEs. There is also evidence that interest rates on SBCI loans are lower than market rates.

The European Investment Bank also supports SMEs through their funding of the SBCI, which amounted to €188 million in 2015. Further, between 2011 and 2014, the EIB provided an additional €550 million in credit lines for SMEs through the Irish retail banks and the SBCI. ISIF have also been a major player in the SME financing environment and have, to date, invested €355 million in a number of debt and equity SME funds. Such policies should help alleviate financing bottlenecks in the SME market.

Brexit

The latest ISME surveys show that Brexit is now the biggest concern facing Irish SMEs. The SME sector is especially exposed to shifts in the Sterling-euro exchange rate, the level of economic activity in the United Kingdom and the prospect of new barriers to trade between Ireland and the UK.

While exporters selling to the UK are most immediately affected, there are additional channels by which the exchange rate affects the SME sector. First, in many domestic sectors, the market share of domestic firms will be threatened by imports from the UK. Second, many domestically-orientated firms are suppliers to exporters or rely on employees in exporting firms as customers. Third, Sterling depreciation is associated with an increase in cross-border shopping.

While these are adverse forces, it is also important to point out that a weaker Sterling may benefit some SMEs that rely on imported inputs from the UK and that real income gains to households due to cheaper imports from the UK may in part be recycled into higher spending on domestically-produced goods and services.

Over the longer term, the Irish SME sector will have to adapt to the post-Brexit environment. The current uncertainty about the future UK-EU relationship will delay many investment plans. In turn, as clarity about the post-Brexit world improves, firms will have to develop new strategies to respond to the new configuration. In response to higher trade barriers between the UK and the EU, some firms may plan to serve UK customers through FDI into the UK, while others may search for new export markets. In the other direction, some UK firms may look to set up affiliates in Ireland both to serve the Irish market and as a platform for EU-wide trading.

SMEs and the Central Bank

The mission statement of the Central Bank is "safeguarding stability, protecting consumers." The last decade has provided a painful reminder that the SME sector is especially exposed to volatility in domestic macroeconomic and financial conditions. The current work of the Central Bank is dedicated to improving the resilience of the financial system and mitigating pro-cyclical dynamics in credit allocation.

In relation to resilience, a primary international strategy (implemented through the work of the ECB's Single Supervisory Mechanism) is to improve the capacity of banks to withstand shocks by fortifying capital and liquidity buffers and implementing a more intrusive supervisory model. In addition, the Bank Recovery and Resolution Directive provides a framework that will make it easier to restructure or shut down failing banks, with limited recourse to the taxpayer.

As the national macroprudential authority, the Central Bank is also working to reduce the risk of destabilising credit cycles. In addition to the the new mortgage rules, the Central Bank has additional macroprudential policy instruments, including the counter-cyclical captial buffer which can be raised if there are signs of overheating in the credit system. The vigorous use of national-level macroprudential policy is essential for small, open economies, given the elevated exposure to external financial shocks.

Such measures can play a substantial role in helping to reduce macro-financial volatility. However, it is also important to recognise that small economies will always be more volatile than larger, more diversified economies. Given this reality, decision makers in all sectors (SMEs, large corporates, households, the government) should make financial plans on a prudent basis, with sufficient equity and cash buffers to cope with adverse shocks and due risk assessment of investment and consumption plans.

Finally, let me turn to the consumer protection work of the Central Bank, which extends to the SME sector. The Central Bank has consistently recognised the importance of ensuring that

regulated lenders treat small businesses fairly. A new set of regulations came into effect on 1 July 2016 for all lenders that provide SME credit, except for credit unions, which must comply from 1 January 2017. These Regulations provide protections for micro, small and medium-sized enterprises when they are either applying for or already have credit facilities and also for guarantors of SME credit. In summary, the Regulations aim to strengthen protection for SMEs, while also facilitating access to credit, by introducing specific requirements that regulated lenders must comply with such as: giving SME borrowers transparency around the application process; providing SME borrowers with reasons for declining credit, in writing, that are specific to their application; providing protections for guarantors of SME credit; providing SMEs with the option of an annual meeting to review their credit facilities; contacting SME borrowers who have been in arrears for 15 working days; warning SME borrowers if they are in danger of being classified as not co-operating; and providing SME borrowers with the right of appeal.

We have produced a Guide for SMEs on these Regulations which is available on our website and I would encourage you all to read this[4]. ISME were a key stakeholder for us in undertaking the development of these Regulations and I would like to thank ISME for its very constructive engagement in this work and its assistance in circulating our Guide to its members.

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[1] Martina Lawless (2013), *"Age or size? Determinants of job creation"*. www.centralbank.ie/publications/Documents/02RT13.pdf

[2] James Carroll, Paul Mooney and Conor O'Toole, "Irish SME Investment in Economic Recovery". www.centralbank.ie/publications/Documents/QB2%202016%20Irish%20SME%20Economic%20Investment%20in%20Economic%20Recovery%20Article.pdf

[3] Using interest rates on non-financial loans under €250,000 as a proxy for SME lending rates.

[4] The Guide is available here. The Press Release issued in June 2016 is available here.