



## The importance of banks in SME financing: Ireland in a European context.

Martina Lawless, Fergal McCann and Conor O'Toole

Vol 2013, No. 5

### Abstract

Financing for working capital and investment is essential for the survival and growth of Small and Medium Enterprises (SMEs). The recent financial crisis has provoked much debate in Ireland and Europe around the provision of *bank* financing to SMEs. This article provides empirical evidence, using both pre- and post-crisis data, that Irish SMEs' external funding mix is more reliant on commercial banks than almost all other European countries. Such a reliance on banks is likely to increase the vulnerability of the real economy to shocks to the banking sector. We note that the share of firms using bank borrowing to finance either working capital or investment has fallen by roughly 50 per cent between 2005 and 2012, reflecting both supply and demand factors. Continuation and expansion of policy initiatives to widen the range of financing options available to SMEs are crucial in order to facilitate investment and employment growth as the Irish economy moves toward recovery.

## 1 Introduction

The provision of finance to the Small and Medium Enterprise (SME) segment is a topic of crucial policy importance. In Ireland, over two-thirds of private sector employment is accounted for by these firms (Lawless et al., 2012), with their prospects more closely linked to that of the domestic economy than is the case for larger firms. The post-crisis debate in Ireland has focused almost exclusively on the provision of bank credit to SMEs. While banks are generally thought of as the chief provider of external finance to SMEs (Beck et al., 2008), their importance in the financing of Irish SMEs has not been empirically assessed. This Letter uses three independent survey data sets to shed light on the issue, both by comparing Irish SME financing to other European countries, and by high-

lighting changes in Irish SMEs' funding mix since the onset of the financial crisis.

Firstly, we use data from 2005 and 2012 to compare the importance of banks in funding Irish SMEs' working capital and investment relative to SMEs across Europe. Evidence is provided that Irish SMEs are either the most, or second most, reliant in our European sample on bank borrowing, whether measured by the share of SMEs that use bank borrowing, or by the percentage of firms' working capital or investment financed by bank borrowing. That these findings hold in both pre- and post-crisis surveys suggests the patterns are structural characteristics of the Irish economy.

Secondly, comparable data on the funding mix of Irish SMEs in 2005 and 2012 are created to highlight changes occurring since the onset of the financial crisis. The data reveal a striking pattern

<sup>0</sup>Lawless: Irish Economic Analysis Division, Central Bank of Ireland. McCann: Financial Stability Division, Central Bank of Ireland. O'Toole: Economic and Social Research Institute. E-mail: martina.lawless[at]centralbank.ie; fergal.mccann[at]centralbank.ie; conor.otoole[at]esri.ie. We thank Petra Gerlach and Gerard O'Reilly for helpful comments and suggestions. The views expressed in this paper are those of the authors and do not necessarily reflect those of the Central Bank of Ireland, the ESCB or the ESRI. Any remaining errors are our own.

whereby, *among firms with a demand for financing*, the share of firms using bank borrowing for either working capital or investment purposes has fallen by one half between 2005 and 2012. Internal funding (for investment), along with trade credit and equity (for both investment and working capital) are being used more intensively by Irish SMEs in 2012 than in 2005, suggesting that a substitution from bank to alternative financing has taken place.

It is likely that SMEs in countries with a heavy reliance on banks for funding will be disproportionately impacted by difficulties in the banking sector. While banks, with a comparative advantage in credit information processing and intermediation, must continue to play an important role in funding the SME segment, a more diversified mix of funding options than those currently available would represent a more sustainable long-run Irish SME financing environment. At both national<sup>1</sup> and European level, a range of policy actions have been put in place which aim to create a more diversified set of viable funding options for SMEs. The findings of this Letter provide support for such policies.

## 2 The importance of banks in SME financing

The aim of this section is to compare the importance of bank borrowing in the funding structure of Irish SMEs to that of SMEs across Europe. To ensure that patterns uncovered are not related to specific point-in-time factors, we provide comparisons using data from both the pre-financial crisis expansionary period and the post-2008 economic downturn. If findings are consistent across these two periods, we believe they can be attributed to structural characteristics of the Irish economy.

Our pre-crisis data come from the 2005 Business Environment and Enterprise Performance Survey (BEEPS), which is carried out by the European Bank for Reconstruction and Development (EBRD), in cooperation with the World Bank. The survey was undertaken in thirteen European countries: the Czech Republic, Estonia, Germany, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Slovakia, Slovenia and Spain with a total sample of 6,354, of which 501 are Irish. The sampling frame comprised firms that

had been in business for at least three years, so the financial structure of new start-ups cannot be analysed.<sup>2</sup>

Firms in the BEEPS data are asked the following question related to their funding structure:

*“What proportion of your firm’s working capital and new fixed investment has been financed from each of the following sources, over the last 12 months?”*. Examples of working capital are given as “inventories, accounts receivable, cash” and investment as “new investments (i.e. new land, buildings, machinery, equipment)”.

- Internal funds/Retained earnings
- Equity (i.e. issue new shares)
- Borrowing from local private commercial banks
- Borrowing from foreign banks
- Borrowing from state-owned banks, including state development banks
- Loans from family/friends
- Money lenders or other informal sources (other than family/friends)
- Trade credit from suppliers
- Trade credit from customers
- Credit cards
- Leasing arrangement
- The government (other than state-owned banks)
- Other

We group the three responses related to “Borrowing from Banks”, and create two charts containing four cross-country comparisons:

- The share of firms using any form of bank borrowing to finance working capital (Figure 1).
- The share of firms using any form of bank borrowing to finance investment (Figure 1).
- The percentage of total funding for working capital accounted for by bank borrowing, *conditional on the firm using bank borrowing to finance working capital* (Figure 2).
- The percentage of total funding for investment accounted for by bank borrowing, *conditional on the firm using bank borrowing to finance investment* (Figure 2).

<sup>1</sup>See pages 25-33 of the Irish government’s Action Plan for Jobs 2013: <http://www.djei.ie/publications/2013APJ-Annex.pdf>

<sup>2</sup>A complete description of the survey methodology is available from <http://www.ebrd.com/pages/research/economics/data/beeps.shtml>

Figure 1 shows that the percentage of firms in Ireland that used bank borrowing to finance investment or working capital was in both cases the second highest in our European sample in 2005, behind Germany. Figure 2 illustrates the percentage of investment or working capital that was funded by bank borrowing, *among firms that used some bank borrowing to fund that activity*. For investment, this intensity of usage of bank funding was highest in Ireland among all sample countries in 2005, while for working capital Ireland had the second highest share.

The post-crisis data come from the European Central Bank / European Commission Survey of Access to Finance of SMEs (SAFE). The 6 month period September 2012 to March 2013 is used here. The sample size is 7,510 firms, of which 500 are based in Ireland. Firms are asked the following:

*"For each of the following sources of financing, could you please say whether you used them during the past 6 months, did not use them but have experience with them, or did not use them because this source of financing has never been relevant to your firm?"*

We focus on responses to the above question relating to bank overdrafts and bank loans. Figure 3 plots the share of respondents in each sample country that reported that they used the facility in the last 6 months. The graph shows that Ireland has the highest share of firms that reported using bank overdrafts, while for bank loans Belgium, Austria, France, Germany and the Netherlands report higher shares. It is likely that the relatively low usage of bank loans in Ireland can be explained by the weak economic climate, where firms have low investment appetite and therefore use banking for day-to-day activities rather than for expansion.

Figure 4 pools firms that used the bank facility in the previous six months with those that have had previous experience using the facility. Using this measure, Ireland remains the country with the highest share of firms using bank overdrafts, while for bank loans it is now the third highest in the euro area. The conclusion of this analysis of SAFE data is that, in the post-crisis period 2012-13, Ireland remains among the countries with the highest usage of banks for SME funding. The question of post-crisis *reliance* of SMEs on banks cannot be answered in a cross-country setting, as the SAFE

data do not contain a question on the *percentage* of investment or working capital funded by each potential source.

### 3 The changing funding structure of Irish SMEs

In this section, we draw on the BEEPS 2005 data used in section 2 and compare this to recently collated data from the RedC/Department of Finance SME Credit Demand Survey (March to September 2012) (RedC/DoF). The RedC/DoF survey provides a snapshot of firms' interaction with credit markets and, for the latest wave, questioned firms on the sources they used to fund investment and working capital. This provides a direct comparison with the corresponding questions in the BEEPS. Our analysis is limited to firms in the manufacturing, construction and real estate, and market services sectors.<sup>3</sup> Firms in agricultural sectors, financial intermediation and insurance, public administration and health and social work have been omitted in order to make the BEEPS and RedC/DoF samples as comparable as possible. We also omit sole traders and large firms as these are not covered in the BEEPS or RedC/DoF data.

Our analysis is limited to four financing sources: internal funds, trade credit, bank borrowing and equity financing.<sup>4</sup> Again, we focus on both working capital and investment financing and present both the percentage of firms that use the specific financing source as well as the proportion of working capital/investment covered by this source *if it is used by firms*. We break down the analysis by firm size to provide a more granular review of the heterogeneous effects of the crisis.

The main results are presented in Table 1. In terms of working capital usage, there is a slight decline in the number of firms using internal finance following the crisis but a slight increase in the intensity of its usage. This suggests that the crisis has not hugely altered firms' internal financing policies for working capital. However, the effect of the crisis is very evident when reviewing the use of trade credit, bank borrowing and equity. We find a dramatic reduction in the number of firms using bank finance to fund working capital and considerable increases in firms' use of trade credit and

<sup>3</sup>This includes wholesale and retail, hotels and restaurants and professional and technical services.

<sup>4</sup>The data on bank borrowing differs between this section and section 2 as the DoF/RedC data does not have information on leasing. As leasing is included in the category with informal finance, we are unable to split these out.

equity. These effects are also evident in relation to the intensity of usage if the source is selected.

In relation to investment financing, we find that the number of firms using internal funds to cover investment expenditures increased by 33 percent between 2005 and 2012 while the intensity of usage also increased by 17 percent to 91 percent. The number of firms using trade credit to fund investment more than doubled to 7.5 percent as did its usage intensity. This is mirrored by the change in equity: the share of firms using equity financing increased considerably as did its usage intensity. The share of firms using bank financing has decreased by over one half to 16.8 percent. Its usage intensity has actually risen but only marginally.

Tables 2 and 3 show that the patterns described above are broadly similar for small and medium firms, with small firms having more marked shifts towards trade credit and equity with medium-sized firms moving relatively more towards internal financing across both working capital and investment. These figures provide evidence that *within the subset of firms that have a demand for finance*, firms have moved away from banks as a source of funding. While undoubtedly tighter credit conditions have played a role in the observed switching between financing sources<sup>5</sup>, a crisis-related shift in investment demand, whereby firms are no longer expanding and do not require large volumes of external finance, is likely to explain some of the increase in usage of internal finance for investment.

While it may be desirable for the economy to move to a new long-run diversified equilibrium, caution must be exercised when viewing these post-crisis patterns. Recent research by Casey and O'Toole (2013) suggests that, in terms of investment spending, a forced reliance on non-bank, non-market external financing can be detrimental for firms due to higher costs and lower volumes of capital. This finding suggests that, in the short-run at least, the movement of SMEs towards other

sources of funding, often more expensive and less developed than bank financing, comes with risks for growth. In fact, Fitz Gerald et al. (2013) note that a key risk to the Irish economy's medium-term recovery prospects is a lack of credit for expansion and investment. A restoration of normal functionality and lending activity in the banking sector, along with the development of deeper markets for non-bank alternatives, are critical to financing such activity.

## 4 Conclusion

While bank credit to SMEs is a topic that generates much public debate and policy attention, little empirical evidence exists on the importance of banks for SME financing in Ireland. This Letter confirms that, both pre- and post-crisis, Irish SMEs are among the most reliant on banks in Europe, across a number of different measures. This helps provide context to the debate around SME credit policy, in showing that the indigenous private sector (99 per cent of which are SMEs) is, and has been, disproportionately exposed to potential weaknesses in the banking sector, relative to other European countries. We further document changes in the funding mix for SME working capital and investment since the crisis, showing that the share of bank borrowing has fallen by roughly one half between 2005 and 2012, having been replaced by trade credit, equity and internal funding. While a diversification away from reliance on bank funding is desirable, it is important that policy makers mitigate the risk that firms are merely turning to other under-developed and costly forms of financing due to an inability to access bank credit. Policy must aim simultaneously to stimulate the flow of bank credit and to create well-developed markets for a range of alternative financing sources to complement the role of banks in financing the SME segment in Ireland.

## References

- Beck, T., Demircug-Kunt, A. and V. Maksimovic (2008). Financing patterns around the world - Are small firms different? *Journal of Financial Economics*, 89, pp 467-487.
- Casey, E. and C. M. O'Toole (2013). Bank-lending constraints and alternative financing during

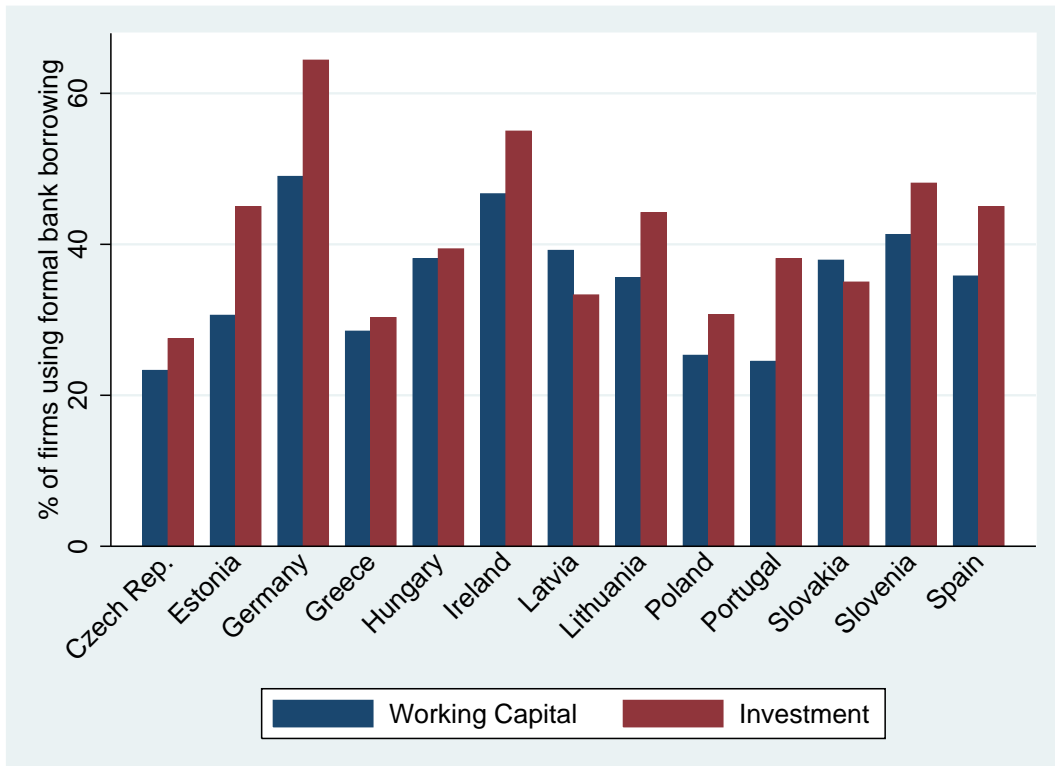
<sup>5</sup>Holton and McCann (2012) and Holton et al. (2013) provide evidence that Irish SMEs are among the most credit constrained in Europe in the 2010-2013 period.

the financial crisis: Evidence from European SMEs. Papers WP450, Economic and Social Research Institute (ESRI).

- FitzGerald, J. and I. Kearney (eds.), Bergin, A., Conefrey, T., Duffy, D., FitzGerald, J., Kearney, I., Timoney, K. and N. Znuderl. (2013). Medium Term Review: 2013-2020, Economic and Social Research Institute.
- Holton, S. and F. McCann (2012). Irish SME credit supply and demand: comparisons across surveys and countries. Central Bank of Ireland Economic Letter 2012 No. 8.
- Holton, S., Lawless, M. and F. McCann (2013). SME financing conditions in the Europe: Credit crunch or fundamentals? National Institute Economic Review No. 225, August 2013.
- Lawless, M., McCann, F. and T. McIndoe-Calder (2012). SMEs in Ireland: Stylised facts from the real economy and credit market, Quarterly Bulletin Articles, Central Bank of Ireland, pages 99-123.

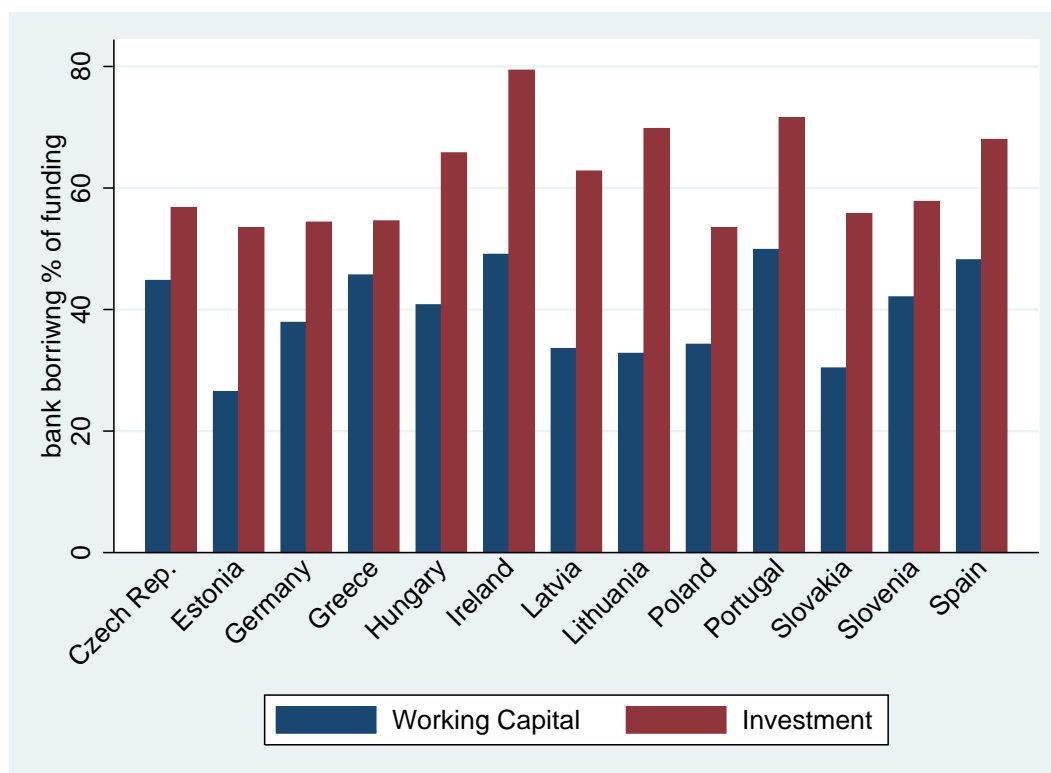
## Tables and Figures

Figure 1: Percentage of firms reporting the usage of bank borrowing to fund working capital and investment activity; 2005. Source: World Bank / EBRD (BEEPS survey)



Note: Respondants may report that more than one source is used in funding each activity

Figure 2: Average percentage of total funding for working capital and investment accounted for by bank borrowing; 2005. *Source: World Bank / EBRD (BEEPS survey)*



Respondants may report that more than one source is used in funding each activity  
Only non-zero responses used, i.e. figures are conditional on the firm using each funding source

Table 1: Irish firm financing since the crisis - All firms

	Working capital financing					
	% of Firms			Usage Intensity if Used		
	2005	2012	% Change	2005	2012	% Change
Internal	82.2	79.9	-2.9	75.6	77.6	2.6
Trade	22.4	33.2	48.3	39.6	47.4	19.8
Borrowing	46.7	24.3	-48.0	49.3	47.2	-4.3
Equity	3.3	17.6	435.9	38.1	45.5	19.4
Number of firms	456	1,004				
	Investment financing					
	% of Firms			Usage Intensity if Used		
	2005	2012	% Change	2005	2012	% Change
Internal	60.2	80.4	33.7	77.5	90.9	17.2
Trade	3.6	7.5	107.9	34.4	75.8	120.2
Borrowing	38.6	16.8	-56.6	75.7	78.8	4.0
Equity	2.0	5.6	180.6	54.0	61.7	14.2
Number of firms	251	322				

Source: Authors' calculations using BEEPS and RedC/DoF Data

Figure 3: Percentage of firms using bank facilities in last 6 months ; 2013. Source: ECB / EC (SAFE survey wave 8, Sept 2012-March 2013)

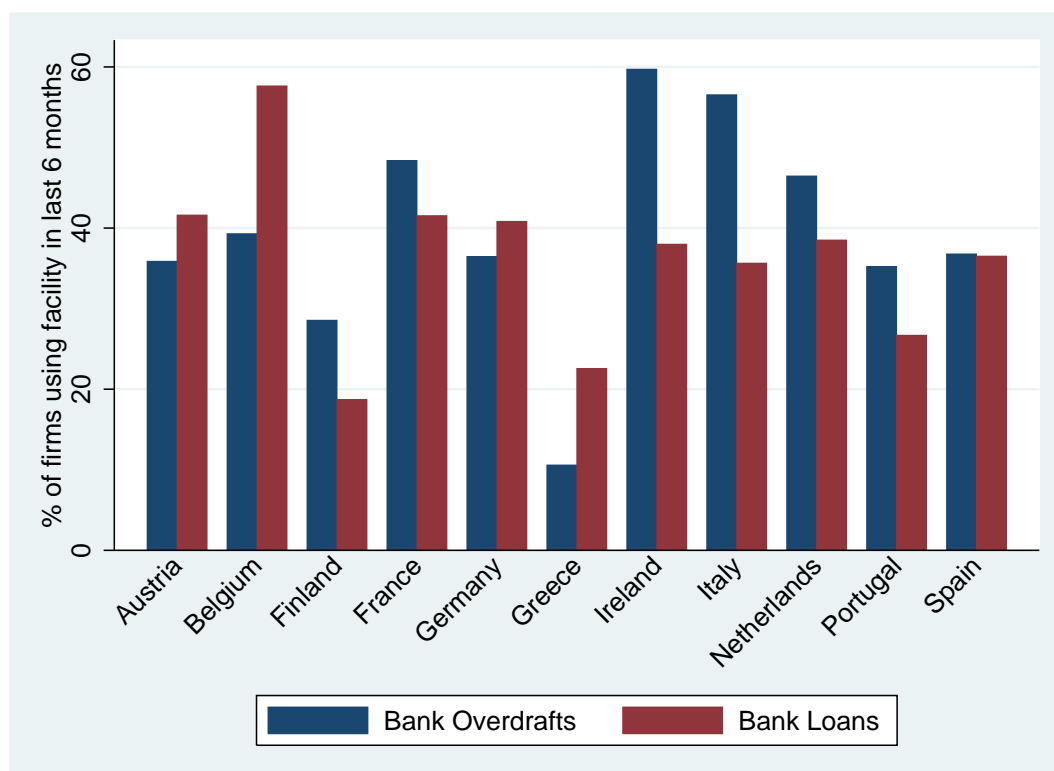


Table 2: Irish firm financing since the crisis - Small firms

Small Firms						
Working capital financing						
	% of Firms			Usage Intensity if Used		
	2005	2012	% Change	2005	2012	% Change
Internal	82.9	78.5	-5.3	74.8	77.8	4.0
Trade	22.0	35.6	61.3	38.9	48.5	24.6
Borrowing	48.3	25.4	-47.3	50.2	47.4	-5.6
Equity	2.6	15.3	483.3	27.3	39.5	44.5
Number of firms	381	405				
Investment financing						
	% of Firms			Usage Intensity if Used		
	2005	2012	% Change	2005	2012	% Change
Internal	59.3	72.1	21.6	76.4	88.4	15.8
Trade	3.0	9.8	226.2	30.8	89.2	189.2
Borrowing	38.7	21.3	-44.9	76.1	80.8	6.2
Equity	1.0	4.9	389.3	22.5	65.0	188.9
Number of firms	199	122				

Source: Authors' calculations using BEEPS and RedC/DoF Data

Figure 4: Percentage of firms using bank facilities in last 6 months or have previous experience ; 2013.  
Source: ECB / EC (SAFE survey wave 8, Sept 2012-March 2013)

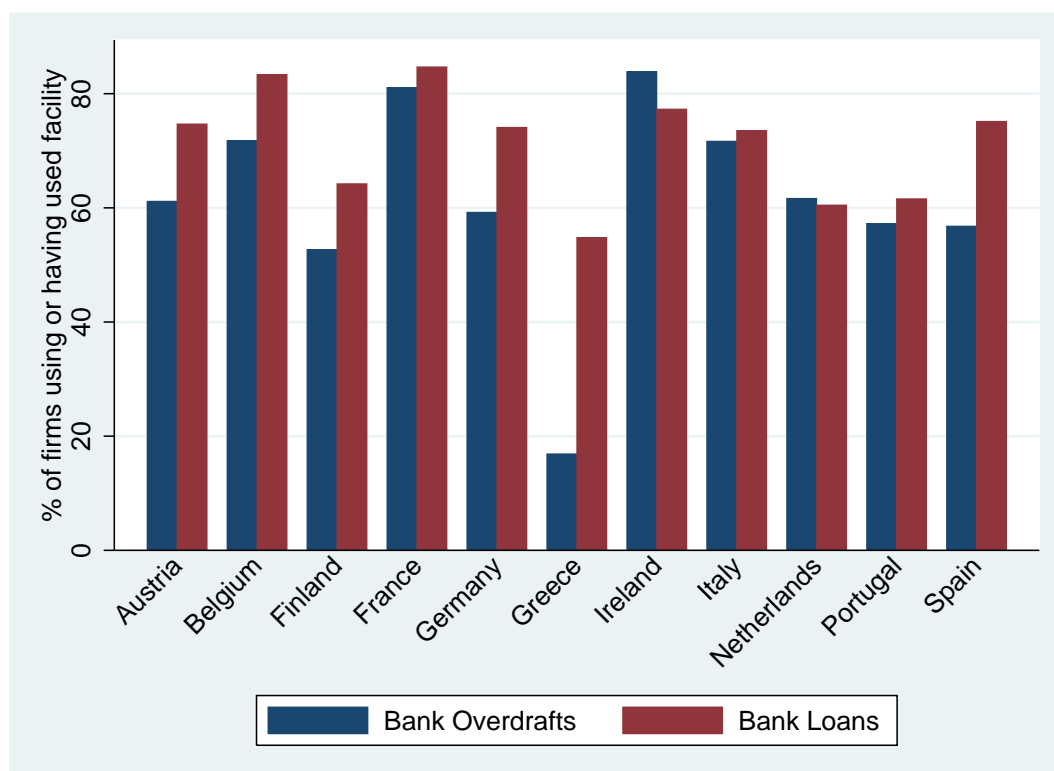


Table 3: Irish firm financing since the crisis - Medium-sized firms

Medium-Sized Firms						
Working capital financing						
	% of Firms			Usage Intensity if Used		
	2005	2012	% Change	2005	2012	% Change
Internal	78.7	84.7	7.7	80.2	78.3	-2.3
Trade	24.0	33.1	37.7	42.7	39.9	-6.6
Borrowing	38.7	30.2	-22.0	44.0	45.9	4.3
Equity	6.7	10.7	61.2	59.8	48.3	-19.3
Number of firms	75	242				
Investment financing						
	% of Firms			Usage Intensity if Used		
	2005	2012	% Change	2005	2012	% Change
Internal	63.5	87.4	37.8	81.7	94.0	15.1
Trade	5.8	4.4	-23.7	41.7	62.9	50.9
Borrowing	38.5	12.6	-67.3	74.5	76.8	3.0
Equity	5.8	4.4	-23.7	75.0	65.0	-13.3
Number of firms	52	159				

Source: Authors' calculations using BEEPS and RedC/DoF Data