Financing SMEs in Recovery: Evidence for Irish Policy Options

October 2014

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An Roinn Airgeadais
Department of Finance

ESRI

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Executive Summary

As the economy moves into growth after the recent difficult period, ensuring that small and medium enterprises (SMEs) are in a position to expand, investment and employment will play a central role in the sustainability of the recovery. Access to finance is an important component in facilitating this. The risks involved in over-reliance on bank credit have been well-illustrated by the experience of the financial crisis. Learning from this, the development of a financing ecosystem for SMEs that provides a diversified set of debt and equity options from a range of sources is an important element in building a robust and successful SME sector.

This report draws together the empirical results and policy messages of a programme of research, funded by the Department of Finance, to help understand how the financing of SMEs in economic recovery can be supported. The main objective of the programme was to develop a body of evidence with which to understand SME financing and to evaluate international and domestic evidence on the appropriate policy response to SME funding challenges.

SMEs play a crucial role in the Irish economy, accounting for the vast majority of businesses and most employment. Access to finance is an important determinant of a firm's ability to grow and we provide evidence on the positive contribution debt plays in this regard. However, high debt burdens relative to turnover can have negative effects and we also show how over-indebtedness impedes performance and increases default probabilities.

We provide forecasts of the expected credit demand of Irish non-financial corporations and SMEs in the medium term, using a number of different scenarios on the speed of economic recovery. Total credit stocks are estimated to remain relatively stable at their current levels over the near term, returning to the long-run average equivalent to 40 per cent of GDP. At a sector level, we see a reduction in the dominance of property lending accompanied by expansion of credit in other sectors.

Following our description of the general issues relating to SME financial structure and credit outlook, the remainder of the report looks at each of the three main sets of financing types available to SMEs – bank credit, non-bank debt and equity financing. For each of these, we provide evidence on the extent of current usage by SMEs in Ireland, benchmarked to European comparators. We then look at the current policy supports and initiatives in place in Ireland and internationally in order to assess how the broad policy mix is operating. From this, we identify some gaps in the existing range of supports and make some suggestions as to how others could be made more broadly accessible for firms.

Bank credit accounts for the main source of external financing for the majority of SMEs in Ireland and is likely to remain a very significant source even in the event of a wider range of funding options being established. The structure of the Irish banking market in the future is an area of concern given the decline in the number of banks active in the market. International evidence has shown that lower competition can have potentially negative effects on lending volumes. In addition to its direct effect on increasing credit supply and provision of new products, the recent establishment of the Strategic Banking Corporation of Ireland (SBCI) should play an important broader role by facilitating entry and enhancing competition. This aspect of the SBCI mandate has the potential to have a much greater impact on the performance of the market over the longer term than the direct volumes of new funding it brings to existing market participants. Other policy recommendations in the area of bank credit include:

- Implement the existing recommendations on expanding the Credit Guarantee Scheme; specifically the removal of the restriction covering refinancing and working capital and the extension in term length should broaden the usage of the scheme. The feasibility of a specific guarantee scheme for start ups should be explored. If possible such guarantees should not be provided in isolation but in conjunction with a suite of services such as business development training, financial capacity building and other enterprise supports.
- Place the Credit Review Office's role as an external appeals and mediation office into a more permanent structure that is independent, transparent and that engages with all banks operating in the country, with a referral and appeal process that is as clear and simple as possible. Because this office has a role in assessing and resolving specific cases, it is essential that it be independent in the exercise of its functions and be as transparent as possible.
- In developing a more permanent structure, it may be advisable to look at the French model. It involves mediators from the Banque de France, supports such as guarantees from their financial development organisation and wider business development institutions providing an existing "one-stop-shop" service which is independent, transparent and integrated.
- Review the operations of the Microfinance scheme and expand its scope by increasing the current limits on loan size and term length. Introduce some flexibility in product offerings. Greater promotion to raise awareness of the scheme among SMEs is recommended.
- A review should be set up to examine the possible role that credit unions might play in extending credit to micro and smaller SMEs.
- Given the importance of exporting firms for the Irish economy, the lack of any provision for tailored credit and financial support for exporters is a significant gap in the range of policy supports. An evaluation of the demand for such a scheme and how it could be most effectively implemented should be carried out without delay.[1]
- At a European level, Irish policymakers should support and engage with the development of a European market in SME securitisation to enable banks to reduce some of the risk currently held on their balance sheets.
- To improve risk evaluation, the completion and rollout of the credit register should be considered a priority.

[1] Throughout this report, we make the following distinction: "Trade Credit" is supplier financing on accounts receivable or payable whereas "Export Financing" is the provision of specialised financing instruments for firms involved in international trade.

Non-bank debt financing can come from formal or informal sources. We find that formal debt issuance is fairly uncommon as a financing source amongst Irish firms. Informal finance on the other hand, whether from trade credit or from sources such as friends, family and business partners is a common source of finance, especially for smaller and younger firms. A newer source of funding opportunity comes from crowdfunding or peer-to-peer lending and we find considerable interest on the part of SMEs in this source, although its current use remains limited. Looking at the policy interventions and proposals in this area, we find:

- The current evaluation of the proposal for a 'retail mini bond' market should be completed. There is some potential for this to provide additional funding opportunities to some firms but it is likely to apply to a relatively small number of enterprises. If the successful introduction of such a scheme is a policy objective, some type of tax incentives (e.g., capital gains exemption, stamp duty exemption) would be probably needed to counteract the level of risk involved for investors in a mini-bond market if it is to be successful. However, this report does not specifically call for such an incentive and a full evaluation would be required if this is to be taken further.
- In the area of trade credit, the development of an environment of corporate social responsibility towards payments through the *Code of Conduct on Prompt Payments* is a welcome development. A promotion and awareness campaign to encourage participation would help maximise the effectiveness of the scheme.
- Initiatives to provide information and increase awareness of crowdfunding could expand this type of finance. Further examination of the supports for crowdfunding in place in the UK should be undertaken to see if they could be used as a model here.

Equity finance also covers a range of different types of investment, including venture capital, business angel and also less formal sources such as equity from friends and family and business partners. Moving firms away from the current high level of reliance on debt financing towards a greater use of equity to fund investment is a central strand in broadening the financing mix. However, it is also important to make a distinction between two groups of firms: high-growth, export-oriented enterprises with expansion prospects and domestic-oriented firms who are smaller in scale and have modest growth prospects. Developing an equity financing landscape for these two groups poses very different challenges and may require very different suites of policy support. It must also be noted that the contribution of equity, venture and growth capital in Ireland is above average in an international context. Therefore, the ability to increase the share of this funding is limited. However, there are opportunities to expand equity financing for the more domestically-oriented group of firms. Some specific examples of policy actions that would help to support this transition include:

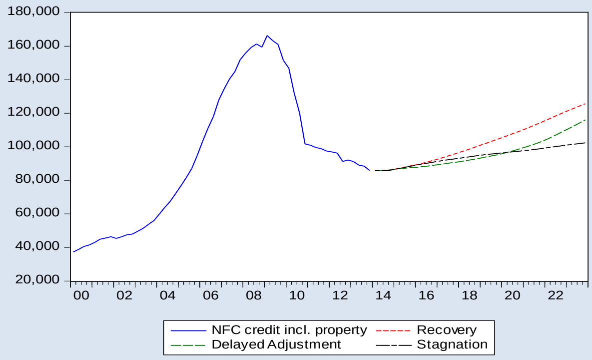
- Expand and make more accessible the Employment and Investment Incentive Scheme (EIIS) and Seed Capital Schemes by simplifying the application procedure and easing restrictions on types of enterprise and investor that can avail of them.

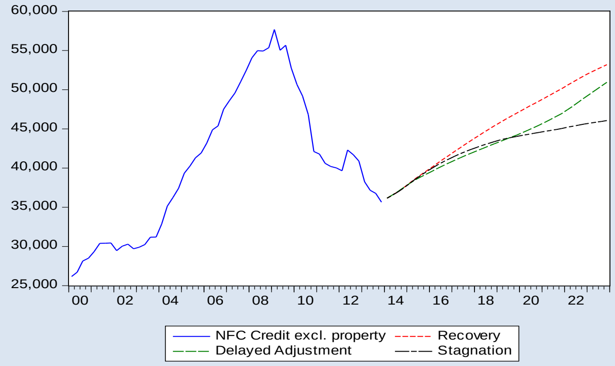
- Engage in more active promotion of these schemes, targeting both business owners and potential investors, as knowledge of the provisions appears to be limiting current usage.
- Examine the possibility and costs of offsetting losses in SME investments against other taxes to reduce downside risks for investors and increase investment rates.
- Revise the employee equity investment schemes to increase their attractiveness in a manner that protects the integrity of the tax system.
- Examine the differential tax treatment of debt and equity at the firm level and investigate the feasibility of a move towards greater neutrality, which is possible using Belgium as a benchmark.

Moving firms towards a more diversified set of financing options involves a long-term, structural change in the funding ecosystem. Some policy interventions that apply broadly across all of the financing types involve increasing awareness of the different sources of finance available and providing information to increase familiarity with the diverse range of options available. On the investor side, active promotion of opportunities for investment in local businesses would build awareness of these options. In addition, efforts should be made to ensure that the costs associated with legal procedures and financial disclosures do not operate as obstacles in accessing new sources of finance.

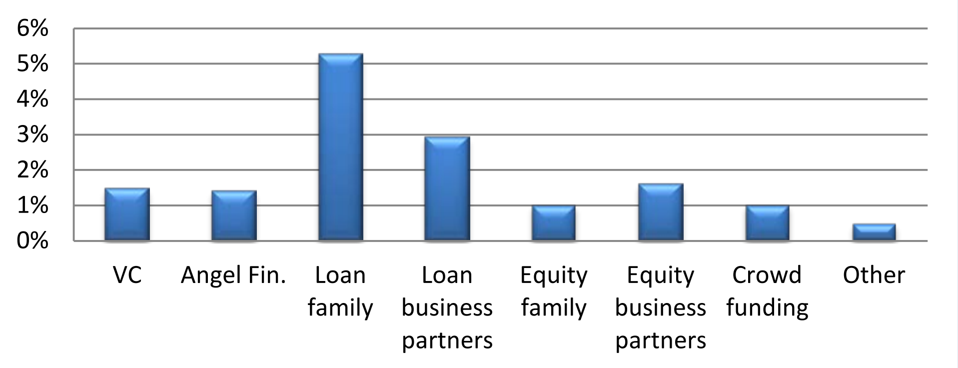
Key Findings: Graphical Overview

Credit forecasts for recovery: How will bank credit volumes evolve?

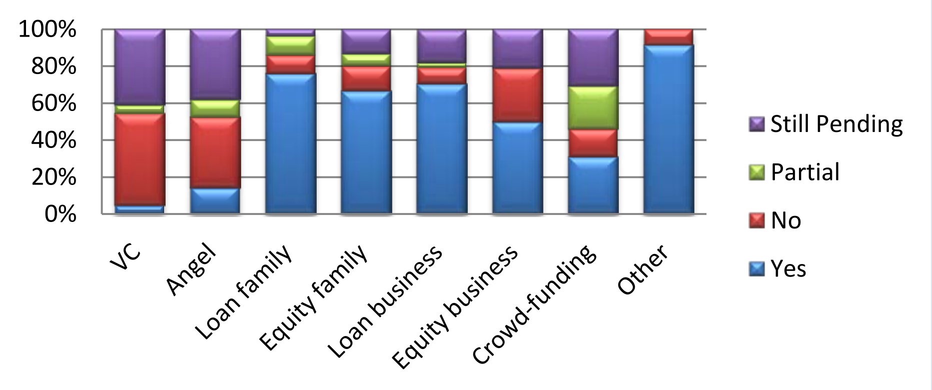




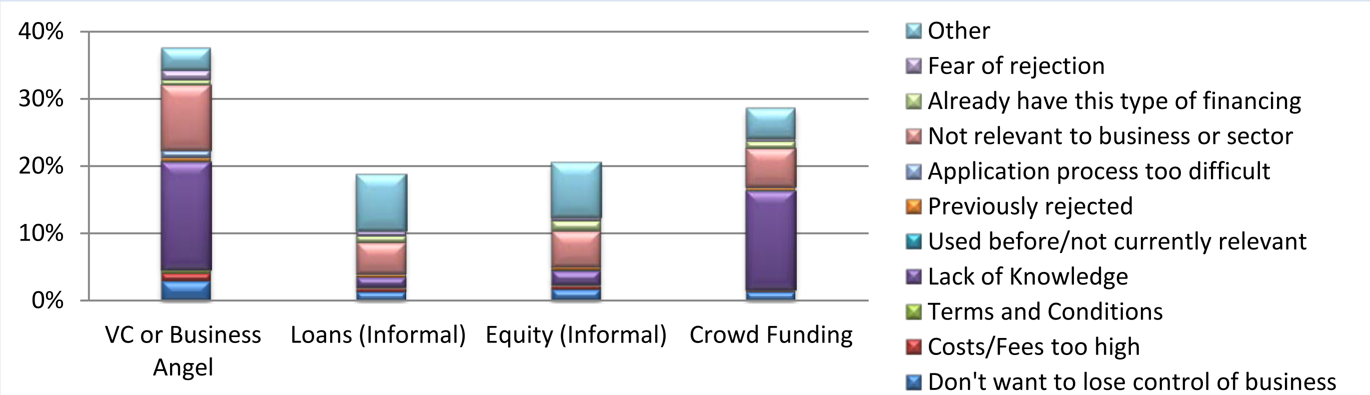
Is there demand for non-bank finance in Ireland? Application rates for selected sources



How successful are applications for non-bank finance?



Why do Irish SMEs not apply for alternative financing?



Note: These data refer to the sample of firms who do not apply for non-bank financing. The residual to 100 per cent are firms that indicated they did not need that particular financing type.

Chapter 1

Introduction

As Ireland recovers from the economic and financial crisis and returns to growth, shaping the longer-term policy environment to support and sustain this recovery is now moving to a central position. Establishing a stable growth path and avoiding a return to the credit-fuelled boom that was a core contributor to the scale of the recent crisis is a primary policy objective. In this context, supporting the ongoing development of the small and medium enterprise (SME) sector, which accounts for the bulk of employment within the economy, is an important component.

Irish SMEs have been faced with a slump in demand for their goods and services and with a drastically changed lending environment since the onset of the crisis in 2008. As a result, many enterprises scaled back on investment and employment. However, as the economic recovery takes hold, it is crucial that SMEs have access to finance to fund their ongoing business operations and to facilitate expansion. The high level of reliance on bank lending as a source of SME finance in the lead up to the crisis and the dramatic expansion in overall credit in the economy at the time raise concerns that SME financing options in Ireland may continue to be constrained in the future unless a more diversified set of finance alternatives become available and are utilised by firms.

To contribute to this policy objective, the ESRI has undertaken a programme of research, funded by the Department of Finance, focusing on the financing of SMEs in economic recovery. The research aims to contribute a policy environment that facilitates a smooth recovery in the SME sector. The aims of this programme have been to develop a body of evidence with which to understand SME financing in economic recovery and to evaluate international and domestic evidence on the appropriate policy response to SME funding challenges. This report brings together the results of that research programme, drawing on a number of background papers and providing an overall evaluation of the current mix of policy supports in this area, along with recommendations on some gaps identified in the policy spectrum. The remainder of the report is organised as follows:

Chapter 2 provides a description of the current SME operating environment in Ireland. This provides context on the size of the contribution of SMEs to the economy and the extent to which they were affected by the economic downturn, including the ongoing impact of debt overhang. This chapter also provides a discussion of why financing of SMEs is regarded internationally as an important area for policy interest given that financing options for firms are strongly impacted by their age and size profile. This chapter also contains some indicative forecasts of credit demand in the non-financial corporation and SME sectors over the coming years.

Chapter 3 focuses on formal bank credit, which accounts for the main source of external financing for the majority of SMEs in Ireland. We discuss the recent trends in bank lending and compare the use of bank credit in Ireland with other European countries. We then outline the range of policy interventions to support bank credit introduced in recent years and discuss the impact (or likely impact in the case of the most recent initiatives) that these are having on the credit market and some recommendations that could enhance the performance of these schemes further, particularly if consideration is to be given to placing some of the temporary supports on a more permanent basis.

In Chapter 4, we examine the extent to which Irish firms use non-bank sources of debt financing. This covers a range of instruments such as issued debt, trade credit, loans from friends, family and business partners, and peer-to-peer lending or crowdfunding. We look at how these are used by Irish firms compared to firms elsewhere in Europe and also use survey data from within Ireland to examine application rates, success rates from the applications and the reasons that firms use some types of non-bank financing more extensively than others. Policy interventions have been limited in this area, particularly compared to bank credit, so we discuss some international examples of supporting non-bank debt finance that may be appropriate to consider in an Irish context.

Chapter 5 covers how firms use different types of equity finance, including venture capital, business angel, mezzanine finance instruments and also less formal sources such as equity from friends and family and business partners. We examine the current supports provided to firms raising equity finance, both directly and indirectly (through the operation of the taxation system). We place these supports in an international context to provide suggestions for how they could be enhanced in a number of directions.

Chapter 6 draws together the evidence on current SME financing structures and the policy evaluations of the report.

Chapter 2

Overview of SME Financing and Credit Outlook

Summary of Chapter Findings

- Small and medium-sized enterprises (SMEs) account for 99.8 per cent of all active enterprises in Ireland, contributing 68.6 per cent of employment and over 50 per cent of turnover in the economy.
- The contraction in the overall economy and in domestic demand in particular had a severe impact on the performance of SMEs in recent years.
- We find that the use of debt is an important factor in facilitating firm growth and investment. However, high debt burdens relative to turnover have significant negative effects on all measures of firm performance. We also find that higher levels of debt-to-turnover are associated with higher credit constraints and greater default probabilities.
- Comparing the impact of banking crises on recovery from recessions using international comparisons, we find that growth rates are dampened in countries where government spending and debt were well above trend coming into the crisis.
- Reviewing the international evidence on financing mix over the life cycle of firms, we see that Irish firms are in line with the European average in terms of their current number of finance sources.
- We provide forecasts of the expected credit demand of Irish non-financial corporations and SMEs in the medium term, using a number of different scenarios on the speed of economic recovery.
- Two different approaches, based on aggregate and sector level data, give substantially similar results with total credit stocks estimated to remain relatively stable at their current levels over the near term, before returning to the long-run average equivalent to 40 per cent of GDP.
- At a sector level, we see a reduction in the dominance of property lending towards expansion of credit in other sectors.

2.1 Introduction and Overview

Understanding their operating environment is critical to providing solutions to the problems SMEs face in Ireland. To provide context for our more detailed evaluation of individual bank and non-bank financing instruments, and to provide a better understanding in broad terms of the SME funding environment as the economy recovers, this chapter presents the following:

Section 2.2 reviews the importance of SMEs to the economy highlighting their contribution to employment and gross value added. Section 2.3 discusses the impact of the financial crisis on SME operations, focusing on the falls in their main domestic markets. We also review new research on whether unsustainable legacy debt is restraining investment and employment. In section 2.4 we briefly review the international literature on how SMEs finance their operations across their life cycle. Section 2.5 discusses funding diversification by SMEs in Europe and how financing is managed across different firms. In section 2.6, to give some guidance on the total credit volumes required in Ireland under different recovery scenarios, we provide forecasts for corporate credit for the medium term.

2.2 Contribution of SMEs to Irish Economy

SMEs are of considerable interest to policymakers due to the size of the impact they have on economic activity in most countries. In fact, the vast majority of enterprises in the European Union are characterised as small or medium enterprises with over half of the labour force in the European Union employed by the SME sector. Further information regarding the contribution of Irish SMEs to the Irish economy can be found in the *Business in Ireland 2011* report released by the Central Statistics Office.[2] The report found that 99.8 per cent of all active enterprises were classified as SMEs, with 68.6 per cent of employment and over 50 per cent of turnover accounted for by the SME sector, highlighting the significant contribution made to the Irish economy by SMEs.

With regards to firm size distribution, 90.8 per cent of firms were classified as micro firms (fewer than ten employees), 7.7 per cent were small (between 10 and 50 employees), and 1.3 per cent were medium-sized enterprises (between 50 and 250 employees). Out of the total labour force, 27 per cent were employed by micro-sized enterprises, 22.6 per cent were employed by small firms and 19 per cent were employed by medium-sized firms. The Gross Value Added (GVA) by SMEs into the Irish economy was recorded at 46 per cent, which is quite low once the high levels of activity and employment of Irish SMEs are considered and demonstrates the large productivity contribution of the multinational sector. Micro enterprises were responsible for 13.6 per cent of the total GVA while small and medium-sized enterprises accounted for 14.5 per cent and 18 per cent of GVA respectively.

Looking across sectors, services firms made up the bulk of small and medium enterprises with 47.7 per cent of all SMEs classed in this sector. A further 22.7 per cent were classed as distribution firms, whereas the construction, industry, and financial sectors made up 19.5 per cent, 7.3 per cent, and 2.9 per cent of SME market sectors respectively. With regards to employment, 45 per cent of SME employment is in the services industry and 28.4 per cent of employment is attributed to the distribution sector. The construction, distribution, and financial sectors of the SME market account for 9.7 per cent, 13.4 per cent, and 3.5 per cent of SME employment respectively.

2 Online version of the report is available at http://www.cso.ie/en/media/csoie/releasespublications/documents/multisectoral/2011/businessinireland2011.pdf

Turnover appears to be higher in the distribution sector of the SME market than the services sector, regardless of the lower employment rate, with the distribution sector accounting for 47 per cent of turnover and the services industry accounting for 26.7 per cent of turnover of SMEs. However, the Gross Value Added to the Irish economy by the SME market is much higher for the services industry at 42.7 per cent, whereas GVA for the distribution sector is at 26.5 per cent. Industry accounts for 21.2 per cent of turnover and 23 per cent of GVA whereas construction accounts for 5 per cent of turnover and 7.8 per cent of GVA in the SME market.

The CSO report goes on to discuss the impact that the economic downturn has had on employment in the SME sector, with a fall in employment from 1,045,000 to 839,000 from 2006 to 2011 this represents an almost 10 per cent fall in SME employment for the total business economy during this period. The construction and industry sectors were impacted most severely with almost 128,000 job losses in the construction sector and over 31,000 job losses in the industry sector.

Given the relative importance of SMEs to the Irish economy, as illustrated by the CSO data, and the negative impact of the economic downturn on SME employment, the contributions that the SME market can make to the revitalisation of the Irish economy illustrates the importance of identifying the financial challenges of SMEs as a significant policy priority for the future.

2.3 Impact of the Financial Crisis on SMEs

Changing Demand and Investment

According to the latest data from the OECD Scoreboard[3] there has been a large fall in real GDP in Ireland from 2008 onwards. Real GDP fell by 2.1% in 2008, 5.5% in 2009 and 0.8% in 2010 before recovering in 2011 and 2012. The cumulative impact saw GDP contracting by over 12% from its peak. During this period exports of goods and services from Ireland, as a percentage of GDP, increased by 35% from 80% of GDP in 2008 to 108% of GDP by 2012. Although some of this increase in exports relative to GDP can be explained by the fall in GDP during this period, this data still shows that exports have been on the increase and helped sustain a higher overall GDP in Ireland compared to domestic demand. This is confirmed by the data below which plots the change in GDP, exports, household consumption, domestic demand and investment indexed to the 2008 level.

Figure 1 shows that domestic demand has suffered a greater fall than exports and GDP overall, and with many SMEs being domestically orientated, this suggests that SMEs may have been more highly affected by the fall in GDP and the fall in investment than other sectors that may be more internationally orientated.

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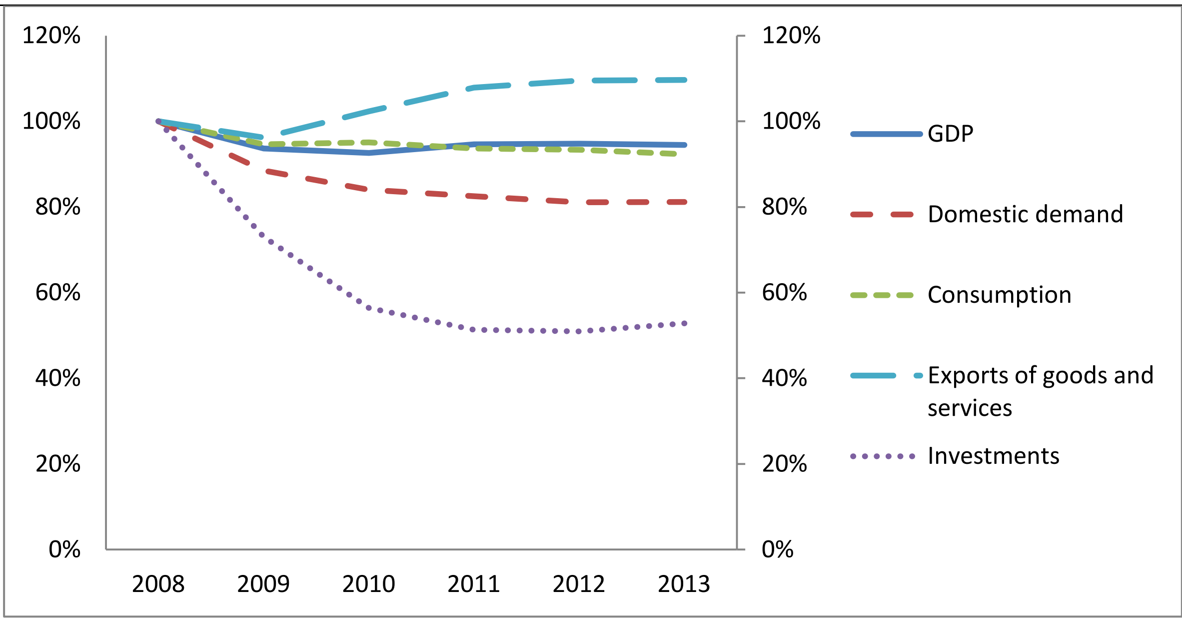
3 http://www.oecd.org/cfe/smes/SMEs-Scoreboard-2014.pdf

Figure 1: Changing Demand, GDP, Exports and Investment



Source: Eurostat.

The most extreme way in which the economic downturn hit firms can be seen in the increase in firm failure over the recession period. Bankruptcies increased continuously during this period with 3,028 examinerships, receiverships or liquidations in 2011, representing an increase of 12% from 2010 with 2,701 bankruptcies recorded and an almost doubling of reported bankruptcies compared to 2007 when bankruptcies were at 1,422.[4]

Table 1: Total and Business Investment in Ireland, 1980-2012

	1980-84	1985-89	1990-94	1995-99	2000-08	2009-2012
Total investment						
€ billion	10.3	9.1	10.7	17.5	29.2	19.5
% GDP	20.20%	16.10%	15.50%	18.60%	19.30%	12.10%
Of which business investment contributes:						
Buildings						
€ billion	1.5	1.2	2.2	3.1	4.4	2.1
% GDP	3.00%	2.10%	3.20%	3.30%	2.90%	1.30%
Machinery & Equipment						
€ billion	3.1	2.9	3.2	5.2	7.6	5.8
% GDP	6.20%	5.10%	4.60%	5.60%	5.00%	3.60%

Source: Lydon and Scally (2014).

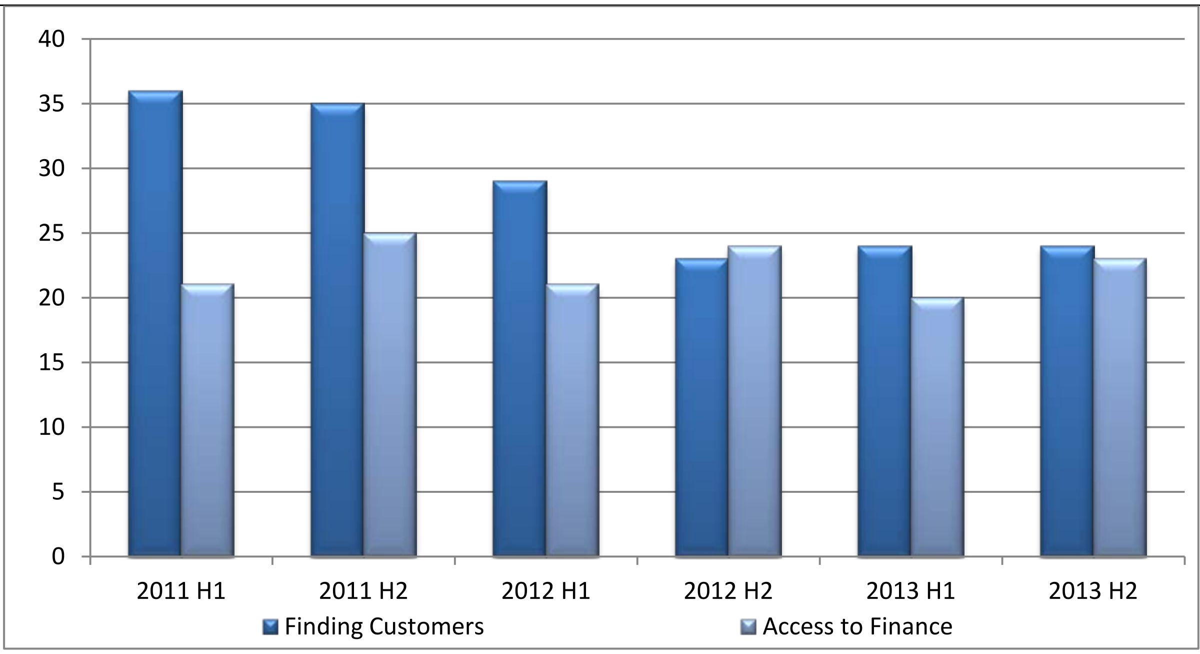
Looking in more detail at the investment declines, Lydon and Scally (2014) estimate long- and short-run trends in the subcomponents of both buildings and equipment investment. They find that the ratio of investment to GDP fluctuates around a relatively stable long-run level. As shown in ,

[4] *Source*: Department of Jobs, Enterprise and Innovation and OECD Scoreboard

in 2012, business investment in machinery and equipment accounted for 3.7 per cent of GDP, below its long-run average of 5 per cent, while building investment was also significantly below trend. They identify a moderate pick-up in investment towards the end of the sample period, which suggests that firms may be beginning to restock following the recession, particularly in equipment where depreciation plays a greater role. They note that the speed of return to longer-term investment rates depends on a variety of factors, notably GDP growth, credit growth and the cost of capital.

Throughout this period, concerns about the performance of the economy have been the dominant response to surveys when firms have been asked about the main problem they face. Figure 2 shows that general economic sentiment is improving and concern about finding customers is gradually declining as the main problem being faced by firms. Access to finance, while initially ranked less frequently as the main problem faced, has not seen the same degree of improvement over time and continues to be an issue for over 20 per cent of firms.

Figure 2: Main Problem Encountered by Irish SMEs:
% Reporting Access to Finance and Finding Customers as Main Problem Faced



Source: ESRI Analysis of SAFE data.

Debt Overhang and Bad Debts

Due to the large expansion in credit leading up to the financial crisis, one of the most important legacy issues that has had to be dealt with is the large residual stock of outstanding corporate and household debt. At the SME level, this has led to expressions of concern that these debt levels may hamper economic growth and recovery on an ongoing basis. In a detailed background paper to this report, Lawless, O'Connell and O'Toole (2014b) use firm-level survey data to examine how debt overhang affected the subsequent performance of the firm using data drawn from the RedC survey of SME finances.[5] The measurement of indebtedness used was the level of outstanding debt and the debt burden (measured as the ratio of debt to turnover). We then tested the impact of the volume and burden of debt on employment changes and investment decisions of the firm, controlling for a range of other characteristics.

We used a debt-to-turnover ratio that is similar to the debt-to-income ratio used in the household finance literature. Using such a measure is a departure from the corporate literature which mainly measures debt overhang using a debt-to-asset ratio. There are a number of reasons to believe that our measure is more appropriate in the context of financial crises. First, firm assets are priced to book values on the balance sheet and this does not capture the potential valuation changes that may occur following excess volatility in real estate prices. Second, while debt to asset measures may capture firm solvency, the relative size of generated resources (turnover) relative to debt may provide a more accurate representation of the firm's liquidity position.

A number of interesting findings emerged. While the level of debt is generally associated with positive firm performance (higher employment growth and investment), higher debt burdens, (measured as the level of debt relative to turnover), have significant negative effects on all measures of firm performance. This suggests potential problems with debt sustainability and overstretching of earlier credit commitments that have a negative material effect on the investment and employment growth of domestic SMEs. We also find that higher levels of debt-to-turnover are associated with higher credit constraints and default rates as well as higher levels of a composite financial distress index.[6]

These effects are non-uniformly distributed across the economy and are different for employment and investment channels. For employment growth, we find that the effects are higher for small and micro firms with medium-sized firms unaffected. The wholesale and retail sector is the most affected. For investment, the effects are greatest for older firms, manufacturing firms and medium-sized firms. Across both investment and employment, we find that exporters are more affected than non-exporters.

One of the problems hampering current bank lending is that there are currently a high number of loans in difficulty or default that have to be dealt with by the banks. According to a 2014 Central Bank report,[7] there was a total of €21 billion worth of loans reported in the SME lending dataset as of December 2013. Of these loans, there was a default rate of 26% of loans and 41% by loan balance. SME loan defaults were particularly high in the construction, hotels, and restaurants and personal sectors with a balance-weighted default rate of between 55 and 65 per cent. This represents a large

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5 See data appendix for details on this survey.

6 The financial distress index includes indicators of rejections of formal loan applications, loss-making by the firms, increases in the number of days taken for suppliers to pay them for goods provided on credit and increases in the number of days the firm delayed payment to suppliers.

7 http://www.centralbank.ie/stability/Documents/SME%20Market%20Report/SME%20Market%20Report%202014H1.pdf

challenge for SMEs gaining access to finance due to the large percentage of SME loans currently in arrears.

In 2011 the Central Bank revised the statutory Code of Conduct for Businesses Lending to Small and Medium Enterprises to ensure that lenders deal with customers with financial difficulties in an honest and fair way. The new code requires that lenders allow appropriate time for borrowers in difficulty to resolve these financial difficulties, and it requires that lenders communicate alternative repayment arrangements.

Looking at international experiences, research completed within this research programme considered how economies recover following credit booms and banking crises (McInerney and O'Toole, 2014). The research focuses on the output dynamics following the credit booms, in particular where credit booms have been accompanied by a banking crisis. Output dynamics are measured using compound annual average growth, cumulative growth and relative compound average growth from the boom peak to 3, 5, and 7 years after the boom. A number of findings are of relevance to Ireland's recovery. The work identifies the strong impact of credit on output dynamics in the recovery phase. This suggests the importance of ensuring credit transmission following boom periods even if deleveraging is required. The research also finds that when government spending and government debt were well above trend coming into the crisis, the recovery is slower. These results suggest that having fiscal space coming into the boom can help support the recovery. Consequently, the positive developments in Ireland's fiscal position should be supportive of recovery being sustained.

Examining the impact of financial constraints during the crisis across a range of countries, Clarke, Cull and Kisunko (2012) found that firms were more likely to survive the crisis if they had access to external credit. As smaller and younger firms are more likely to face difficulties in accessing finance, they were particularly hard hit by the tightening of credit in the crisis and more at risk of exit. They also found that constraints were less severe in countries with well-established foreign banks and that the increase in financial constraints was largest for big firms than others during the crisis (although large firms continued to have less severe constraints on average reflecting their ability to borrow internationally).

Examining the relationship between economic shocks and the job creation rates of different types of firm, Adelino, Ma and Robinson (2014) find that younger firms are systematically more sensitive to fluctuations than older firms, with the result that younger firms create more jobs in upturns but create proportionately fewer jobs in downturns. This leads to a direct policy recommendation that easing access to finance for younger firms could have a direct job promoting effect. They stress that the policy focus should be on finance for start-ups and early stage firms rather than aimed at small firms more generally as age is the main factor driving the job creation result.

2.4 Financial Structure of SMEs Internationally

Informational opacity is the defining feature of small firms, with much detail kept private and no active trading of shares to signal quality to the market. As a result, the financial institutions that provide funding to smaller firms tend to be more active in their engagement with the firm, in terms of screening and monitoring this helps them to overcome the asymmetries in information so that relationships between the institution and the firm are more important for small firms than for large firms with more transparent measures of information and reputation.

As firms become more established and information about them becomes more readily available, the types of financing they use change. This can be thought of as a “financial growth cycle” and Berger and Udell (1998) provide a stylised figure of the evolution of financing as firms become older and larger. The smallest and youngest firms, which face the greatest difficulties in convincing investors or lenders of their quality, tend to rely on initial financing from the business owner’s own resources, trade credit and, in certain cases, from angel finance.

As the firm grows and becomes more established, it begins to gain access to more formal sources of finance. At this stage equity financing may become an option from venture capital funds but more commonly the funding comes from raising debt from banks and other types of financial intermediary. As firms get older and larger, accumulated retained earnings may also become an important source of funding in themselves as well as providing reassurance for potential external funders of the firm’s performance. For the largest, more mature firms, participation in public equity and debt markets may eventually become an option.

According to this typology of financing sources, bank financing is not generally available to firms at the very early start-up stage, when the business idea is still being developed and there are limited tangible assets for use as collateral. Only once the business has been established as a trader and some level of tangible assets have been acquired is external debt likely to be available to the firm. This does not totally exclude start-up firms from obtaining external debt, but rather results in the loans obtained frequently being collateralised by the business owner’s personal property or being guaranteed by the owner or other family or associates.

On a related point regarding the close interconnection between personal and firm finances, it is also worth pointing out that some entrepreneurs may set up a business as a “life-style” move, where the objective is to be their own boss and not necessarily with the intention of the firm growing into a large enterprise.

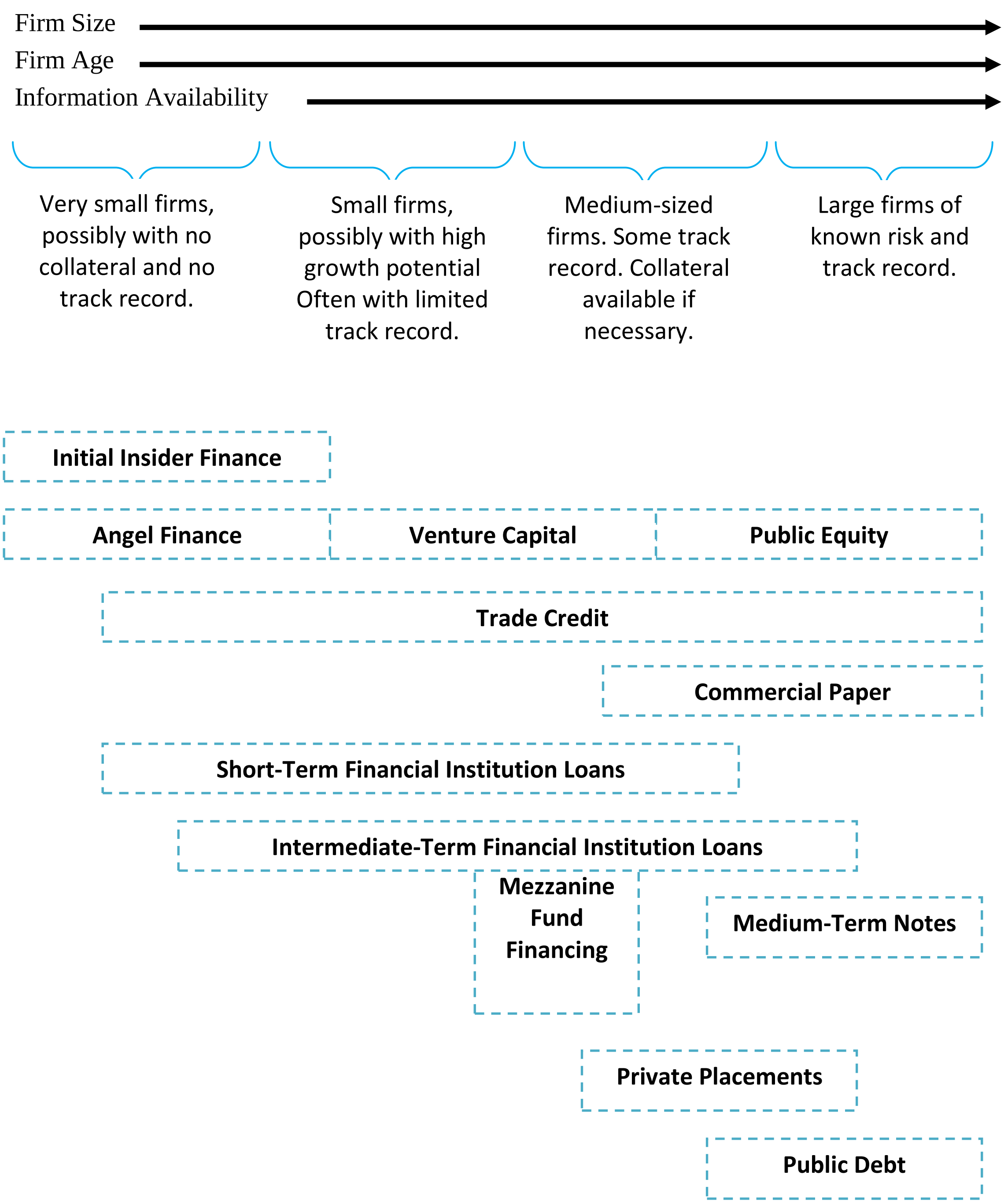
Berger and Udell (1998) argue that the financing mix will vary across firm types:

> *Firms with different types of earnings profiles are likely to be financed with different combinations of equity and debt. Small businesses in high-growth, high-risk sectors more often obtain external equity investments from angels and venture capitalists, whereas firms with steadier income flows more often obtain external debt finance*

from banks and other financial institutions. Similarly, small businesses with more generic physical inputs like motor vehicles, buildings, and simple equipment may more often borrow from financial institutions because they can use these inputs as collateral to back the loans.

Berger and Udell (1998) combine these patterns of financing to generate a stylised "financial growth cycle". This shows the evolution of the range and types of financing available as firms become older and larger, replicated here as Diagram 1.

Diagram 1: Sources of Finance (Berger and Udell, 1998)



Two reasons that financing constraints from both bank and non-bank sources are negatively correlated with firm size relates to the existence of fixed transaction costs and information asymmetries which are particularly likely to cause difficultly for smaller firms. Fixed transactions costs relate, for example to the processing and monitoring costs of a loan, which (even if not entirely fixed) will be higher per euro borrowed for a small loan than for a large loan. The heterogeneous nature of SME loans mean that relationships are important and this involves an investment of time and personnel from the bank side, even for low-volume customers to overcome the differences in information about the firm and its prospects that the bank and firm have available to them (Levine, 2005).

Coleman and Robb (2011) find that the problems of informational opacity are particularly relevant for high-technology start-ups and that consequently these firms have to rely on greater proportions of owner-provided equity until they can build up a credit record that enables them to access external funding. They hypothesise that the reason that external funding is less available to these high-technology firms is due to their limited tangible assets and high level of intangible intellectual property which cannot be pledged as collateral. They are, therefore, viewed as more risky, at least in the early stages.

Prior to the financial crisis, Mac an Bhaird and Lucey (2010) surveyed 299 Irish SMEs to investigate the determinants of their capital structure. They found that internal sources such as retained earnings are preferred to external sources, emphasising the role of firm profitability in funding further investment. The availability of collateral is an important factor in accessing debt financing and, when this is limited within the firm, the personal assets of the owner are commonly pledged. Correlation coefficients show a negative relationship between the use of owner's collateral and the age and size of the firm, at the same time that retained earnings become more important as the firm ages and grows. Long-term debt is also negatively related to firm age, presumably also being superseded by internal funds, although a positive relationship is observed between long-term debt and firm size.

2.5 Funding Diversification of European SMEs

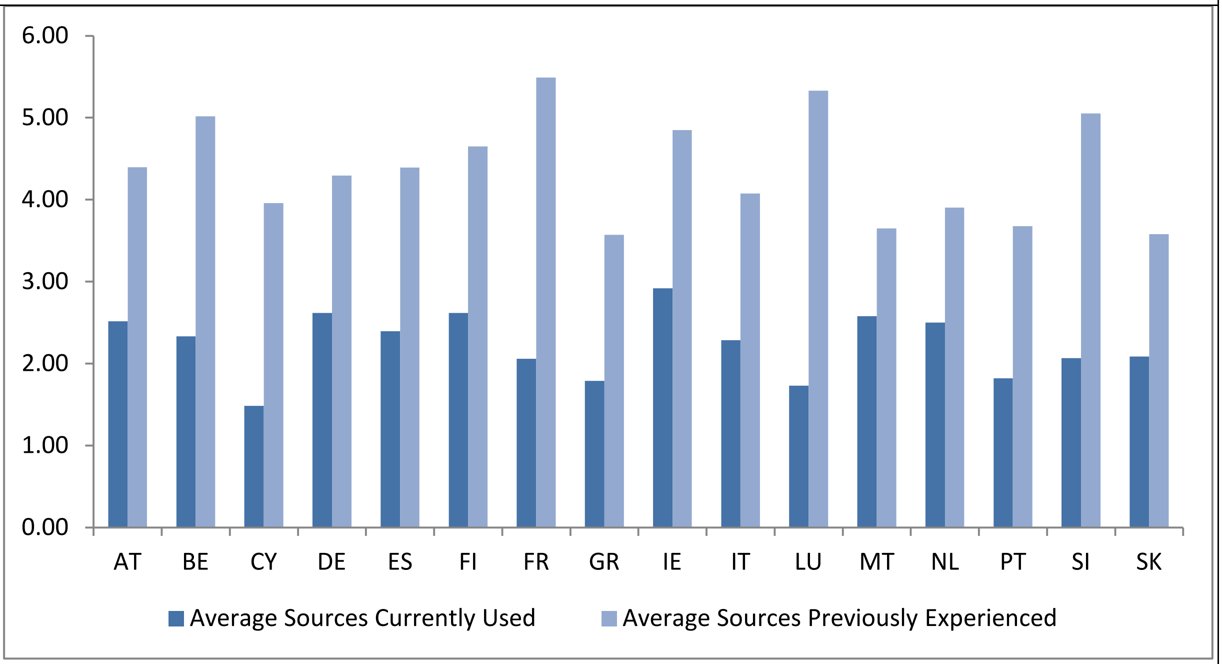
In related work leading up to this report, Lawless, O'Connell and O'Toole (2014a) examined how firms used different finance mixes across countries. Looking at how firms across Europe use different financing sources from the SAFE data, for each of the ten sources of finance, the firm is given three possible answers: They can respond that that type of finance is being currently used ("used in the past 6 months"), that the firm "did not use in the past 6 months, but have experience with this source of financing" or that it "did not use as this source of financing has never been relevant to my firm".[8] This allows us to examine both the current financial structure of firms by looking at the types of finance currently being used, and also to look at a broader measure of all finance types that the firm has had some previous experience of using. We use this measure on the assumption that

[8] See data appendix for details on this survey.

previous experience of a finance type indicates that this type of finance is a source the firm is familiar with and could potentially use again in the future. As such, it is a useful broader indicator of the portfolio of financing options for each firm type.

Across all countries, we find that firms are currently using two or three sources of finance to fund their firms' operations. The range of sources of which firms have had experience is considerably more diversified than those that they are currently using, implying that firms are actively managing and changing their funding mix, either in response to changes in their own requirements or because different types of finance become more easily available or more suitable at different stages of the firm's development. In terms of the numbers products currently being used and those with which the firm has previous experience, Ireland has rates that are in line with the overall average as can be seen in Figure 3.

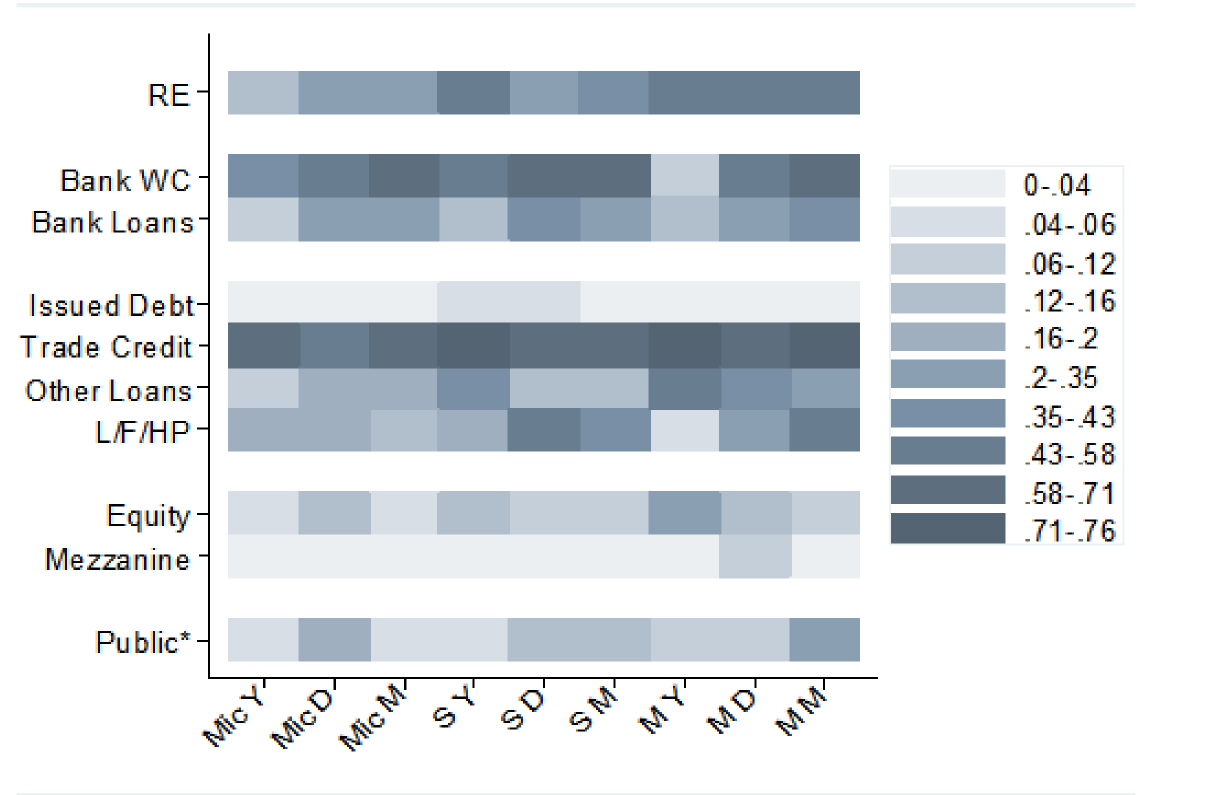
Figure 3: Finance Sources By Country



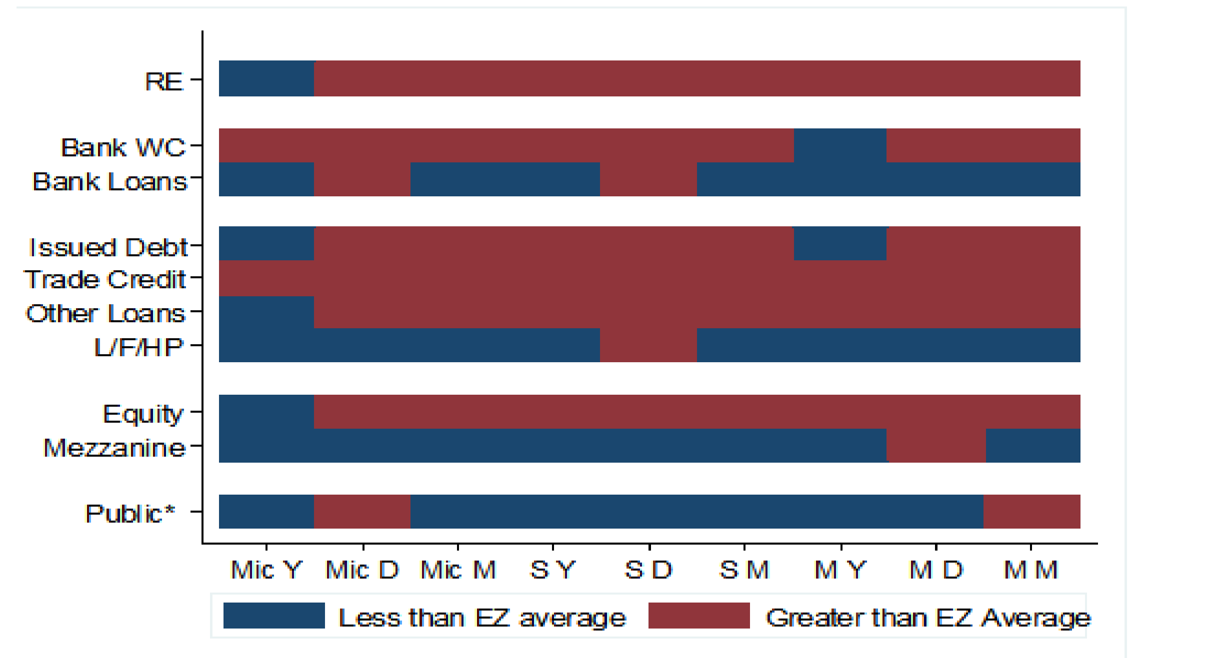
Source: Lawless *et al.* (2014a).

Figure 4 presents a heat map of the usage intensity of different internal and external financing sources for Irish SMEs drawing on the ECB SAFE data. Along the horizontal axis, firms are grouped by size, and within that by age. This is to capture how financing develops across the lifecycle. The darker the colour the greater each source is used by SMEs in Ireland. We can see that bank working capital and trade credit are the two main sources of external financing. The bottom graph plots whether or not Ireland's usage intensity is greater or less than the Eurozone average.

Figure 4: What Type of Financing is Used by Irish SMEs? Heat Map of Usage Intensity and Comparison with Eurozone



How do we differ from Europe?



Source: ESRI Analysis of ECB SAFE data.
Notes: Mic – Micro sized firms, S – Small Sized Firms, M – Medium Sized Firms. Y – Young firms (under 5 years), D – Developing (between 5 and 10 years), M – Mature (Greater than 10 years).

2.6 Looking Forward: Credit Forecasts

In order to place some context on the financing requirements of Irish SMEs as the economy recovers, obtaining some indication of the likely evolution of credit supply and demand is an important ingredient to the policy discussion. As part of the research programme behind this report, Lawless, McInerney, McQuinn and O'Toole (2014) use historical Irish data to examine the long-term determinants of bank credit to Irish non-financial firms and SMEs and to generate forecasts of credit over the medium term.

Two different approaches are used to forecast credit stocks over the time horizon from 2014 to 2020. The first approach uses a macroeconomic model of the banking sector to simultaneously model supply and demand. The second approach uses sectoral data to estimate a long-run relationship between each sector's credit and output and then applies an error-correction model to forecast how these will evolve over time taking into account the current over-or-under leverage rates of the different sectors.

For both approaches, data from the Central Bank of Ireland on the stock of non-financial domestic firm credit are used. It is necessary to generate the initial forecasts using data for all non-financial firms to establish relationships between credit and other variables because a separate series that can distinguish SME credit from the total stock is not available prior to 2010. Using the current share of SME loans in the total, we can rescale our forecasts for total firm lending to generate the implications for SMEs.

As the main inputs to forecasts, different scenarios for GDP and sector output are taken from the ESRI *Medium-Term Review 2013-2020* (FitzGerald and Kearney, 2013) to give a range of possible paths for credit depending on the outturns for the economy. The scenarios are based on different speeds of recovery: the first of these is a "Recovery" scenario that returns the economy to its historic average growth rate of 4 per cent by 2015, resulting in a gradual decline in unemployment to 5.6 per cent by 2020. The second scenario is one of "Delayed Adjustment", where it takes until 2017 for GDP growth to get close to 3 per cent and the third scenario is a "Stagnation" alternative in which GDP growth remains below 2 per cent for the entire period in the case where the external economy is hit with further shocks that have a knock-on negative effect on Irish recovery.

Both the aggregate and sectoral approaches give substantially similar results with total credit stocks estimated to remain relatively stable at their current levels over the near term, but with a re-orientation of lending away from property towards expansion of credit in other sectors. Here we present the results from the aggregate approach, which controls simultaneously for supply and demand determinants.

The demand for credit by non-financial corporations is assumed to rise with economic activity, proxied by real GDP, and fall with the real cost of credit. The *ex ante* real interest rate is the average interest rate on Non-financial Corporations (NFC) credit minus (annualised) lagged quarterly inflation. On the supply side, the model assumes that lending to non-financial corporations (NFCs) depends on the return from lending (i.e. the interest rate charged), the cost of funding that banks face, the opportunity cost of lending to NFCs and a measure of the perceived riskiness associated with corporate lending.

The funding environment that faces the banking sector is controlled for through the inclusion of the volume of deposits and the money market rate. The former reflects the volume of retail funding that the bank holds, while the latter reflects the cost of alternative financing (via wholesale money markets). The model assumes that banks maximise the risk-adjusted return on a portfolio of assets. The interest rate on ten-year government bonds, a measure of the long-term risk-free rate, is used to proxy the opportunity cost of lending to non-financial corporations. We use lagged annual GDP growth to capture macroeconomic risk.

Figure 5 shows the path for NFC credit (including credit to the property sector) in the three scenarios. Total outstanding NFC credit is forecasted to rise to €109 billion by 2020 in the Recovery scenario, €99 billion in the Delayed Adjustment scenario and €97 billion in the Stagnation scenario. Figure 6 shows the forecasted path for NFC credit excluding property related lending in the three scenarios. NFC credit for non property businesses rises to €49 billion by 2020 in the recovery scenario, €45 billion in the Delayed Adjustment scenario and €44 billion in the Stagnation scenario.

To establish long-run relationships and generate forecasts based on sector level output projections, we were obliged to use series for credit that related to the entire non-financial corporate sector. From a policy perspective, however, it is particularly the demand and availability of credit to the SME component of the economy that is of interest with larger firms typically having greater access to other sources of funding and less reliance on banks. Scaling our non-financial corporate forecasts to apply to SME sector (including and excluding property respectively), we assume that the current relative shares of the SME and non-SME firms remains broadly constant going forward.

This gives broad paths of credit that evolve along the same lines as total credit stocks. From a 2013 base of €58 billion in outstanding credit, these forecasts give a Recovery scenario stock of €56 billion in 2020. The range of values depending on the speed of economic growth goes from €45 billion in the Stagnation scenario, to €50 billion in the Delayed Adjustment scenario and an upper estimate of €56 billion by 2020.

As with total NFC credit, a re-balancing of credit shares across sectors is expected at the SME level, with credit stocks growing in all sectors other than Property. Current non-Property SME credit is in the order of €25 billion and this is expected to reach between €38 billion and €46 billion by 2020 depending on the speed of overall economic growth.

Figure 5: Path for Total NFC credit

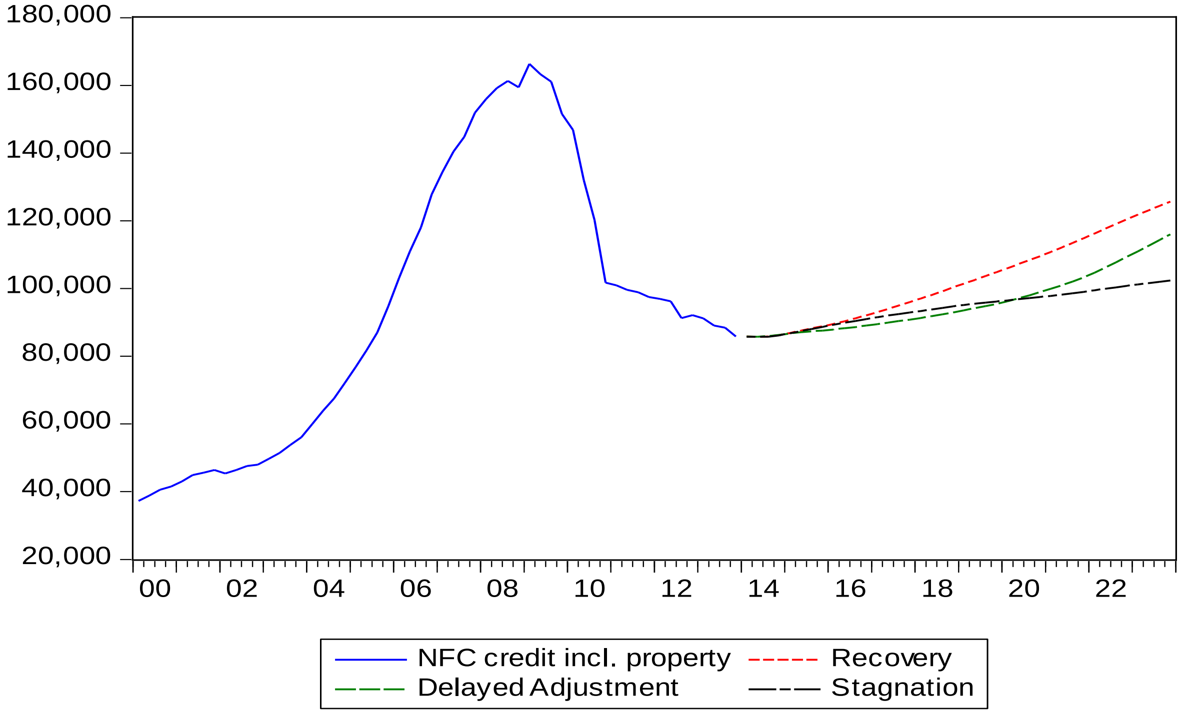
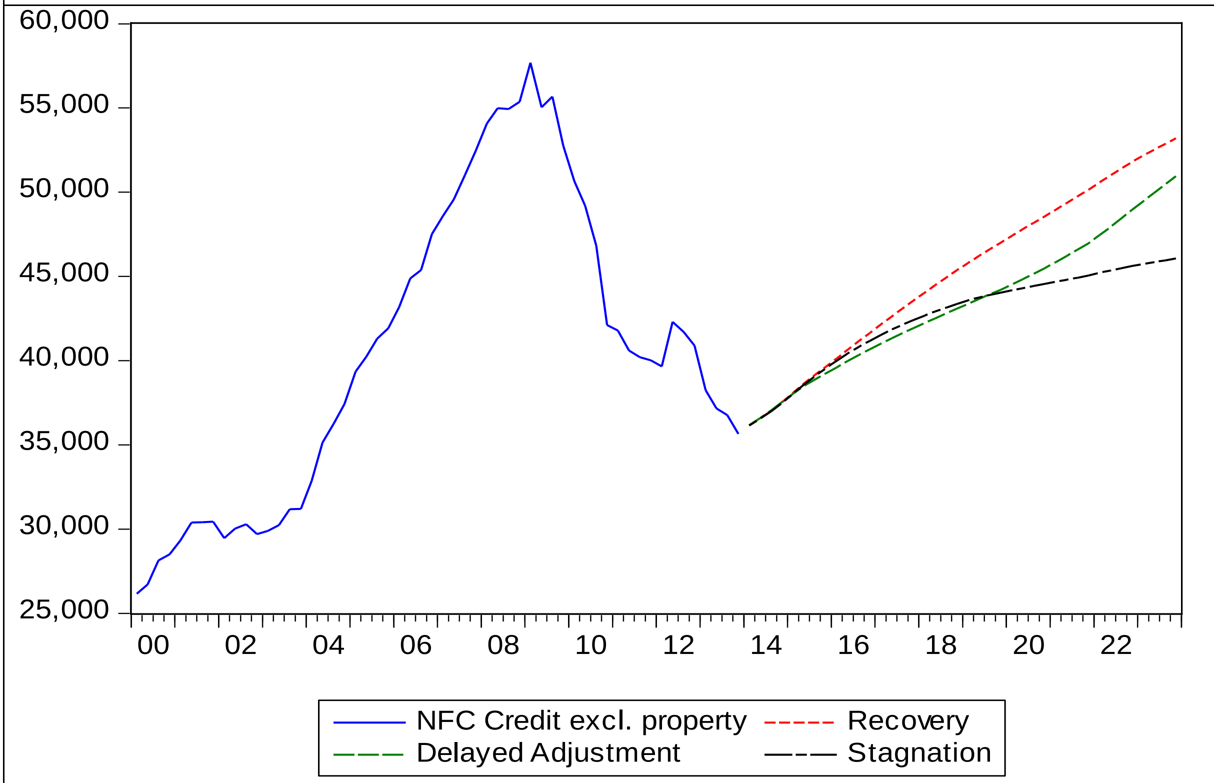


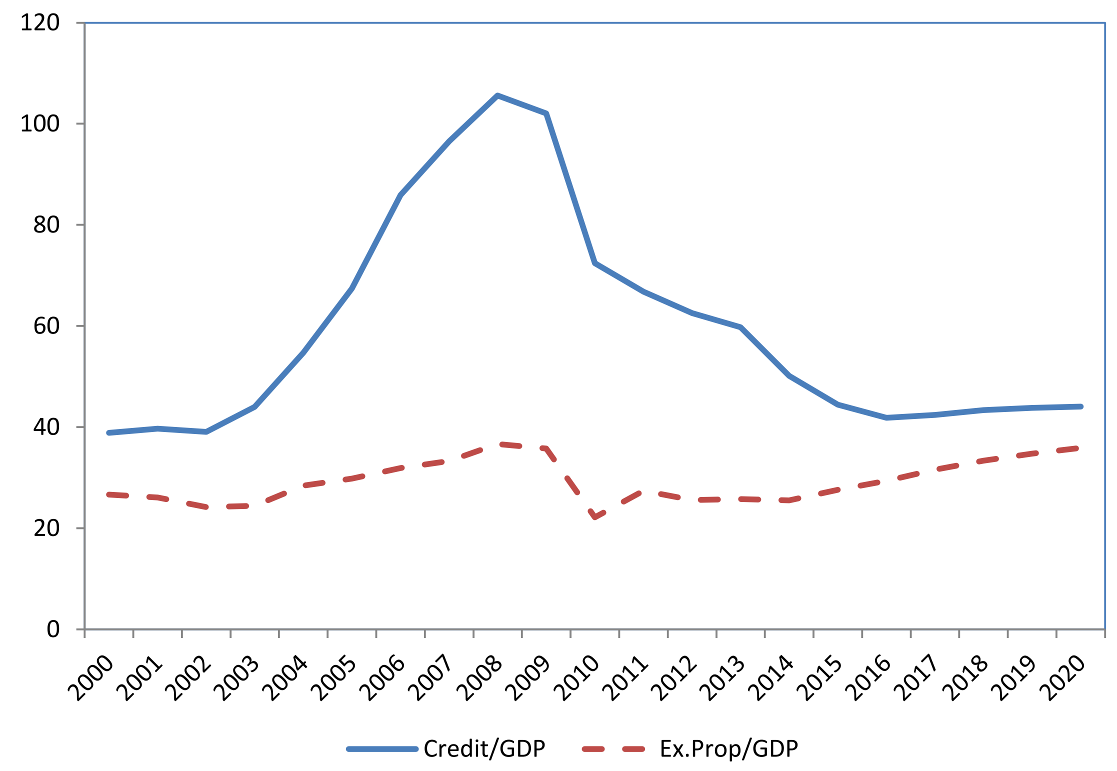
Figure 6: Path for NFC Credit Excluding Property



Source: Lawless, McInerney, McQuinn and O'Toole (2014)

To place these forecasts in the context of the overall economy, Figure 7 graphs the expected recovery scenario levels of credit (for all sectors and excluding Property) relative to GDP. This shows that the forecasted levels of credit to non-financial firms are expected to return to stabilise at a pre-boom level of approximately 40 per cent of GDP, with the subsequent growth in credit stocks evolving broadly in line with GDP. This graph also demonstrates the disproportionate contribution of the Property sector to the peak credit-to-GDP ratio, with credit in other sectors deviating only relatively slightly from the longer-term relationship with GDP even during the mid-2000s.

Figure 7: Firm Credit Relative to GDP (%)



Source: Lawless, McInerney, McQuinn and O'Toole (2014)

As with all forecasts of economic activity, there are a number of caveats to be attached to these projections. There is continued pressure on banks to deleverage and increase capital ratios which may constrain their ability to extend new credit. The changes in market structure in banking, particularly in terms of the increased concentration in banking sector institutions, may have an effect on the supply of credit. On the demand side, firms that took on debt during the past decade may also be focused on deleveraging. Given the experiences of the financial crisis and subsequent reccession, there is a possiblity that the risk appetite for new credit may be diminished, on the side of both banks and firms.

Chapter 3

Bank Finance

Summary of Chapter Findings

Total bank credit to Irish non-financial firms grew from €50 billion in 2003 to €175 billion in 2007, and now stands at just over €90 billion. The SME sector's credit stock has been at a relatively stable level of just under €60 billion since the series was introduced in March 2010.

- Since late 2008, the transactions have been negative for property and other sectors, indicating broadly that more credit is being paid-off than is being extended.
- Property makes up 58 per cent of total firm credit and 56 per cent of SME credit. The next largest sector is trade and hospitality which accounts for 18 per cent of total firm credit.
- Irish SMEs have the highest rate of usage of bank working capital facilities (overdrafts, credit lines and other short-term funding) compared to firms in other countries across Europe.
- Credit applications in Ireland remain below the European average, which could be a result of ongoing concerns about economic growth and uncertainty by firms.
- Credit constraints are also high in Ireland in a comparative context. This is driven both by bank rejections and by borrowers who did not apply due to possible rejection.
- Irish firms are among the most likely to report increased collateral requirements. The most common types of collateral used are buildings and personal assets of the owner.
- The differential between interest rates for small and large Irish loans has increased considerably since the crisis and is much higher than for other selected economies except Spain.
- The evidence on the potential effect of highly concentrated banking markets on SME lending is reviewed and shows that there are significant concerns that the current structure of the Irish lending market risks restricting credit to some firms as the economy recovers and the demand for loans increases.

Key Policy Reflections and Recommendations

1. Implement the recommendations on expanding the Credit Guarantee Scheme made in the review of the scheme in 2014. In particular, the removal of the restriction covering refinancing, overdrafts and the extension in term length should broaden the usage of the scheme. Consideration should also be given to making the application process clearer.
2. The potential development of a specific guarantee for start-ups should be evaluated. This guarantee should not be provided in isolation but in conjunction with business

support and financial development training.

3. The Credit Review Office could continue to benefit the functioning of the banking system by preserving an external appeals and mediation office. Because this office has a role in assessing and resolving specific cases, it is essential that it be independent in the exercise of its functions. Its operations should also be as transparent as possible and it should engage with all banks operating in the country with a referral and use appeal process that is as clear and simple as possible.
4. A more permanent structure might draw on the French model which involves mediators from the Banque de France, supports such as guarantees from their financial development body and wider business development institutions provides a “one stop shop” service which is independent under the bank’s mandate.
5. For smaller firms, the Microfinance scheme should examine if the cap on loan size is overly restricting its operations. The term length of the loans should be increased (say to seven years) and flexibility could be added by allowing some variation in the interest rate across different types of application, in return for payment delays or other adjustable mechanisms. Greater promotion to raise awareness of the scheme is recommended.
6. To increase the supply of credit to firms, the Strategic Banking Corporation of Ireland (SBCI) has been set up to provide a new stream of lower-cost funding channelled through existing lenders, promoting longer-term and more flexible lending products.
7. Following the evidence presented on the effects of concentration in the banking market, expanding competition and facilitating entry is an important policy objective. Because it may reduce barriers to entry in SME financing, the role of the SBCI is likely to play an important role in this regard, above and beyond the direct effect of the new funding it brings to existing market participants.
8. A review should be set up to examine the possible role that credit unions might play in extending credit to smaller SMEs.
9. A policy gap in Irish firm supports exists with the lack of any provision for tailored financing support for exporters, in contrast to almost every other OECD country. Given the importance of exporting firms for the Irish economy, an evaluation of the demand for such a range of instruments and how it could be most effectively implemented should be carried out without delay.
10. At a European level, policymakers should support and engage with the development of a European market in SME securitisation to enable banks to reduce some of the risk currently held on their balance sheets.
11. To improve risk evaluation, the completion and rollout of the credit register should be considered a priority.

3.1 Introduction and Chapter Overview

Banks are critically important for financing SMEs. Ireland has traditionally had a long history of bank-based financing, and despite the difficulties faced since the financial crisis, banks will remain the largest source of external working capital and investment finance for the majority of small firms.

Indeed the majority of policy measures introduced to date in Ireland have correctly addressed the issues of how to ease credit supply constraints in the banking sector.

This chapter has two sections. First, we provide a statistical overview of bank financing of Irish SMEs and second, we review the main bank financing policy developments in Ireland providing selected international comparisons.

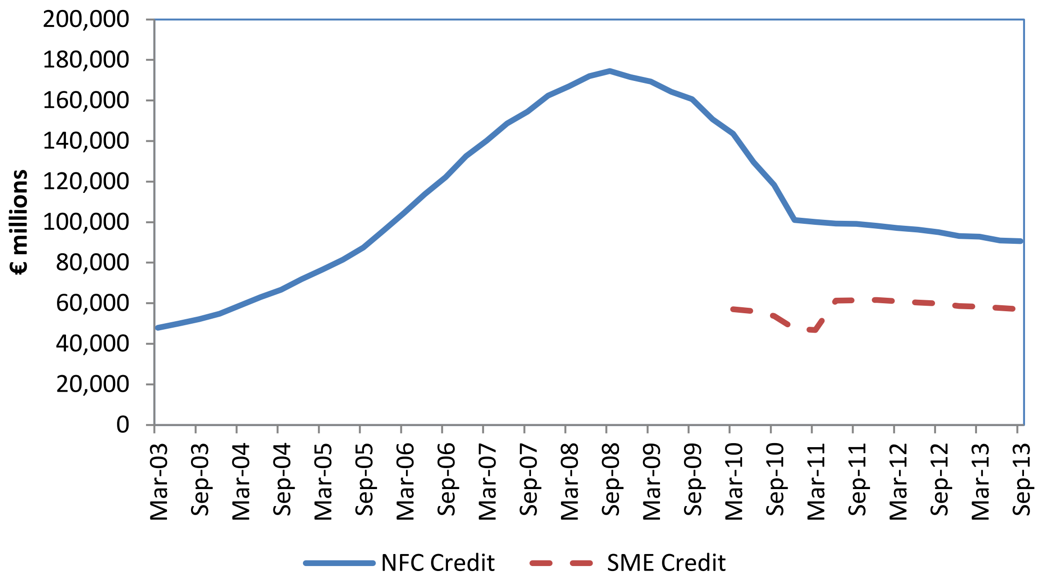
Our statistical overview considers the following issues. In section 3.2 we present an aggregate overview of trends in bank lending in Ireland and how credit is distributed across industrial sectors. Section 3.3 discusses the usage of bank working capital and loan finance for different age, size and other groups of firms in Ireland as well as providing a comparison with other Eurozone countries. This discussion also considers how credit constraints differ in Ireland relative to selected other countries. We also review collateral requirements for SME loan applications and review interest rate developments for Irish firms relative to other Eurozone economies.

In section 3.4 our review of policies, and topics of policy relevance, considers the following issues: section 3.4.1 SME Credit Guarantee Scheme, section 3.4.2 Credit Mediation and the Credit Review Office, section 3.4.3 Micro Finance Ireland, section 3.4.4 The Strategic Banking Corporation of Ireland, section 3.4.5 Regulatory Changes, section 3.4.6 Competition Issues, section 3.4.7 Working Capital for Exporters, section 3.4.8 SME Securitizations, and section 3.4.9 selected other issues.

3.2 Aggregate Bank Credit Trends

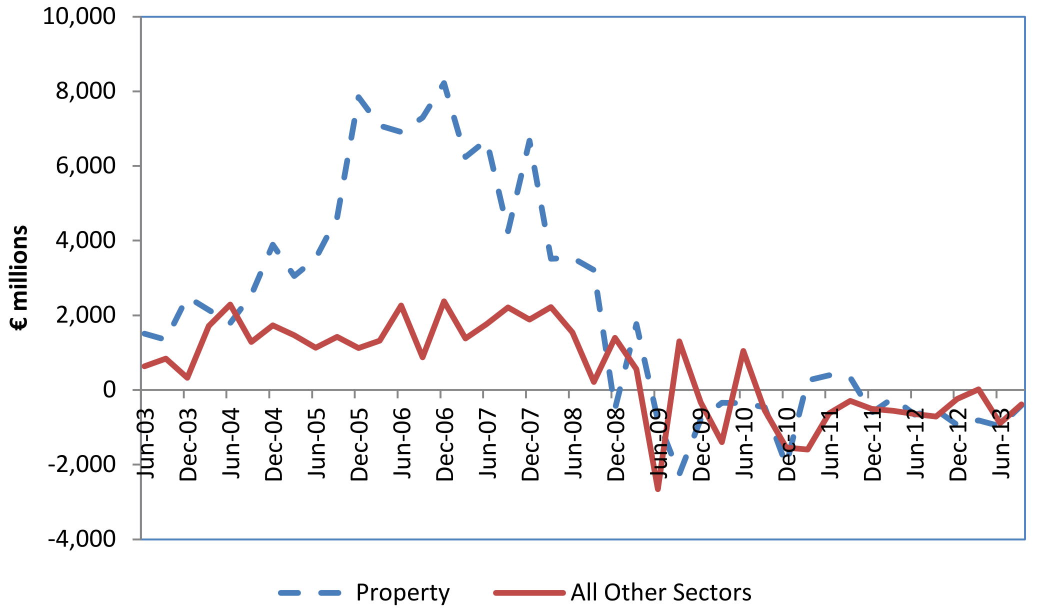
The evolution of Irish domestic firm credit for all non-financial corporations (NFCs) and SMEs is shown in Figure 8, which focuses in on the period from 2003 to 2013. This shows the dramatic increase in credit, which tripled between 2003 and the peak reached in 2008. Although the growth in house prices and associated increases in household indebtedness are the better known features of the Irish credit boom, borrowing by firms also increased at a rapid pace. Credit extended to Irish non-financial firms increased from slightly under €50 billion in 2003 to a peak of €175 billion in 2007, before falling back sharply as the financial crisis and recession hit. The SME sector’s credit stock has been at a relatively stable level of just under €60 billion since the series was introduced in March 2010 so we are unable to identify if the boom-bust pattern was more or less pronounced for these firms compared to the total.

Figure 8: Domestic Firm Credit 2003-2013 (Excluding Financial Intermediation)



Source: Central Bank of Ireland.

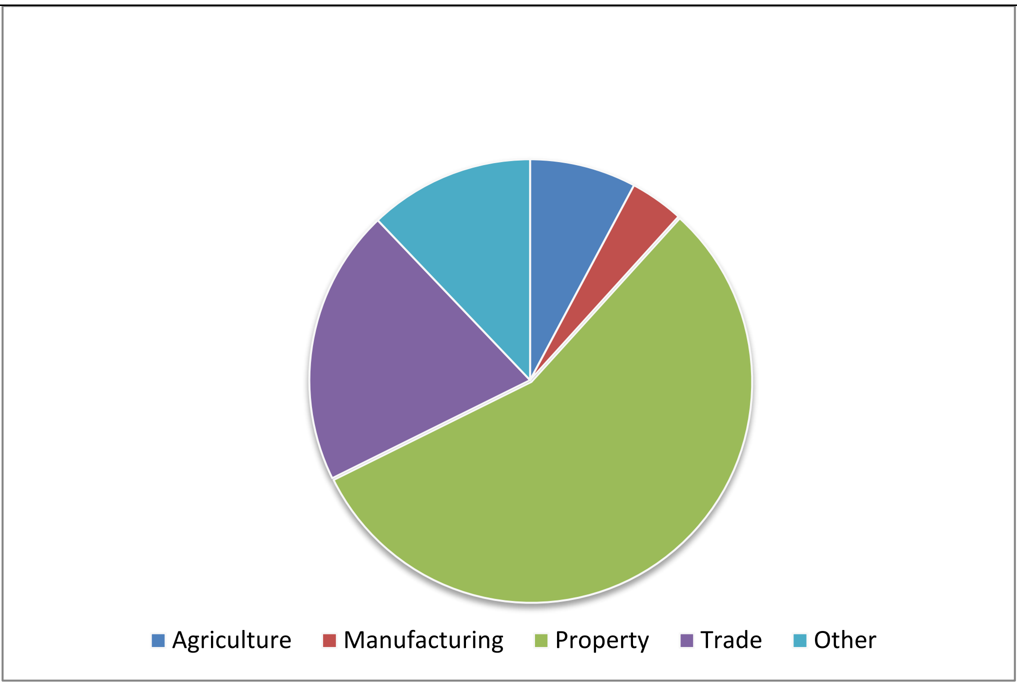
Figure 9: NFC Credit Transactions



Source: Central Bank of Ireland.

The growth and decline in credit can also be seen in the transactions shown in Figure 9. This separates the credit into property lending (broadly defined as including both construction and real estate) and all other lending. This shows a clear link between the property sector boom and overall firm credit, with transactions in the property sector outweighing all other lending by a factor of three at the height of the boom. Since late 2008, the transactions have been negative for property and other sectors, indicating broadly that more credit is being paid off than is being extended.[9]

Figure 10: Sectoral Allocation of SME Credit (September 2013)



Source: Central Bank of Ireland.

Property makes up 58 per cent of total firm credit and 56 per cent of SME credit. The next largest sector is trade and hospitality which accounts for 18 per cent of total firm credit. Agriculture and manufacturing each account for approximately 5.5 per cent of total NFC credit, but agriculture is a slightly higher proportion of SME lending at close to 8 per cent. The “other” group includes a range of different smaller sectors, primarily other services and communications. Close to 13 per cent of credit is currently extended to this category of firms.

3.3 Firm Use of Bank Credit

Traditionally, Irish SMEs have been very dependent on bank finance (Lawless *et al.,* 2014a). This dependence heightens their financial vulnerability to shocks in the banking sector. Given the scale of the crisis in the Irish financial sector, the inevitable consequence has been tightened credit availability to SMEs. Previous ESRI research has identified the degree of credit constraints facing Irish SMEs and identified that such constraints are limiting their investment in fixed assets and lowering their employment levels (Gerlach-Kristen *et al.,* 2013; O’Toole *et al.,* 2013). Ensuring adequate

9 The transactions series is calculated from quarterly differences in outstanding amounts which are adjusted for reclassifications, other revaluations, exchange rate variations and any other changes which do not arise from transactions. Information on the credit data series and definitions is available from the Central Bank website at: http://www.centralbank.ie/polstats/stats/cmab/Documents/Business_Credit_and_Deposits_Explanatory%20Notes.pdf.

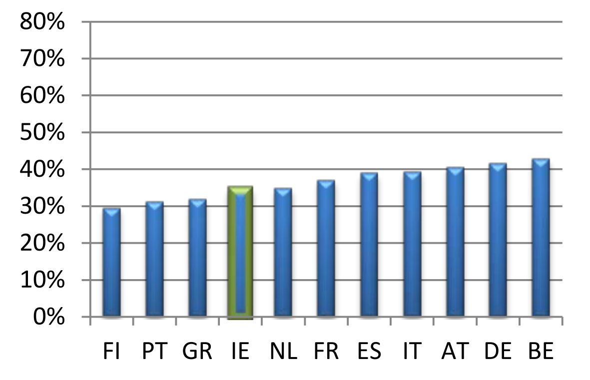
access to bank financing is an important element of any SME recovery, and despite calls for funding diversification, bank credit will remain a key source for SMEs. Indeed, many of the policy initiatives introduced to date have targeted the transmission of financing through the banking sector.

In this section, to provide evidence on bank financing to inform our discussion of both funding diversification as well as the policy response to increase the flow of credit, we provide some overview data on the usage of bank finance by SMEs in Ireland, consider the change in credit constraints, collateral requirements, and provide an overview of the cost of credit for Irish corporations.

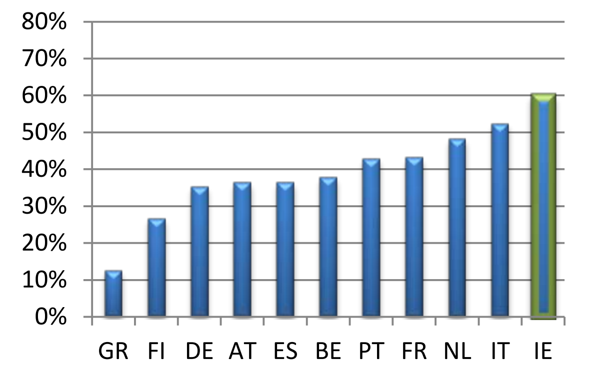
Figure 11 presents the current usage of bank financing in Ireland relative to other selected Eurozone countries. Chart A outlines the usage of bank loan finance while Chart B outlines data on the use of bank credit lines/overdrafts. Irish SMEs have the highest rate of usage of bank credit lines and overdrafts in the selected economies. This highlights the dependence of Irish SMEs on working capital funding through the banking sector. The usage rates of loan finance are lower relative to comparison economies. However, the lower loan usage potential reflects a more subdued investment climate and a lack of investor appetite to take out term loans for capital expenditure. Gerlach Kristen *et al.* (2013) show that the number of SMEs investing in Ireland has fallen by over 50 per cent since the onset of the crisis.

Figure 11: Usage of Bank Credit Amongst European SMEs (% Firms)

Usage of Bank Loans (A)



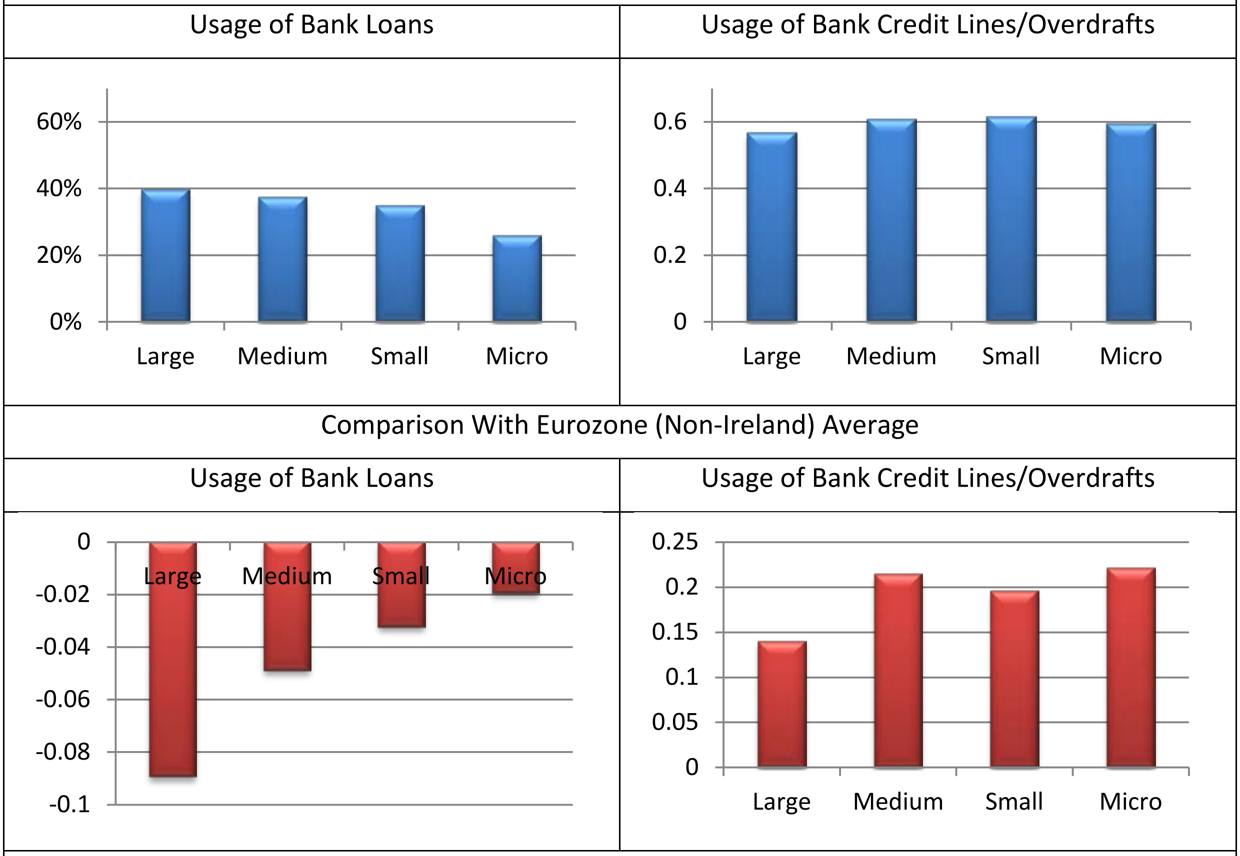
Usage of Bank Credit Lines/Overdrafts (B)



Source: ESRI Analysis of ECB/EC SAFE Survey.

Figure 12 presents the bank loan and bank overdraft facilities usage rates by firm size for Irish SMEs and a comparison with the average for Eurozone countries in the SAFE data. It can be observed that the usage of bank loans is increasing by firm size, i.e., micro firms have much lower usage rates relative to larger firms. However, for bank credit lines and overdrafts, there does not appear to be a change in the trend with firm size, i.e., the usage rates are broadly similar across all the size classes. This demonstrates the importance of bank credit in funding working capital and operational finance across the spectrum of Irish businesses.

Figure 12: Usage of Bank Loans and Bank Working Capital Facilities Amongst Irish SMEs By Size (% Firms)



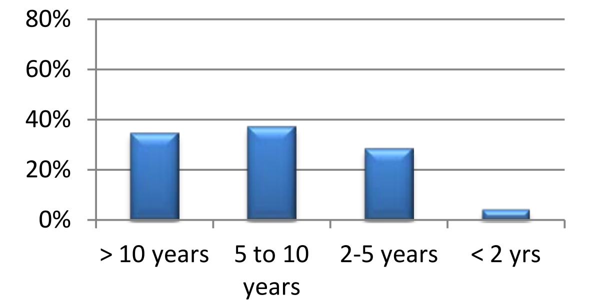
Source: ESRI Analysis of ECB/EC SAFE Survey.

Figure 13 presents the usage rates of bank loan and bank overdraft facilities by firm age for Irish SMEs and a comparison with the average for Eurozone countries in the SAFE data. The data indicate that start-ups are much less likely to use bank loans compared to older firms. While this does not necessarily demonstrate credit market imperfections, the general literature on funding start-up firms indicates that due to a lack of a track record and other informational deficits, these firms find it difficult to convince banks to extend credit.

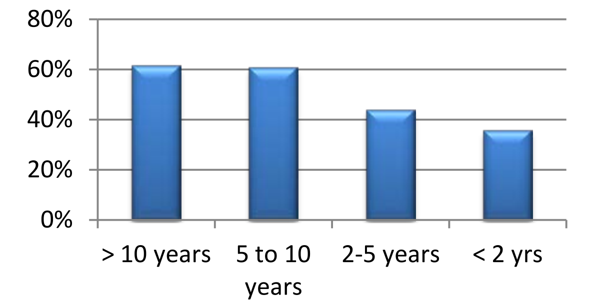
The data on overdrafts also suggest that younger firms do not use bank credit lines and overdrafts to the extent of older firms. Indeed, relative to the average in the Eurozone sample used in our analysis, Irish start ups disproportionately do not use bank financing. The usage rates for overdrafts are, however, higher for all Irish age groups relative to other Eurozone firms, in particular for large and medium-sized enterprises.

Figure 13: Usage of Bank Loans Amongst Irish SMEs By Age

Usage of Bank Loans

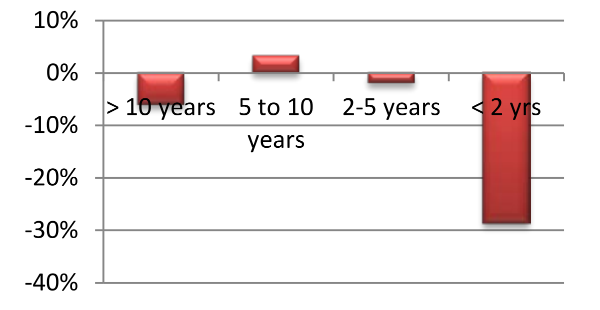


Usage of Bank Credit Lines/Overdrafts

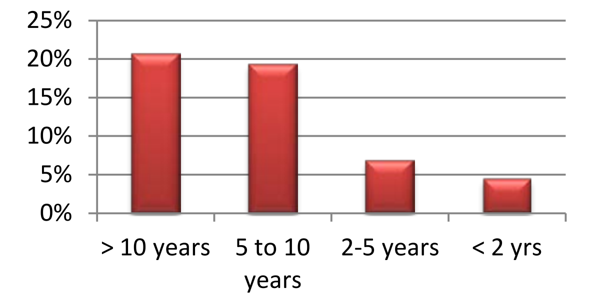


Comparison With Eurozone (Non-Ireland) Average

Usage of Bank Loans



Usage of Bank Credit Lines/Overdrafts

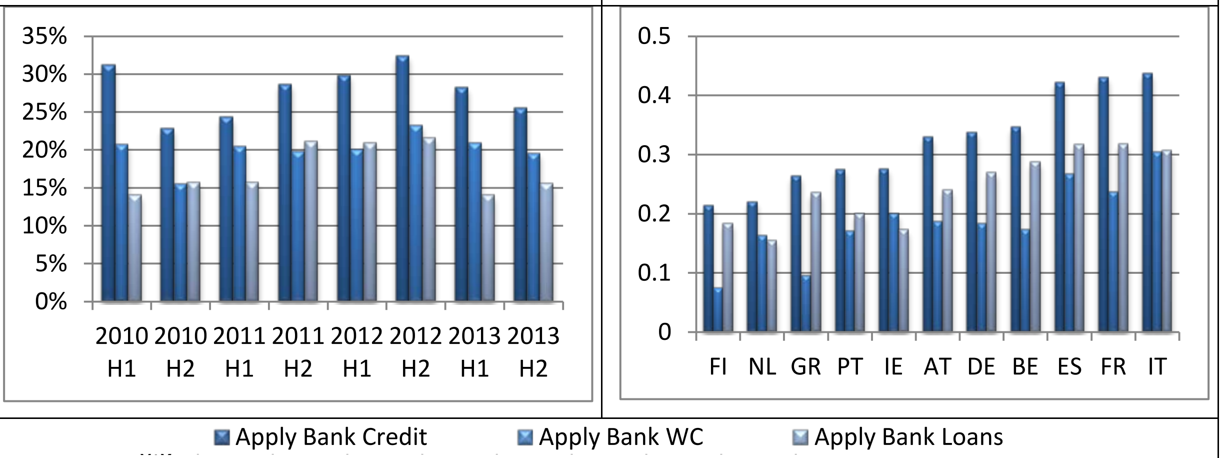


Source: ESRI Analysis of ECB/EC SAFE Survey.

Focusing on usage rates implicitly combines the operation of both the supply and demand sides of SME credit. To disentangle these individual factors, we next look at applications for bank finance as well as the success rates of applications. Figure 14 presents the application rates for bank loans and overdrafts/credit lines by SAFE wave for Ireland and a comparison across countries for the most recent data. We can see that applications over time in Ireland increased through to end-2012 but have actually fallen back somewhat in 2013. This is surprising given the fact that Ireland has been in relative recovery since 2013. The fall has been steeper for working capital facilities. However, this could reflect the fact that, with the improvement in economic conditions, internal finance availability has increased. Credit demand for loan facilities actually increased marginally in the very last wave. Across countries, credit applications in Ireland are below the mean potentially reflecting the subdued economic conditions and uncertainty on the investor side.

Figure 14: Applications for Bank Credit Facilities by Irish SMEs

Applications by Wave | Applications by Country



Source: ESRI Analysis of ECB/EC SAFE Survey.

A key measure of the function of the financial system is its ability to screen borrowers and effectively allocate credit. This requires credit officers to make loan decisions based on the project, ability to repay and firm characteristics. The scale of the Irish financial crisis has brought to the fore concerns over the degree of credit rationing by banks and the change in rejection rates (Lawless and McCann, 2012; Holton *et al.,* 2014; Holton and McCann, 2012). Such constraints were found to be particularly acute in the domestically non-traded sectors and amongst micro firms (O'Toole *et al.,* 2013).

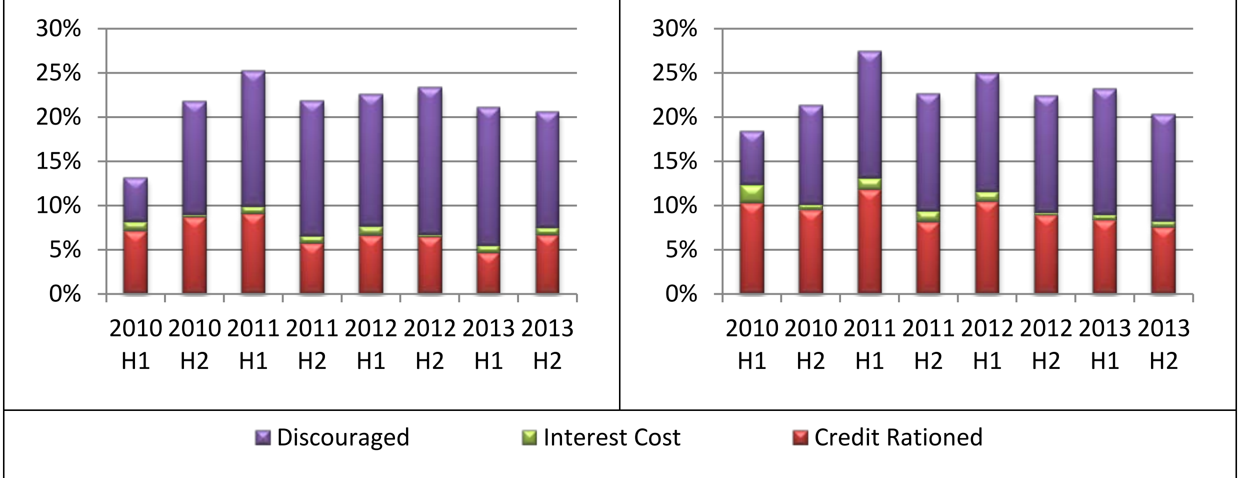
To provide context, Figure 15 below presents the share of Irish SMEs that are credit constrained over the SAFE waves. We use the definitions of credit constraints presented in Casey and O'Toole (2014) and Gerlach-Kristen *et al.* (2014) which are as follows:

- Credit rationed: firms were either partially or fully rejected in applications for finance.
- Cost too high: the firm had an offer from a financial institution but decided to reject the offer as the cost was too high.
- Discouraged borrowers: Firms that did not apply due to possible rejection.

Figure 15 below outlines these constraint indicators for both bank loan facilities and bank overdrafts/credit lines. By far the largest component of constraints in Ireland is borrower discouragement. This is a demand side constraint in the sense that the borrower did not make a formal application for finance. The data appear to indicate that constraints have been falling in Ireland since mid-2012. However, focusing on the sub-components of constraints, there is considerable variation across the measures and there is no clear trend in any particular indicator.

Figure 15: Bank Lending Constraints Faced by Irish SMEs by SAFE Wave

Credit Constraints for Bank Loan Facilities | Credit Constraints for Bank Overdrafts/Credit Lines

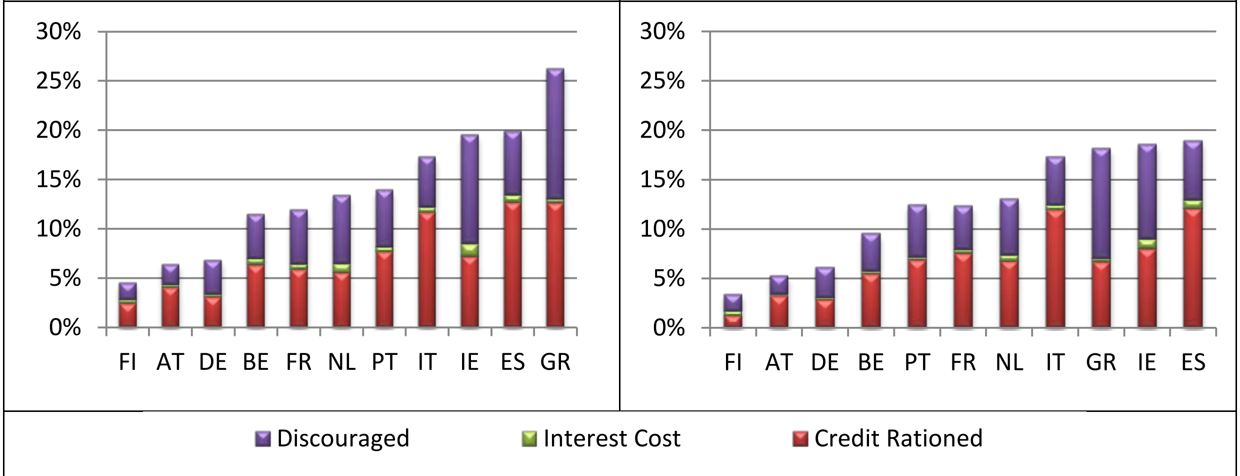


Source: ESRI Analysis of ECB/EC SAFE Survey.

To provide some cross-country comparison of the degree of credit constraints, Figure 16 presents the constraint indicators for each of the Eurozone economies in the data. It is clear that Ireland has one of the highest levels of constraints of any Eurozone economy. This may reflect tightening of credit on the bank side through reductions in risk appetite, changes to lending standards and increases in capital requirements. However, as these figures do not control for borrower quality it may also reflect heightened firm default risk in crisis economies.

Figure 16: Bank Lending Constraints Faced Across Eurozone Members

Credit Constraints for Bank Loan Facilities | Credit Constraints for Bank Overdrafts/Credit Lines

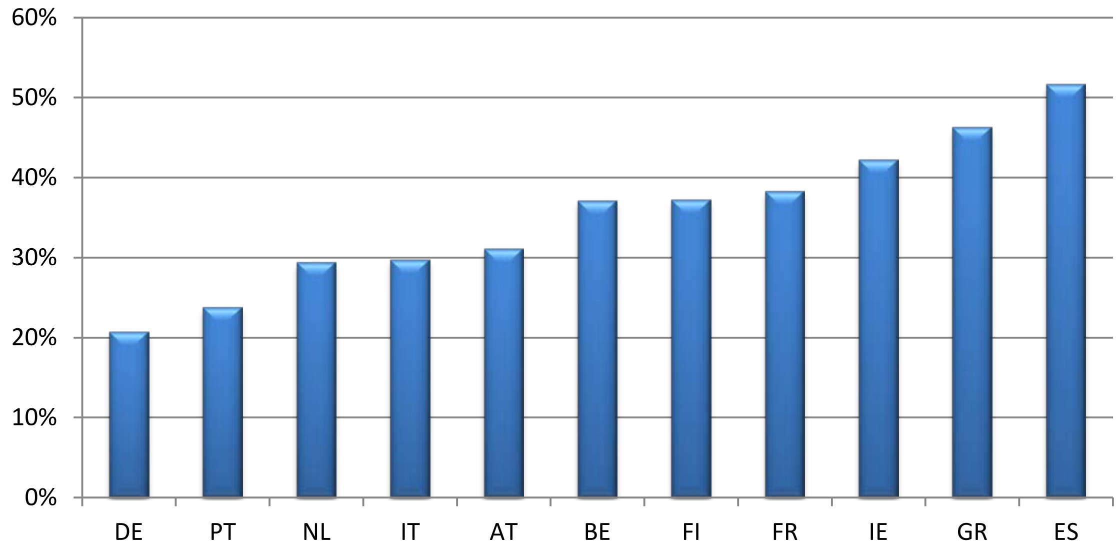


Source: ESRI Analysis of ECB/EC SAFE Survey.

One particular issue that arises for many SMEs is the lack of collateral with which to secure a loan. Indeed much of the theory around the use of credit guarantee measures is to address this particular failure in the credit markets (Honohan, 2008). Following credit crunches, in particular those which are associated with falls in asset prices, collateral constraints can be particularly acute for SMEs. To provide some evidence on collateral issues for Irish SMEs, we present data from the SAFE survey on the percentage of firms indicating that collateral requirements were increased by banks and from the Department of Finance (DoF) survey on the types of collateral that Irish firms were asked for.[10]

Figure 17 outlines the percentage of firms reporting increased collateral requirements in Ireland relative to other selected Eurozone economies. The share of Irish firms reporting increased collateral requirements was on the upper end of the country distribution.

Figure 17: Percentage of Firms Reporting Increased Collateral Requirements



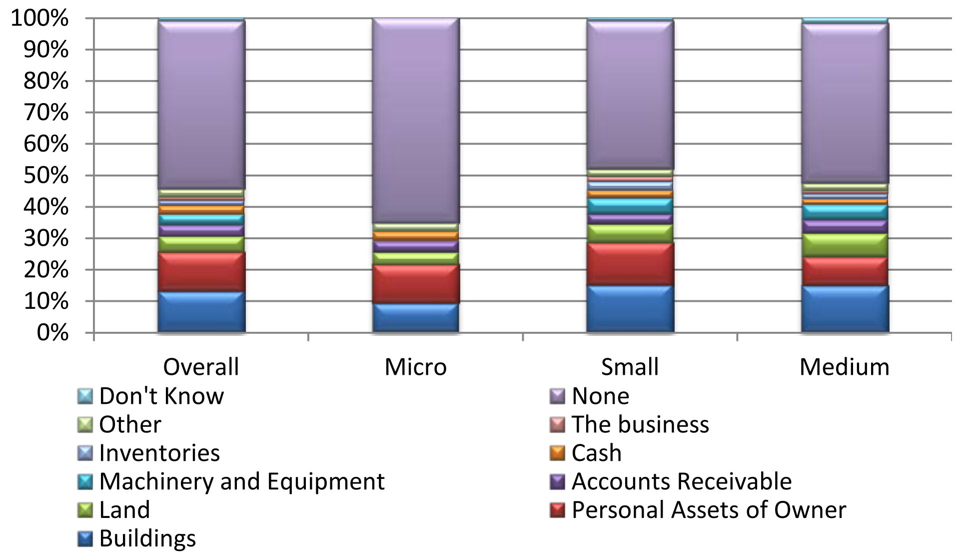
Source: ESRI analysis of ECB SAFE data.

Figure 18 reports the types of collateral required by SMEs in Ireland by size of the firms applying for loan finance. Interestingly, a majority of firms reported providing no collateral. If collateral was pledged, the most likely source was buildings and personal assets of the owner. One issue of possible policy relevance is the risk assumed by entrepreneurs in pledging personal assets in order to access business loans. Mac an Bhaird and Lucey (2010) argue that this "negates the limited liability status" of many small firms and that there is a role for public policy in preventing the loss of the family home as a consequence of default on a business loan. This could be supported by a reduction in the reliance of financial institutions on asset-based lending in favour of lending based on the assessment of financial statements.

Micro-sized firms surprisingly have the lowest rate of collateral usage. However, if they do pledge collateral, they are most likely to post personal assets. Medium-sized firms are most likely to post buildings as collateral.

10 See Appendix for details on the SAFE and DoF surveys.

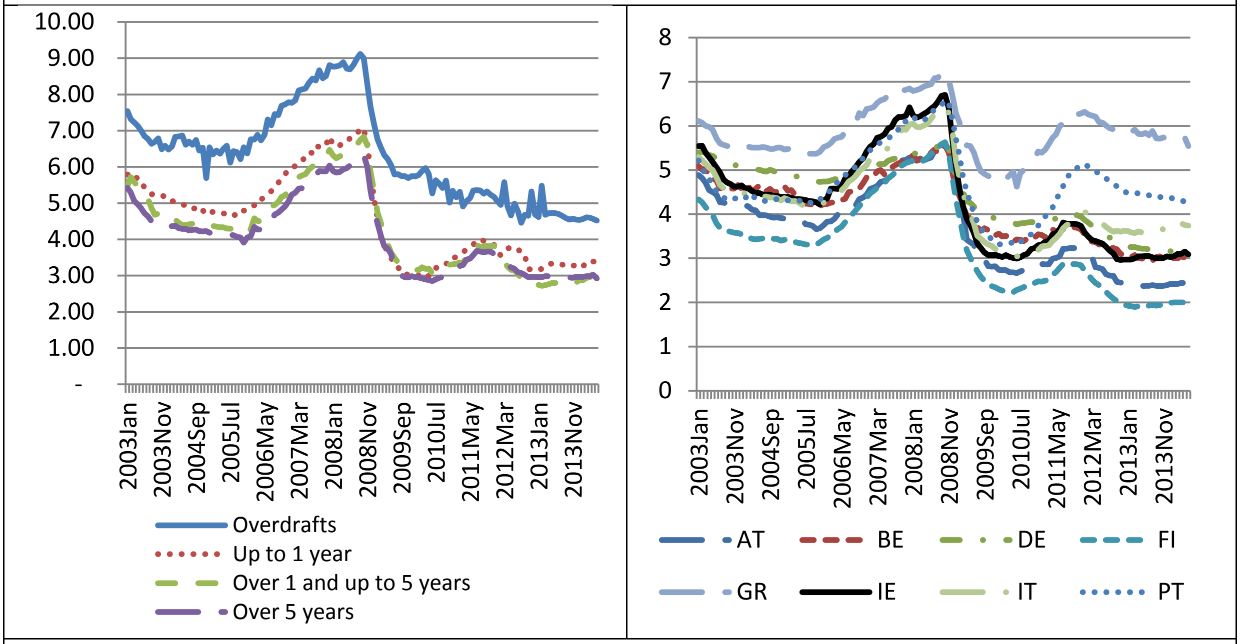
Figure 18: Types of Collateral Required by SMEs in Ireland



Source: ESRI Analysis of RedC data.

The final issue we consider is the cost of credit for Irish SMEs. As can be seen from the credit constraint indicators above, the majority of constraints relate to volume rationing (rejections) rather than price rationing (providing an offer than is prohibitively expensive). However, despite this fact, cost of credit is still an important issue, in particular in a market which has seen a dramatic drop in competition (McCann and McIndoe-Calder, 2012a). Figure 19 presents the interest rates on Irish non-financial corporate loans by maturity and product type since 2003.

Figure 19: Interest Rates on Irish Non-Financial Corporate Loans by Maturity and Product Type



Source: ESRI analysis of ECB data.

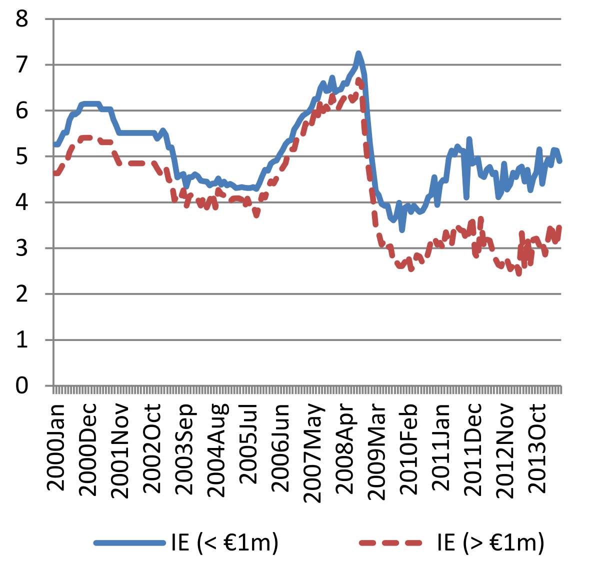
In line with changes to benchmark ECB policy rates, large falls in interest rates are evident since the onset of the crisis. Across products, overdrafts carry the highest interest rates with other loans of less than one year higher than longer duration products. Also presented is a comparison of Ireland's lending rate on all non-financial corporate loans compared to selected European countries. While somewhat elevated, the rate on Irish NFC loans is not as high as in other crisis countries.

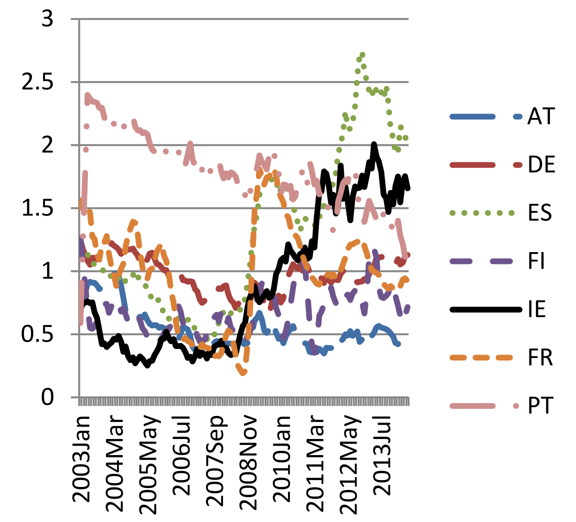
The data in Figure 19 cover all non-financial corporations. However, in many cases, large firms have access to international capital markets and do not source financing domestically. Therefore, developments in the interest costs for these firms are not a good indication of the ability of the system to finance small business. While no explicit interest rates for SMEs are available from the ECB, data on interest rates for loans of less than €1 million and greater than €1 million are available. As the majority of SME loans are small in volume, these data can be used as a proxy for the funding costs for SMEs relative to larger borrowers. The data in Figure 20 first presents the loan rates for volumes of greater than and less than €1 million for Ireland (left). This shows that the differential has widened considerably since the onset of the crisis suggesting tighter financial conditions for smaller sized loans.

On the right hand side of Figure 20, the data presented cover the "Small Loan Mark Up" which is the difference between these two series for selected economies. Ireland has the second highest cost differential between large and small loans across the selected countries. Only Spain is higher. The trend in the data is increasing across the sample period which suggests that financing costs for smaller loans are increasing.

Figure 20: Interest Rates on Irish Non-Financial Corporate Loans by Loan Size

Loan Rates by Loan Size Ireland A	Difference between Large and Small Loan Rates (Small Loan Mark Up) B





Source: ESRI analysis of ECB data.

Table 2 provides a very simple test of how the difference between small and large loan costs has changed since the financial crisis. For each of the series presented in Figure 20 B, we estimate a simple OLS time series regression on a constant and a structural break for the financial crisis. Ireland has the second highest increase in the difference between the cost of small and large loans compared to any other economy selected. The interest rate differential has increased by 0.83 percentage points since the crisis in Ireland.

Table 2: How Has the Differential Between Large and Small Loan Rates Changed since 2008?

Austria	-0.163***
	(0.023)
Germany	-0.096***
	(0.023)
Spain	0.904***
	(0.077)
Finland	0.131***
	(0.028)
Ireland	0.831***
	(0.063)
France	0.144**
	(0.068)
Netherlands	0.713***
	(0.060)
Portugal	-0.374***
	(0.040)
Eurozone Average	0.384***
	(0.041)

Notes: These coefficients are taken from a simple OLS model of the rate differential and just a dummy variable for the post-crisis period (2008 onwards).

3.4 Policy Supports and Issues

In this section we provide an overview, discussion and analysis of the following policy initiatives: the SME Credit Guarantee Scheme, Credit Mediation and the Credit Review Office, Micro Finance Ireland, The Strategic Banking Corporation of Ireland, Regulatory Changes affecting SME Lending, Competition Issues, Finance for Exporters, SME Securitisations, and selected other issues.

3.4.1 SME Credit Guarantee Scheme

Background: Loan Guarantee Schemes Internationally

Loan guarantee schemes are a popular instrument to reduce credit constraints for SMEs. The existence of the guarantee lowers the risk to lenders and, if all goes well, can allow the government to leverage a relatively small outlay into a large number of loans. The selection and monitoring function remains with the private sector bank, which still shares some of the risk if the guarantee is not unlimited. Despite these attractions, loan guarantee schemes have not always been particularly successful, with the blame often put on complicated and time-consuming claims procedures (see Honohan, 2008).

Cowling (2007) analysed the UK government initiated loan guarantee scheme (SFLGS) from 1981 to study whether or not the scheme achieved its goal of alleviating financial constraints to credit constrained small businesses that have been refused all possible debt financing options. The data are comprised of small firms over the period of 1993 to 1998 and the results of the paper generally supported the concept that the loan guarantee scheme reduced credit constraints for small firms as firms that were on the scheme showed little evidence of undergoing further credit rationing.

Chandler (2012) investigated the economic impact of the Canada Small Business Financing Program (CSBFP) using data from a follow-up survey of both participants and non-participants. A difficulty in evaluating the economic impact of guarantee programmes is that there may be an element of self-selection and it is, therefore, difficult to establish if firms have grown or invested because of the programme itself or because firms with better prospects were more likely to take part. Chandler dealt with this issue by comparing the guaranteed firms with three kinds of SMEs: all SMEs, firms denied credit and firms borrowing from private lenders without a guarantee. He also controls for the financing behaviour of the business and its growth objectives. For participating firms, the guaranteed loan programme increased growth in employment by 12 percentage points and revenues by 7 percentage points. Salaries also increased but no effect was found on growth in profits. Overall, the estimated effect of the guarantee was to have contributed around 5,000 jobs, approximately 3.8 per cent of those created in the period in question by small private businesses.

Honohan (2008) discusses the scope for government sponsored credit guarantee schemes for the purposes of improving societal welfare and financial intermediation for SMEs. However, these schemes can often come with a high and somewhat unknown cost with little benefit and so Honohan makes the following recommendations: There should be well defined welfare improving goals, a reliable approach to calculating costs, an appropriate evaluation of outcomes, and sufficient attention paid to the scheme to maximise the likelihood of achieving the stated goals.

Similar loan guarantee schemes can also be found across Europe since the onset of the crisis. In France, for example, a €250 million EU loan guarantee scheme was agreed between the European Investment Fund and Banques Popularies-Caisses d'Épargne (BPCE Group) in June 2013. The scheme is designed to encourage banks to lend to innovative small and medium-sized enterprises and small mid-caps in need of financing or operating capital to fund research, development and innovation. With approximately 25 banks expected to participate in the scheme, the scheme aims to encourage banks to lend between €25k and €7.5 million.

In the Netherlands the government's SME Loan Guarantee Scheme (BMKB) will guarantee up to 67.5 per cent of a bank start-up loan up to a maximum of €266,667 provided that the firm applying for the loan was unable to provide the bank with adequate collateral, has favourable future prospects, the loan is not for a project or investment but to provide additional capital, and the owner guarantees 25 per cent of the loan. In Belgium, the European Investment Fund and the Belfius Bank signed a guarantee agreement for the Competitiveness and Innovation Framework Programme (CIP) to help start-ups SMEs with access to finance over 2 years. Under the agreement up to €450 million worth of loans can be provided with up to 2,000 Belgian Start-ups expected to benefit from loans as high as €500,000.

An ADB–OECD study (2014) on enhancing financial accessibility for SMEs emphasised the importance of the design of any credit guarantee scheme to ensuring that a balance is struck between enhancing financial availability to companies that are on the margin of refusal without the government taking an overly large share of the lending risk and thereby undermining the incentives of the financial institutions to perform proper levels of due diligence and risk control. In particular, this report identified the following risk management tools as having a direct impact on the additionality of lending coming from having the backstop of a guarantee scheme:

- Credit risk assessment by both loan originator and guarantor improve scheme performance (but incur high costs).
- Impact of the extent of the guarantee relative to loan amount (coverage ratio) – higher coverage ratio is an attractive feature for borrowers and lenders but may lower the incentive of the lender to properly screen borrowers.
- Eligibility – if schemes restrict eligibility to firms denied regular market lending or if they are targeted at specific sectors/types of firms.
- Price of guarantees need to strike a balance between financial returns and attracting viable customers.

To provide context, an overview of selected credit guarantee schemes internationally is presented in Table 3. Looking across the different schemes, a number of patterns appear to arise:

- First, in nearly all cases, the firm must apply to the financial institution for the loan and then be recommended to the guarantee programme by the bank. This ensures that the original screening occurs based on the bank's credit evaluation practises.
- While the majority of programmes cover investment loans to be used for capital and fixed assets, a large range of schemes also provide guarantees for working capital and overdraft facilities. In many cases, cash flow management is important for firms' development and covering these types of facilities can be critical to firm growth.
- Guarantees are provided in conjunction with wider SMEs supports in many jurisdictions. For example, SMEs in Korea apply to the development agency which then provides a wide range of supports including consultancy, financial capacity building, technical supports and other inputs. These can then be provided to build the SMEs as well as just provide guarantees.

- A number of schemes have explicitly higher coverage rates for start-up loans. This is the case in Denmark, Israel, Mexico and the Netherlands, for example.
- While some countries facilitate the guarantee to cover portfolios of loans, the most typical situation is for the guarantee to be applied on an individual basis to each retail loan.
- While the credit evaluation is mainly undertaken by the bank, there are cases where the scheme providers will also undertake a credit assessment.
- Maturity lengths vary depending on whether the scheme covers working capital or investment financing. The important message is that there is flexibility in the maturity to cover the specific product that is demanded.
- Some countries allow guarantees to be applied to larger firms as well as SMEs. However, the financing additionally of this approach would seem questionable.

Table 3: Overview of Selected Credit Guarantee Schemes for SMEs

Country	Applications	Ownership	Investment Loans Included?	Working Capital Loans Included?	Clustered with other supports?	Guarantee Amount	Volume per borrower	Maturity	Just SMEs	Retail or Portfolio?	Credit Evaluation
Austria	Bank	Public	n.a.	n.a.	Yes	80 %	€2.5mn	n.a.	Yes	Retail	n.a.
Belgium	Direct	Public	Yes	Yes	n.a.	80 %	Up to 250,000	2 years		Retail	Lender
Canada	Bank	Public	Yes	No	Yes		Max $500,000,		Yes	Retail	
Chile	Bank	Public	Yes	Yes	Yes			26 mths (av)	Yes	Retail	Lender
Colombia	Bank	Public	Yes	Yes	Yes	Typically 50%				Retail	Lender
Czech Republic	Bank	Public	Yes	No	Yes	Between 60 and 80 per cent	N.a.	15 years max, 7 average	No	Retail	Both
Denmark	Bank	Public	Yes	Yes	Yes	75 % for start-ups to DKK 10mn and 65% larger				Both	n.a.
Finland	Bank	Public	Yes		Yes					n.a.	n.a.
France	Bank	Public-Private	Yes	Yes	Yes			15 years max, 6 average		Both	Lender
Greece	Bank	Public	Yes	Yes	n.a.	80 per cent	Up to 350,000	3-6years	Yes	Retail	n.a.
Hungary	Bank	Public-Private	Yes	Yes	n.a.	Up to 85 per cent	2.5bn HUF	25 years but average 2	Yes	n.a.	Both
Israel			n.a.	n.a.	n.a.	70%, start-ups 85 % [1]	NIS 500m	5 years	Yes	Retail	Lender
Italy	Bank	Public/Mutual	n.a.	n.a.	n.a.		Up to 2 mn	average 12	YEs	Retail	n.a.
Korea		Public	Yes	Yes	Yes	50-85 to 85-100		Up to 2 years	No both covered	Retail	n.a.
Mexico	Bank	Public	Yes	Yes	n.a.				No	Retail	Lender
Netherlands	Bank	Public	n.a.	n.a.	n.a.	50 per cent but to 67 per cent for start-ups	1.5mn	12	Yes	Retail	Both
Portugal	Bank	Public/Mutual	Yes	Yes	n.a.	50-75 per cent of loan	1.5mn	average 4 years		Retail	Both
Slovenia	Bank	Public	Yes	No	Yes		1.2mn	10 average 7	X	Retail	Both
Spain		Public	Yes	Yes	Yes	50	1mn	12-18monts		Retail	Lender
Switzerland	Bank	Public	n.a.	n.a.	n.a.	65 per cent	500000 CHF			Retail	Lender
Turkey	Bank	Public/Private	n.a.	n.a.	n.a.		TYR 1 mn	8 average 3	Yes	Retail	Both
UK	Bank	Public	n.a.	n.a.	n.a.		Up to 1mn £	3m to 10 y	Yes	Retail	Lender
United States	Bank	Public/Private	Yes	Yes	n.a.	75-90%	5.5mn USD		Yes	Retail	n.a.

Notes: (1) Israel has a scheme where the borrower must commit a portion of the commitment with the bank only taking a small slice.

Irish SME Credit Guarantee Scheme

The SME Credit Guarantee Scheme introduced in 2012 takes the form of a state-guaranteed loan, and is intended to target SMEs that are unable to access credit due to either inadequacy of collateral, or the inability to understand the novelty of a business model, market, sector or technology. The scheme also supports a number of debt instruments, such as term loans and on-demand performance bonds. This scheme does not preclude an SME from obtaining other State Aid, such as a grant, but the maximum amount of De Minimis State Aid a business may receive over a rolling three year period is €200,000.

The decision on whether or not it is appropriate to use the scheme is delegated to the participating lenders which consist of Ulster Bank, Bank of Ireland, and Allied Irish Bank (AIB), which will assess whether or not the applicant business is capable of making the repayments. The borrower faces an interest rate from the bank and a charge of 2 per cent (annually or quarterly) as part of a Scheme Guarantee Premium to contribute towards the cost of running the scheme. Some common exclusions from the scheme include cases where the primary focus of business is in the agriculture, horticulture or fisheries sectors, businesses seeking to refinance existing debts, overdrafts, and property-related activities.

In order for a firm to be considered for the Credit Guarantee Scheme (CGS) an initial application will have to be made by the business to a participating bank. A firm cannot apply directly for the scheme. If the application is rejected then the firm can be referred to the Credit Guarantee Scheme by the bank. The participating bank will then assess the viability of the business based on its usual assessment criteria and determine if the firm is suitable for the scheme.

A recent report reviewing the scheme for 2014 was published on the Enterprise Ireland website.[11] It found that as of 31st December 2013 there had been 109 sanctioned CGS facilities accounting for a total of over €14.5 million in CGS lending sanctioned at an average loan amount of €133,922.02. The majority of CGS sanctioned lending appears to be sanctioned for the East region (Dublin, Kildare, Meath and Wicklow) with 51.2 per cent or a total of just over €5.6 million sanctioned for this region. By sector, the Wholesale/Retail Trade and Repairs sector receive 25.3 per cent of all CGS loans (21 sanctioned loans). This works out at just under €1.4 million of approved SGS lending for this sector. However, despite only accounting for 18.1 per cent of approved CGS loans, the Manufacturing sector benefits from over €2.3 million in CGS sanctioned lending with this sector receiving the majority of the monetary value of CGS sanctioned loans at 21.5 per cent. CGS facilities were also granted to 25 firms that were exporters.

[11] Online version of the report is available at http://www.djei.ie/enterprise/smes/CGSQuarterlyReport31stmarch2014.pdf

With regards to the impact that the Credit Guarantee Scheme has on the jobs market, a report[12] reviewing the scheme states that as of September 2013 there has potentially been 273 new jobs created and a further 115 jobs maintained as a result of the credit guarantee scheme.

A recent evaluation of the scheme was conducted for the Department of Jobs, Enterprise and Innovation. Following this review a number of changes were proposed by the Minister in response. These are summarised in Box 1:

Box 1: Proposed Amendments to the Credit Guarantee Scheme

In response to these proposals a number of legislative amendments were proposed as per the response by the Minister for Jobs, Enterprise and Innovation[13] to address the following:

- A wider range of financial products to be available including invoice finance, factoring, leasing and overdrafts removing these restrictions.
- A wider range of financial providers to be available.
- The level of guarantee on individual loans to be increased to 80%.
- The portfolio cap to be increased from 10% to 13%.
- The annual portfolio cap to be removed and replaced by a Single Guarantee Scheme portfolio by each bank.
- The maximum length of the guarantee is to be extended from 3 to 7 years increasing the term limits of the scheme.
- The requirement for the formal decline letter is to be removed.
- A dedicated manager/owner is to be appointed to the scheme.
- The scheme is to be re-launched and re-branded with an effective marketing campaign.
- The scheme is to be managed within the Credit Function of each bank.

Ensuring the implementation of these recommendations is paramount to the scheme's development. The most important of these is to include overdraft facilities, given that the majority of Irish firms are applying for these facilities. This change is therefore very welcome. The increase of the limit to 80 per cent is also not out of line with the other international schemes and corresponds to the rates in Austria and Belgium. Our consultations as part of this research would indicate that current scheme pricing is not a particular challenge to SMEs.

While these changes are very welcome, there are a number of other potential aspects of the scheme that could be explored as the guarantee continues to operate:

- Provide a specific guarantee for start-ups which is accompanied by other support services;

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[12] Online version of the report is available at http://www.djei.ie/enterprise/smes/ReviewoftheSMECreditGuaranteeScheme.pdf

[13] http://www.djei.ie/enterprise/smes/MinistersfindingsandconclusionsontheexternalreviewoftheCreditGuaranteeScheme.pdf

- Manage the scheme as part of a wider-support package for domestic firms so that the guarantee does not act in isolation;
- While state-aid rules may limit the value of supports in recovery, the volume of the total loan commitment should be reviewed in line with empirical evidence on the average amount per application for each financial product.

3.4.2 Credit Mediation and Credit Review Office

The Credit Review Office (CRO) was set up by the government to review cases where credit was either refused, withdrawn, or came with unreasonable conditions attached which the applicant perceives to be unjustified. The CRO was announced in December 2009 as part of Budget 2010 in order to initiate a review process for SMEs, sole traders and farm enterprises that had a credit request refused by a bank that is participating in the NAMA scheme. Participating banks include Allied Irish Bank, Bank of Ireland, EBS and Irish Nationwide Building Society with other banks having the option to voluntarily enter the scheme.

The objective of the CRO is to establish a review process for the purpose of carrying out an independent and impartial review of a bank's decision to reject a credit application. The overall purpose is to collate the outcomes of these appeals into a regular report for the Minister for Finance so that the Minister can examine current credit policy and to assist the government when making future proposals to help increase the flow of credit. The CROs findings are not binding as the CRO has no regulatory or mandatory powers to implement the findings it produces in its reviews. However, banks have to date respected the opinion of the CRO.

The Credit Review Office can review cases of credit rejection of applications from €1,000 to €3m with each review applying to a specific declined credit application meaning applicants with total borrowings above this limit can still apply once the individual case is below the upper limit. According to the most recent report from the CRO (13th Quarterly Report March 2014)[14] there has been a total of 2,308 calls made to the CRO helpline with 457 formal applications made to date. Of the 310 applications that have reached a final conclusion, 170 (55%) of these appeals were ruled in favour of the borrower and 140 ruled in favour of the bank. Of the remaining appeals, some of these have been resolved by the bank and borrower, some have been abandoned by the borrower and some are currently in the review process. The report states that €21.6m in credit has been made available to SMEs and farms for 170 borrowers due to the opinions of the CRO being upheld by the banks.

The CRO was established in response to serious concerns regarding credit restrictions as the banks dealt with the impact of the financial crisis. As the economy and banking sector return to more normal operations, the role and structure of the CRO may need to be revised. A number of

[14] http://www.creditreview.ie/docs/Report13.pdf

countries maintain permanent credit mediation arbitrators, either on a statutory footing or on a voluntary basis, as briefly described below.

There is likely to be an ongoing benefit to preserving an external appeals and mediation office to help facilitate a well-performing banking system. This could be done either through the existing CRO structure or by combining it with the broader remit of the Strategic Banking Corporation. A number of modifications to the current operations to enhance its effectiveness would be recommended if a more permanent structure was put in place. There should be a requirement for all banks operating in the relevant lending market to engage with the CRO as there is a risk of strategic opting out by banks not currently covered by the Office (particularly in the case of new entrants). For all banks, the referral process should be as clear and simple as possible, ideally with an option for firms to choose a default option at the application stage to having their documentation reviewed by the CRO if it is turned down by the bank. The independence and reputation of the CRO as a disinterested player should be a high priority in ensuring its recommendations are considered seriously by all market participants.

An overview of selected credit mediation offices in Europe is presented in Table 4 below. This table portrays the different credit mediation institutions as set up in different OECD countries. As can be seen from the table the Irish credit mediation process is overlooked by the Credit Review Office (CRO) which is an independent body set up by the State to mediate in cases where credit has been refused, withdrawn or came with unreasonable conditions as deemed by the SME. The CRO does not have the power to overturn the decision made by the bank but thus far each recommendation has been respected resulting in an additional €9.6 million mobilised for SMEs between April 2010 and September 2012. The UK equivalent is known as the Appeals Process which is an internal process of mediation within the banks and reviewed by an independent external reviewer who draws up a report on the state of access to credit in the market. Fewer appeals have been accepted through this process then with the Irish mediation process, with a 39.5 per cent success rate for appeals as opposed to a 56 per cent success rate in the Irish case.

Although there is no limit set on the duration of the mediation sources set up in Ireland and the UK, Germany, France and Belgium decided to set up temporary sources of credit mediation as a response to the financial crisis that hit Europe from 2008 onwards. The German and Belgian institutions for credit mediation, although deemed a success, were phased out by the end of 2011. Whereas the French Credit Mediation Office was due to be phased out on several different occasions, by the end of 2010 and extended to the end of 2012 and subsequently extended to the end of 2013, but has thus far not been removed with a new national Credit Mediator appointed on January 4, 2013. The extensions were set after access to credit was deemed to have improved significantly for SMEs.

Table 4: Overview of Selected Credit Mediation Offices in Europe					
Country	**Institutions**	**Established**	**Structure**	**Sectors**	**Volume Overturned Credit**
Ireland	Credit Review Office (CRO)	2010	Independent body consisting of the Head of the Credit Review Office but established by the Minister for Finance	SMEs, sole traders and farm enterprises	262 applications with successful mediation of 56% resulting in €9.6m mobilised from April 2010 to September 2012
UK	Appeals Process	2011	Internal mediation within each bank and reviewed by an independent external reviewer		2,177 appeals with 39.5% success rate from April 2011 to March 2012
Germany	The Credit Mediator	2009-2011	Temporary national credit mediation service set up by the German government and phased out by the end of 2011	Self-employed, entrepreneurs or SMEs	307 firms assisted that had been denied credit with 31% successful mediation or 96 cases mobilising €254.5m between March 2010 and December 2011
France	The Credit Mediation Office	2008-	A national credit mediation service set up by the French Ministry, although temporary the scheme has continuously been extended beyond the original timeframes	Entire business sector with no size limit for eligible country	16,501 firms were assisted that had been rejected credit with a 31% success rate mobilising €4,196m between November 2008 and December 2012
Belgium	The Corporate Credit Mediator	2009-2011	Corporate Credit Mediator was set up by the Federal Government of Belgium	Entire business sector with no size limit for eligible country	712 firms assisted with 60% successful mediation mobilising €153m between 2009 and 2011

Source: OECD.

In April 2011, the six largest banks in the UK launched the Appeals Process which sets new guidelines to ensure a fair and just procedure is in place for businesses to undertake an appeals process if credit has been rejected. To be eligible to appeal under this process, businesses must have a group turnover of £25 million or less and potential start-ups are also included. The original decision is reviewed by a different person at the bank who had not been part of the original decision-making process and the bank considers all original information and any further information with their decision communicated within 30 days of the appeal. If the appeal is declined then the bank can provide information on additional sources of finance. The banks also agreed to the appointment of an Independent External Reviewer for the direct purpose of conducting an independent review of the banks internal appeals process and producing annual reports to be made available to the public. The main difference between the appeals process in Ireland and the UK is that in the UK the purpose of the mediator is not to establish an independent external appeals process but to scrutinise the appeals process conducted internally within each of the big banks. The Appeals Process found that between April 2011 and March 2012 there have been 2,177 appeals with a success rate of 39.5% as recorded by an OECD report on Credit Mediation for SMEs and Entrepreneurs.[15] However, only 2 per cent of denied credit requests resulted in an appeal.

The French credit mediation service was initially implemented by the President in October 2008 and has been extended by the Ministry of the Economy. However, the mediation process itself is run by the Banque de France through a network of 105 local mediators. This allows the mediation process to exhibit a degree of independence from Ministry involvement. At the national level, operational costs are covered by the Ministry of the Economy with costs on the department level covered by the Banque de France. This also allows the Credit Mediation Office to combine supports with other national and local credit institutes providing funds for SMEs, in order to provide other forms of financial assistance such as credit guarantees. They are also capable of developing a professional network of support services for SMEs by appointing trusted third-party mediators to each department, including experts from trade associations, and employers' federations and associations. This resulted in the credit mediation process being extended to address issues such as credit insurance and financing needs of SMEs. If Ireland continues to provide credit mediation as a permanent fixture of Irish public policy, then an appropriate model to follow may be the French mediation process due to these three features of the French Credit Mediation Office.

3.4.3 Microfinance Ireland

Microfinance Ireland was established as part of the Action Plan for Jobs to fulfil the Microenterprise Loan Fund as set up by the Irish Government, and it operates on a not-for-profit basis. The purpose of the fund is to provide a number of financial schemes to assist micro enterprises by providing additional lending to commercially viable microenterprises for start-up or growth across industry sectors. The scheme generally is available to sole traders, partnerships, or limited companies.

To qualify, the business must be based in the Republic of Ireland and have a turnover of less than €2 million and less than 10 employees. The business must have been previously rejected for bank credit, either formally or informally, in which case an unsecured business loan of between €2,000 and €25,000 can be provided. Co-funding bank proposals will also be considered. There is a fixed APR interest rate of 8.8 per cent with monthly repayments and the loans are usually for 3 years' duration, a 5-year loan may be considered if the business applied for a loan for capital financing.

Since it was established in October 2012 until the most recent data available at the end of the first quarter of 2014, Microfinance Ireland had lent out €3.022 million to 192 firms. This gives an average loan amount of €15,700. The approval rate has been just over 50 per cent and most of the loans have gone to extremely small firms (fewer than 3 employees), mainly at the start-up stage.

One limitation on the activity of Microfinance in its early stages was a requirement for the applicant to have received a formal rejection for a bank loan. Although the motivation behind this restriction to ensure that the Microfinance lending was additional was reasonable, it created a disincentive and

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[15] http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=CFE/SME(2011)8/FINAL&docLanguage=En

administrative hurdle that was later seen as unnecessary. Although applicants must still provide self-certification that other financing was not available to them, this does not need to come in the form of an official bank rejection. A welcome development related to this is the increasing level of referrals coming from the Local Enterprise Offices (LEOs), which should be the natural conduit for linking micro firms with potential funding sources of this type.

The Microfinance scheme has so far been in operation for a relatively short period of time and has very gradually been increasing the pace of its operations. It is therefore difficult to provide an evaluation of its economic impact. However, discussions with relevant stakeholders have given a broadly positive view that the scheme is beginning to fill an important niche in early-stage firm funding and that continuing the scheme, ideally in conjunction with the LEOs, will contribute to building an entrepreneurial culture and longer term job creation. In this context, we would note that early stage entrepreneurship funding is a structural issue across many countries rather than a temporary crisis-related restriction of credit. Therefore, it is recommended that consideration be given to making this scheme permanent, subject to review of its current performance and ongoing monitoring of the availability of other finance sources.

In continuing the scheme, a number of limitations on its operations were noted in stakeholder consultations and should be examined in order to increase the scope and impact of Microfinance. The cap on loans of €25,000, although fairly significantly above the current average loan amount is still relatively low, and consideration could be given to increasing this limit. The term length of the loans, particularly if they are larger amounts linked to asset purchases rather than working capital requirements, should be increased (perhaps to seven years) to allow the firm more time to become established and some additional flexibility in payment schedules added. Further flexibility could be added by allowing some variation in the interest rate across different types of application and perhaps in return for payment delays or other adjustable mechanisms.

Finally, awareness of the Microfinance scheme was judged to be fairly limited, perhaps not surprisingly so given its relatively recent introduction and the need to establish its operating procedures. Now that it is up and running, however, a greater level of engagement and advertising to promote knowledge and usage of the scheme (and linked to promotion of entrepreneurship more generally) is important.

3.4.4 The Strategic Banking Corporation of Ireland

The Strategic Banking Corporation of Ireland (SBCI) was set up by the Irish government as part of the Action Plan for Jobs 2014 for the purpose of making an additional €800 million available in credit for Irish SMEs. The initial funding required for this new company will be provided by the European Investment Bank (EIB), the German Promotional Bank Kreditanstalt für Wiederaufbau (KfW), and the Irish Strategic Investment Fund (ISIF). Funds will be sourced externally by the SBCI and loaned to SMEs through institutions called on-lenders, such as retail banks, with a lower cost of funding which must be passed on to SMEs. Two types of SMEs that can benefit from an SBCI funded loan include new start-ups and established SMEs seeking funding for growth.

The additional supply of credit channelled through the SBCI has a number of advantages over other potential funding sources. In particular, there will be a focus on providing longer term and more flexible loan products. This is particularly important in terms of the ability of firms to use the loans made available from SBCI funds to engage in productive investment that may have a longer payback period but be of significant economic impact. The lower cost of the loans is also locked in over a longer period of time, thus removing some of the risks associated with shorter-term market funding from the financial institution perspective.

In addition to the direct effect on the supply of credit that it will provide to the market, the SBCI also has significant potential to improve competition in the SME lending sector, which is likely to have an important longer-term effect in facilitating economic growth. As we will discuss in more detail later in this chapter, the current levels of concentration in the SME lending market raise a serious risk of limited competition and accompanying restrictions in ongoing credit supply. The SBCI has the capacity to make an important contribution in this space by providing a new source of potential funding supply and also lowering barriers for entry for new entrants into the SME lending market. With potential new lenders seeking to expand by utilising the SBCI to make inroads into the SME lending market, it could prove that extra funds into the SME lending market may be possible and thus provide adequate additionality through extra funding. It is, therefore, important that this be a central metric by which the SBCI is evaluated, rather than to concentrate on the volume of loans and repayment rates channelled through existing lending institutions.

Some potential challenges facing the Strategic Banking Corporation of Ireland stem from the fact that many banks and firms are currently stating that the big issue in the SME lending market is not the cost of funds, but rather the access to funds. As the SME lending market is currently made up of a few big lenders, it is possible that the SBCI will only serve to provide lower cost funding rather than extra funding and thus result in low additionality and high substitute lending. This concern is strengthened by the fact that the risk of any loans remains on the balance sheets of the individual on-lenders and they may, therefore, channel funds obtained from the SBCI towards safer lending that would perhaps have been undertaken in any case. A recent review of the loans for SME schemes undertaken through on-lending to financial institutions by the EIB noted these same concerns so this is a general issue for any type of development fund rather than a specific feature of the design of the SBCI but it is nonetheless an important one to be cognisant of when evaluating the overall impact of the new lending (EIB, 2013).

The performance of the SBCI and the role it plays should be revisited regularly. The option to broaden its mandate into a role as a direct lender should be considered in the future if its desired impact on attracting additional competition to the SME lending market is found to have been limited after a reasonable length of time. This has been foreseen in the legislation passed to give effect to the SBCI, with provisions for direct lending already incorporated if this is deemed a suitable path to move towards in the future. The model of indirect on-lending is, however, a well-established model to follow for strategic development institutions (international examples are discussed in the next subsection) and the SBCI is not unusual in this regard.

International Examples of Strategic or State Banks Funding SMEs

The German KfW Bankengruppe is a government owned development bank which raises funds from government backed bonds for development investment. The section responsible for providing financial assistance for German SMEs and start-ups is known as the KfW Mittelstandsbank. KfW provides loans, equity and mezzanine finance to German SMEs and it also provides loans to European commercial banks for the purpose of SME financing. Between 2009 and 2013 the KfW has made loans of €14 billion to approximately 20,000 firms. The KfW also allows union officials and employers to sit on the committee to suggest sectors of possible investment in medium-sized industry.

The British Business Investment Programme aims to provide more options for SMEs in the UK with regards to obtaining access to finance by increasing the availability of debt finance markets, expanding the types or amount of available debt funding, providing new financial funding for SMEs, and working with private sector sources to finance new funding for SMEs. The programme will invest £400 million with private investors and is available for lenders seeking government investment of between £10 million and £100 million to provide loans or debt financing to viable SMEs operating in the UK. Types of investments on offer include equity and debt instruments, debt funds or asset backed lenders, and non-bank finance such as supply chain financing or peer to peer lending. The programme has two main categories of investment. There are Managed Investments, which manage investments alongside the private sector into managed lending funds that lend directly to SMEs, and Direct Capital Investments, which are cooperative investments alongside the private sector through equity financing or debt injections for SMEs.

The purpose of the French Public Investment Bank is to provide firms with a wide range of financial instruments and advice to encourage innovation and development. The programme is mainly aimed at SMEs and mid-cap companies. The BPI aims to provide public funding for SMEs and social enterprise players, through equity capital, loans, and credit guarantees, while creating an umbrella structure to develop new management capacity. The BPI has a lending capacity of up to €20 billion which can be provided by loans to firms, with €12 billion extra available in credit guarantees and €10 billion for investment in equity capital. The stated purpose of the BPI is to lessen the negative impact of market failures on SME funding, to invest in upcoming strategic sectors, and to become a powerful financial lever for developing French regions.

The Instituto de Crédito Oficial (ICO) is a Spanish state-owned bank that provides grant loans to firms seeking financial assistance for investment or liquidity purposes. The ICO obtains financing from the national and international markets with a guarantee granted for those debts from the Spanish State. Funds are open to both Spanish firms and firms outside of Spain either directly or through a financial intermediary. To apply for a direct loan firms are required to approach the ICO directly and a minimum amount of €10 million can be provided with long repayment terms. The ICO also provides the financial instruments required by the Spanish government to support exports and developmental aid. The European Investment Bank (EIB) recently granted €1 billion in loans to the ICO (May 2014) with the ICO matching the loan from the EIB bringing the total to €2 billion. These funds are to be made available to help finance investment projects, and to provide funds and facilitate access to bank credit for SMEs and mid-caps. €25 million will be provided to finance investment projects for SMEs and €50 million for mid-caps.

The government in Chile provides direct funding for micro and small enterprises in the agricultural sector through mostly short term loans via an Institute for the Development of Agriculture and Livestock (INDAP). Chile also has a government bank, Banco Estado, to provide a guarantee fund for micro and small business through a public guarantee fund. A similar bank that relies on the Ministry of Economy provides microcredit and loan guarantees.

3.4.5 Regulatory Changes and Risk Appetite of Lenders

There is a risk that the stricter global regulation being introduced as part of the Basel Capital Accord (and the Capital Requirements Directive IV package which transposes the Basel framework into EU law) may have a negative effect in constraining bank lending to SMEs. As the new Accord will require banks to have tighter risk management and higher capital requirements, banks may limit the availability of funding for SMEs, particularly banks that are still under pressure to deleverage as they continue to work through the debt overhang following the financial crisis.

The risk weighing applied to SME loans under the new rules can be reduced if the loans are backed by a government guarantee. In addition to the capital rules, stricter liquidity coverage related to undrawn lines of credit will be required, potentially resulting in overdraft facilities for SMEs becoming more expensive.

Box 2: Implementation of the CRD IV Regulation and SMEs

Overview of Proposed Changes

Following the global financial crisis which revealed weaknesses in the previously initiated Basel I and Basel II regulatory framework, a number of new international financial regulatory mechanisms were required in relation to minimum capital requirements for financial institutions. This resulted in the implementation of the International Regulatory Framework for Banks (Basel III), which concentrated on "internationally active banks", with the European Union implementing aspects of Basel III through the CRD IV and the CRR which was wider in scope and covered all lending institutions and investment firms in the EU. A number of new capital requirements and capital buffers were set out as part of the Capital Requirements Directive in order to provide a greater 'cushion' for absorbing losses.

Five new capital buffers were introduced through CRD IV with two specific buffers of particular interest for SMEs, the capital conservation buffer (CCP) which is 2.5 per cent of total risk exposure and the countercyclical capital buffer (CCyB) which is variable. The purpose of the capital conservation buffer is to act as a supplementary capital cushion to conserve an institution's regulatory capital at the consolidated and individual levels and is due to be phased in from 2016 onwards. From 2016 the capital buffer for SME investment firms will be 0.625 per cent and will gradually build to 2.5 per cent by 2019. The calculation of the countercyclical buffer is based on the deviation of the ratio of credit-to-GDP from the long run trend.

Each institution must calculate their own specific CCyB rate which is calculated as the weighted average of the CCyB rates of their relevant credit exposure. CCyB rates are applicable across different jurisdictions with each jurisdiction establishing a CCyB rate requirement between 0 and 2.5 per cent with the CCyB rates phased in from 2016 onwards. If an institution breaches its combined buffer requirement then it must retain a portion of its earnings while restricting dividends, share buybacks, discretionary bonuses, discretionary pension benefits, and payments on extra Tier 1 (AT1) capital instruments.

Treatment of Bank SME Loans

Due to the importance of SMEs to delivering sustainable economic growth and employment, bank SME loans are treated differently to ensure there is an appropriate flow of bank credit to SMEs to help fill the existing funding gap.

Banks can provide an exemption to the requirement to hold a CCB and a CCyB for small and medium sized enterprises so long as such an exemption does not threaten the financial stability of the Member State. In order to qualify for such exemptions the investment firm must comply with the European Commission's definition of a small and medium-sized enterprise. If the firm however is not a standalone firm then the criteria applies to the wider set of enterprises linked with the firm. The SME or group of SMEs must also not owe more than €1.5m to the banking group. This exemption will aim to reduce the capital charge for SMEs. The exemption also applies on a macro level, so either all SMEs are exempt or none are exempt. The banks must also report the total amount of their exposures to SMEs to competent authorities every three months. These caveats to the new regulatory regime may allow lighter treatment with regards to Irish SME lending from 2016 onwards.

3.4.6 Market Structure and Competition

The level of concentration of SME lending in the market can have a significant impact on the ability of SMEs to access the level of funding that may be required. If the majority of SME loans are granted by a small number of lending institutions with enormous market power, then SMEs may find it more difficult to gain access to finance due to higher interest rates or greater eligibility criteria due to a lack of competition. A recent paper by McCann and McIndoe-Calder (2012a) found that there has been increased concentration in the private loans market, and an even bigger increase in concentration for SME loans, since the onset of the economic and financial crisis in 2008. There also appears to be a trend towards increased market concentration for SME loans in the future. This may be due to the formation of the two pillar banks system, with AIB and Bank of Ireland as the core pillars of the banking industry in Ireland. This suggests that SMEs in Ireland are more likely to face greater difficulty with regards to gaining access to credit. This may make it more difficult for smaller firms to access credit and remain out of default.

In other research, McCann and McIndoe-Calder (2012b) found that the default rates for the smallest 10 per cent of firms are more than twice the size of those of the largest 10 per cent. This suggests that small firms are finding it more difficult in an increasingly concentrated lending market to access the financial assistance they require to continue funding day to day operations or to fend off default. The paper also shows that the highest default rates in Ireland were recorded for sectors that were more closely associated with the mid-2000s boom, such as construction and real estate. This suggests that firms in sectors that benefited most from the pre-crisis boom are those facing great difficulty in accessing credit and therefore facing default.

There is, however, some conflicting evidence with some claiming that market power can allow banks the time to invest in developing long-term relationships with growing firms, whereas other studies suggest that competition between banks is more likely to result in greater availability of lending to SMEs. The effect of competition may vary across countries depending on how easily collateral can be transferred between lenders and how much information about a firm is available to all banks (through credit registers for example) compared to relationship-specific information that may tie a firm to a particular bank (Beck, 2007).

The evidence on the effect of foreign bank entry on SME lending is also somewhat mixed. Cross-country studies, mainly of developing countries, tend to show that firms report easier access to finance where the financial system has a higher share of foreign banks, although it has not been established if this is a direct effect of the foreign banks lending more to firms or an indirect effect of greater competition. On the opposite side, research on credit constraints in individual countries has found that foreign banks are less likely to lend to small firms, perhaps suggesting that it is a competition effect that dominates (Beck, 2007).

Relationship lending is the common style of interaction between small firms and their banks, whereby ongoing contact and provision of multiple different services (current accounts, credit cards, different credit lines and loans) begin to reduce the usual information asymmetries believed to exist between small firms and financial institutions. Relationship banking is therefore expected to be beneficial to the bank in gathering information that allows it to make better lending decisions and also to have benefits for firms in allowing them access to more or lower-cost credit as their reputation with the bank builds over time.

However, a single banking relationship can leave the firm in a difficult position if credit is withdrawn, even if the reason is because of deterioration in the bank's own liquidity position rather than a change in the prospects of the firm itself. Moving to a new institution can be difficult as the information built up over the course of the relationship is not necessarily easy to convey. Information sharing by financial institutions, through a central credit register for example, can go some way to make switching possible and reduce some of the market power a bank in an relationship banking situation may have over a firm (Berger and Udell, 1998).

As discussed above, the policy approach to improving the competitiveness of the Irish banking sector, particularly in relation to SME lending, is to use the Strategic Banking Corporation of Ireland (SBCI) as a conduit for improving the flow of lending supply and to reduce entry barriers. This is a promising initiative but, given that it has just recently been launched, it will require some time to have an influence on the market. The early indications, however, are that new players have expressed an interest in expanding operations into the SME lending area and the SBCI will work towards further encouraging these developments.

For SMEs at the smaller end of the size spectrum requiring relatively small amounts of credit, consideration at a policy and regulatory level should be given to the possibility of expanding the role of credit unions. Currently, there are only a very small number of (mainly larger) credit unions that have approval to engage in this type of lending. The credit union model has the advantage of a wide branch network and local knowledge which would make them a potentially effective outlet for micro-enterprise lending. Their local base on the other hand also poses one of the main risks for credit unions entering this market as their funding sources and lending would be very exposed to local shocks. To be a viable model with a minimisation of risk, it is likely that some level of pooled central fund (either as a main source of funds or as a back-stop) would be necessary. Upfront costs of investment in risk analysis and business lending skills would also have to be made before moving into a new business area. Regulatory issues would play an important role and have to be evaluated in detail before such a development could progress, but would be worthy of some assessment.

3.4.7 Finance for Export Schemes

In general, well-performing export companies are reasonably well-provided for in terms of funding and have access to a number of supports for growth (primarily through Enterprise Ireland). However, one area where recent research identified a gap is in accessing working capital for export purposes (Holton *et al.,* 2013). Exporting by nature incurs additional risks over and above domestic trading activity. These risks can come through commercial relationships with the foreign buyer (through their creditworthiness/risk of default), commercial risk of conducting business across borders with different legislative frameworks and regulatory structures and also through geopolitical risks in external jurisdictions. These risks may be heightened when exporting to emerging markets which may provide the best growth prospects for many Irish exporters.

In addition, it is universally accepted in the literature, that to begin exporting many firms face considerable sunk costs of investing in a new market and can face challenges financing these transitions in both working capital and investment terms (see for example, Roberts and Tybout, 1997).

To address these two particular issues, many governments provide a suite of financial instruments to help facilitate exporting activity. Many are provided through “Export Credit Agencies” or export-specific development banks (EX-IM Bank US, Export Development Bank in Czech Republic) and are also provided in many cases as part of a suite of export support services which help facilitate the development of export capacities and capabilities.

While Enterprise Ireland very successfully delivers support services to Irish SMEs, providing access to growth capital funding and other financing arrangements, Ireland currently does not have these bespoke “Export Credit” services available. In 1998, following difficulties with previous arrangements, Ireland discontinued its export credit insurance scheme. As a small open economy, whose future growth prospects are very much dependent on external linkages, providing these tailored services should help to facilitate greater export propensity. Within the suite of “Export Credit” facilities, there are a range of instruments that are commonly used. A selected overview of commonly used products is provided in Box 3.

Box 3: Typical Export Credit Instruments

As part of the suite of export credit instruments provided across different countries, a number of products are commonly used. These are the following:

- **Supplier Export Credit Insurance:** The exporter provides credit to the international buyer and an insurance product is provided by the state agency on the risk of default to the exporter. These products are usually provided to insure either the exporter or the exporter’s bank against the risk of default on behalf of the foreign buyer. They can be provided direct to the exporter or on the Letters of Credit from the bank. Risk coverage is provided for commercial or political scenarios. Time frames for this financial instrument are usually less than 360 days.
- **Export Loan Guarantees/Financing Guarantees:** These facilities provide guarantees to the exporter’s bank to cover additional lending which enables the borrower to undertake export activity. Financing guarantees can also be provided on letters of credit, a bank guarantee or bill of exchange with the foreign bank. While facilities can be provided on credit of less than 360 days, where longer term financing is required, these products can be tailored to cover loans of a greater maturity. This can be beneficial where large fixed capital goods are the export product.
- **Buyer Financing:** This facility is available to providing financing to international buyers to complete the purchase with the domestic exporter. The risk for re-payment default is then shifted from the domestic firm to the credit agency. This improves the cash flow and decreases the financial vulnerability of the domestic firm.
- **Project Finance:** Project finance facilities can be either insurance or guarantee products and are provided in the case where there is a once off project with a particular risk attached.
- **Pre-Credit Agreements:** Pre-credit insurance provides the exporter with a guarantee against a buyer default which occurs before the date for which the firm is entitled to payment.

- **Direct Loan Facilities:** In some jurisdictions, government agencies can provide direct financing facilities to firms to fund export activities.
- **Contract Bonds:** In many cases, international buyers require contracted bonds from exporters which provide the buyer with security against default risk, substandard provision of goods or services, substandard completion of contract terms or other transition specific occurrences. These bonds can include bid-bonds, performance bonds, advance payment bonds or retention bonds.

Many OECD countries utilise export credit agencies to aid smaller exporters through export credit systems. Some of these agencies will have special teams devoted to small exporters for working capital. Australia, for example, utilises an Export Working Capital Guarantee for SMEs which provides banks with a guarantee for providing working capital to small businesses for the purpose of supporting exports. Canada also has a programme called the Pre-Shipment Working Capital programme which provides a risk-share guarantee to banks for a specific SME export contract. An overview of the Danish export working capital scheme is presented in Box 4.

Box 4: Export Working Capital Financing in Denmark

The Danish Working Capital Guarantee (Eksport Kredit Fonden or EFK) assists businesses with the financing of their current operating costs and it can cover businesses with operational costs in relation to general or specific export orders. Once a business has secured an order for export, additional working capital may be necessary or additional finance may be required to cover the additional security necessary for the buyer to pay in advance. If the bank declines to provide the credit for working capital or collateral then the business can apply for a working capital guarantee from EFK to cover up to 80 per cent of the liquidity required to fill the order. EFK covers up to 50 per cent of the bank's total loss on the loan and the Working Capital Guarantee can be obtained for up to 50 per cent of the company's annual export turnover, with no minimum amount.

If the bank is registered under the scheme, then the bank can initiate this process, otherwise the business will have to contact EFK directly. The application is then processed by both the bank and EFK and if the SME meets the necessary conditions, then EFK will offer to either guarantee the business's credit or guarantee the bank's credit for the business. The SME can then obtain the credit necessary to fund the working capital required while completing the export order, with the guarantee lasting up to 3 years. The premiums required from SMEs are set by the EU and depend on the credit rating of the SME as assessed by EFK.

Table 5 below presents an overview of the products provided by a selected group of export credit agencies from a number of countries. It can be seen that export credit insurance, export credit guarantees, and buyer financing are nearly universally provided across the group of countries selected. Bond products are also widely provided. The direct provision of loans is not universal and many countries prefer to intervene in conjunction with a market participant through insurance or guarantee products.

Table 5: Overview of Product Scope of Selected Export Credit Agencies									
Country	**Institutions**	**Export Credit Insurance**	**Export Credit Guarantees**	**Direct Domestic SME Financing**	**Buyer Financing**	**Bond Products**	**Pre-Credit Facilities**	**Project Finance**	**Internation-alisation Loan**
Czech Republic	The Czech Export Bank (CEB) / the Export Guarantee and Insurance Corporation (EGIC/EGAP)	√	√	√	n.a.	√	√	√	√
Denmark	EKF	√	√	X	√	√	√	√	n.a.
Finland	Finnvera	√	√	√*	√	√	√	n.a.	√
Korea	Small Business Corporation	√	√	√	√	√	√	√	n.a.
New Zealand	New Zealand Export Credit Office	√	√	X	√	√	√	√	n.a.
Sweden	Swedish Export Credit Corporation	√	√	√	√	√	√	√	n.a.
United Kingdom	UK Export Finance	√	√	X	√	√	n.a.	n.a.	X
United States	EX-IM Bank	√	√	X	√	√	√	√	X

Notes * For financing less than €35,000. If greater than this amount, Finnvera can only act as a co-financier.

In providing some guidance for the development of such a funding scheme for Ireland, Table 6 below draws on a number of specific instruments which are typically provided and assesses their likely relevance for the majority of Irish exporting SMEs. The descriptions of the likely candidate firms are adapted from information taken from the New Zealand Export Credit Office (NZECO).

Table 6: Selected Export Credit Instruments and their Relevance for Irish SMEs

Export Credit Instrument	Likely Candidate Firm	Relevance Across Irish SMEs
Contract Bond Guarantee	Exporter who requires a bond to complete contract but it is not forthcoming from market sources. Exporter may not have sufficient collateral to cover the bond.	High
Export Credit Insurance	Exporters who wish to gain cover against commercial or political risk. Can be designed to suit the financing term.	High
Working Capital Guarantee	Exporters who have reached the limit of their banking facilities but require additional trade finance or working capital.	High
Short Term Credit Guarantees	Most exporters who can demonstrate financial and trading capacity and where no market provided finance product is available.	High
Medium/Long Term Credit Guarantees	Manufacturing and industrial firms selling capital goods that have a lifespan longer than the term loan.	Medium
Pre-Credit Guarantee	Exporter with bespoke, buyer-specific goods of limited salvage or resale	Low
Project Finance Facility	Exporters who are conducting a one off, potentially capital intensive project, on a specific contract.	Low
Buyer Finance	Exporters who have buyers that are unable to arrange finance.	Low

Source: ESRI Adapted from NZECO information.

As many export contracts require bond products, a funding agency should provide support for these instruments. Additionally, as the majority of credit applications in Ireland are for working capital facilities, guarantees for export working capital may be a very appropriate instrument for Irish exporters. Credit insurance policies should also be considered and evaluated. Given their international success, Ireland's past experience with these facilities should not be grounds for blocking their implementation, if they are deemed a suitable product for current Irish SMEs.

3.4.8 SME Securitisation

Much policy attention across Europe since the banking crisis has focused on ways to reduce the amount of risk carried on bank balance sheets and hence ease their ability to provide new flows of credit. One specific way in which this can be done is through the securitisation of loans, selling on to private investors tranches of SME-backed pooled loans. As part of the broad Horizon 2020 programme, the European Commission has suggested that it facilitate securitisation of SME debt finance portfolios (European Commission, 2011). The purpose of this securitisation is to enable SMEs to access additional debt financing through the establishment of satisfactory risk-sharing arrangements with targeted institutions, under the condition that originating institutions utilise a significant portion of remaining liquidity for new SME lending (European Commission, 2014) on top of the securitisation of existing loans.

The legal framework currently overlooking these securitisation instruments is subject to the COSME and HORIZON 2020 programmes as set up by the European Commission with COSME serving all SMEs and HORIZON 2020 serving SMEs with potential innovation as examined by Kraemer-Eis, Passaris and Tappi (2013). There is currently an on-going market testing of the initiative with strong interest expressed by stakeholders for such an EU programme that could overcome problems associated with national initiatives. Given the heterogeneity and riskiness of SME loan bundles, it is likely that some back-stop provided by the European Investment Bank or European Investment Fund would have to play a role at least in the initial stages of developing such a market.

From an Irish perspective, the development of a European market in SME securitisation would be a welcome addition to enable banks to reduce some of the risk currently held on their balance sheets. The Irish market alone is too small and illiquid for a national initiative to gain much traction in this policy space but active support to increase the momentum in moving the proposals forward at the level of the relevant European institutions should be of potential benefit to Ireland.

3.4.9 Other Issues

The efficient allocation of credit in any banking system relies on good risk appraisal. Two ways in which this can be improved for the Irish market in the future are the continued investment in skills at banking level and the development of the new credit register to aid banks in their decision-making process.

At bank level, there is widespread agreement that much of the lending during the credit boom was based on the use of property assets as collateral with a resulting degrading of staff skills in making decisions and evaluating risks based on cash-flows or business plans. There has been steady investment in the banks to move business lending back to being based on the appraisal of business plans and cash-flows rather than being largely asset based but skills have to be further developed in these areas.

As we saw earlier in this chapter, the share of Irish firms reporting increased collateral requirements was on the upper end of the country distribution relative to the rest of the Eurozone, indicating that Irish financial institutions remain quite asset-focused in their lending decisions. Pledging of collateral will always have an important role to play in gauging the risks of any lending decision but, particularly for firms in more innovative or services sectors where intangible assets are more significant, it is important that collateral availability is not the dominant driver of credit availability.

The best way to avoid this scenario is to emphasise and build up skills in business planning and evaluation at the level of the financial institutions.

These investments in skills are an issue for individual lending institutions but will be supported by policy initiatives designed to share information and improve risk pricing. The critical development in this regard is the importance of credit register information, which was established as part of the Credit Reporting Act 2013.[16] For all types of financing, increased credit risk analysis and availability of credit rating information reduces costs and risks. The completion and rollout of the credit register should therefore be considered a priority.

16 http://www.finance.gov.ie/news-centre/press-releases/credit-reporting-act-2013

Chapter 4

Non-Bank Debt Financing

Summary of Chapter Findings

- Formal debt issuance is fairly uncommon as a financing source, with less than 1 per cent SMEs funding investment by this method. However, a larger percentage indicated that issuing debt securities is a potentially relevant source of financing.
- We look at the size and performance of the SME bond market in Germany to give an indication of the potential scale an equivalent new market could have in Ireland.
- Trade credit (from suppliers and customers) is one of the most widely used sources of funding by Irish firms and the highest in the Eurozone. One-third of Irish firms used trade credit facilities to fund working capital and 6 per cent used it to fund investment.
- Trade credit usage increases with firm size and age, probably reflecting the need for reputation to be established before such credit is extended. On the other hand, reliance in terms of the percentage of funding covered by the source decreases with age.
- Crowdfunding is a recent development in financing and is currently used by a small fraction of firms. We find that 1 per cent of Irish SMEs applied for crowdfunding between October and March 2014 with a success rate of close to one-third. Applications tend to be higher for very young firms and those in ICT-related activities.
- While a majority of firms indicate that they do not need this financing type, 15 per cent of firms indicated they did not apply because of a lack of knowledge.
- Informal loans from friends, family and business partners play an important role in financing many firms. Success rates for these loans are high, implying a less stringent credit allocation through this source relative to bank financing.
- Applications for informal loans are higher for micro firms and those in the ICT sector, which may find it difficult to get other types of financing.
- It would appear than informal loans from friends or family are being targeted at firms displaying outward signs of financial distress. This includes firms in default and loss making enterprises.
- Research for this report would suggest that innovative enterprises are more likely to apply for non-bank alternative financing which may suggest difficulties at the bank level in funding such firms.

Key Policy Reflections and Recommendations

1. A proposal to broaden the range of funding options for SMEs through the creation of a 'retail mini bond' market is currently being evaluated under the Action Plan for Jobs 2014.
2. Such a market could provide additional funding opportunities to some firms but it is important to note that this type of funding would be most applicable to a relatively small

number of firms at the medium end of the SME market due to the significant regulatory and disclosure costs that would have to be incurred.

3. If the successful introduction of such a scheme is a policy objective, some type of tax incentives (e.g., capital gains exemption, stamp duty exemption) would be probably needed to counteract the level of risk involved for investors in a mini-bond market if it is to be successful. However, this report does not specifically call for such an incentive and a full evaluation would be required if this is to be taken further.
4. Reducing compliance costs by standardising documentation and providing templates for disclosure would contribute to reducing costs for firms listing bonds and encourage the use of such a market.
5. For the smooth operation of trade credit relationships, the focus has been on encouraging a culture of corporate responsibility for larger businesses with regards to payments to their suppliers. The Code of Conduct on Prompt Payments is a welcome development in this area. A promotion and awareness campaign to encourage participation would help maximise the effectiveness of the scheme.
6. Given the high numbers of firms reporting unfamiliarity with crowdfunding/peer-to-peer lending, initiatives to provide information could facilitate greater interest in this type of financing.
7. There are no policy measures in place for crowdfunding in Ireland. We discuss a UK support scheme whereby once private sector investors had committed 90 per cent of the required amount, the government would contribute the final 10 per cent needed to fund the proposed project. We suggest this model be evaluated further to see if it could be used as a model here.
8. These is widespread use of informal loans in financing smaller business. However, if firms are using informal finance because of constraints in accessing more formal credit and equity finance, this may be a source of concern. Policy measures to alleviate bottlenecks in financing through formal channels should reduce any over reliance on informal sources.

4.1 Introduction and Chapter Overview

Reducing Ireland's dependence on bank financing and developing a funding ecosystem with a wider range of capital financing is an important policy objective. To achieve this objective, liquid, widely available alternative sources of financing are going to be required. In this chapter we review a number of non-bank debt instruments or sources and evaluate their potential contribution to further diversifying the funding mix.

Our analysis provides a statistical overview as well as a review of potential policy developments for the following types of financing source: formal debt issuance, mezzanine financing, trade credit, crowdfunding or peer-to-peer lending, and loans from business partners or informal sources of debt. We begin with section 4.2 by discussing Formal Market Debt and SMEs. This section is broken down into individual parts with section 4.2.1 Formal debt issuance, section 4.2.2 Formal Debt Policy Issues, and section 4.2.3 Developing alternative funds. Section 4.3 examines Trade Credit, section 4.4 examines Crowdfunding, and section 4.5 examines Business and Informal Market Lending.

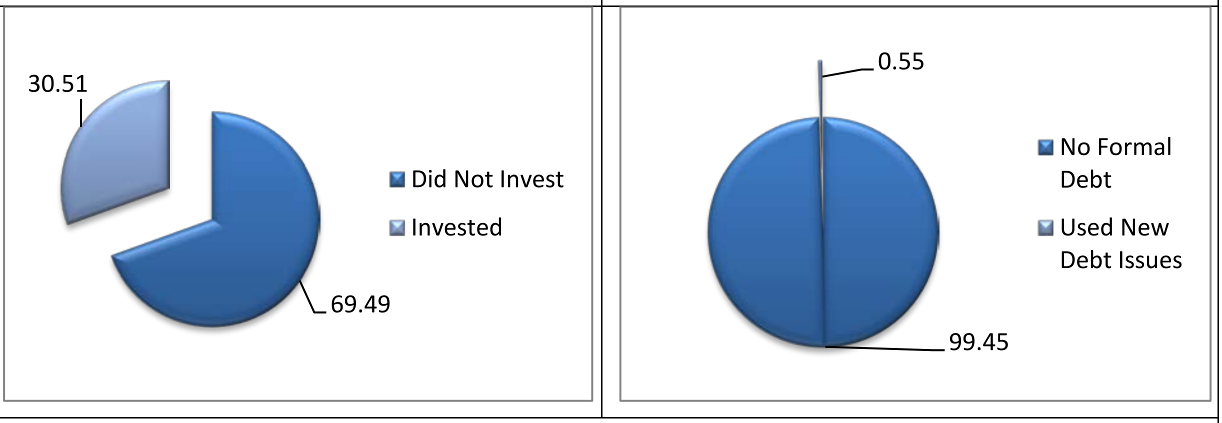
4.2 Formal Market Debt and SMEs

4.2.1 Formal debt issuance

Formal debt issuance is a little used instrument amongst Irish and European SMEs. We do not have applications data on this instrument so we cannot benchmark applications, their success and the reasons for not applying. However, we do know if firms used debt issuance to fund investment. Figure 21 below presents the share of Irish SMEs investing and the percentage of investors that used issued debt to fund investment. The total sample size is circa 1,500 firms from the latest wave of the Department of Finance data, (from October 2013 to March 2014).

Figure 21: Percentage of Irish SMEs Financing Investment using Debt Securities Issued

% of SMEs Investing | % of Investing SMEs using Issued Debt

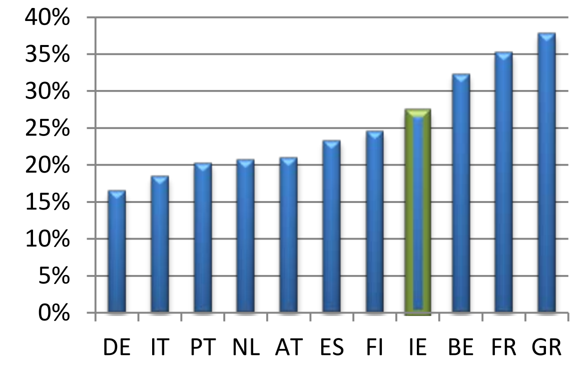
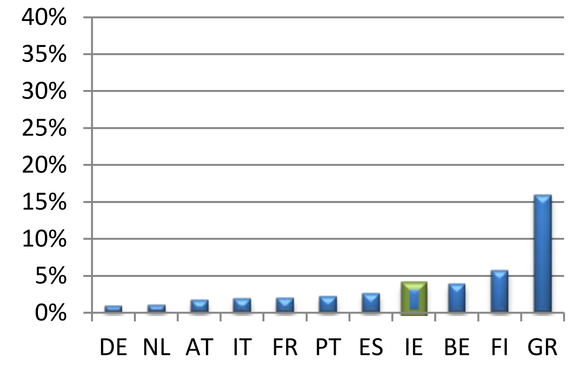


Source: ESRI Analysis of Department of Finance Credit Demand Survey.

While 30.51 per cent of Irish SMEs invested in fixed assets, less than 1 per cent of the investing SMEs used formal debt issuances to fund its activity. For the firms who did use issued debt, on average the volume accounted for 62 per cent of total investment cost. However, with only 5 observations in our data this share must not be viewed as robust or reliable.

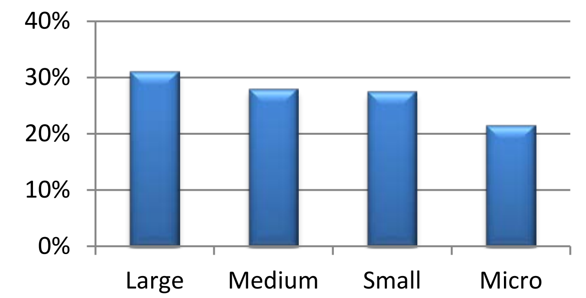
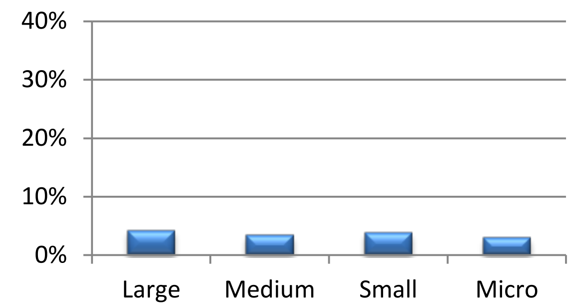
Focusing on the indicators from the ECB SAFE survey, Figure 22 presents the mean values of the relevance and usage variables for each of the Eurozone members for debt securities issued. Both large firms and SMEs are included in these data, and the indicators are split out for large firms and SMEs below. Approximately, 28 per cent of Irish firms indicate that issuing debt securities is a relevant source of financing. However, only 3.8 per cent indicate they issued such securities in the last six months. In a comparative perspective, Ireland is fourth in the use and relevance of this financing type behind Greece, France and Belgium.

Figure 22: Relevance and Usage of Debt Securities Issued Amongst European Firms

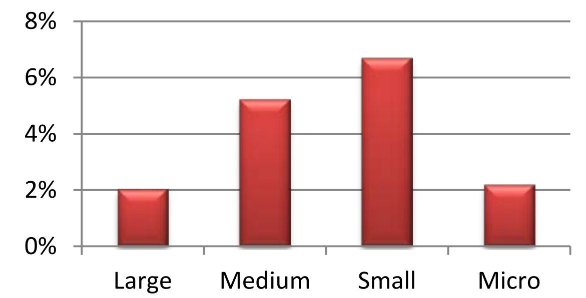
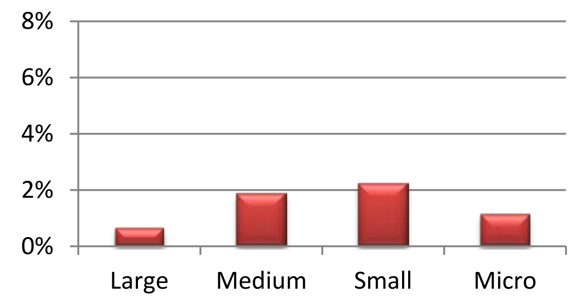
Relevance	Usage
	

Source: ESRI Analysis of ECB/EC SAFE Survey.

Figure 23: Relevance and Usage of Debt Securities Issued Amongst Irish SMEs By Size

Relevance	Usage
	

Comparison With Eurozone (Non-Ireland) Average*

Relevance	Usage
	

Source: ESRI Analysis of ECB/EC SAFE Survey.

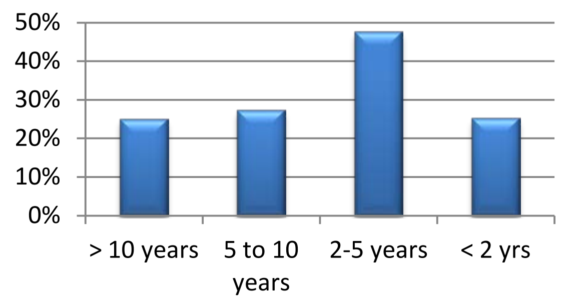
To explore the heterogeneity across firm groups, we present the relevance and usage of issued debt securities split out by firm size and firm age in Figure 23 and Figure 24 respectively. In each case, we also present the data for Ireland relative to the Eurozone average in the data. This is simply the Irish data minus the average for the non-Ireland sample.

In relation to firm size, the relevance and the usage appears to decline with size. However, relative to the Eurozone, Irish medium-sized and small-sized firms indicate a higher usage and relevance of debt security issuance. Given the transactions costs associated with a formal debt financing issuance, economies of scale imply that it is more likely that firms using such financing options are larger.

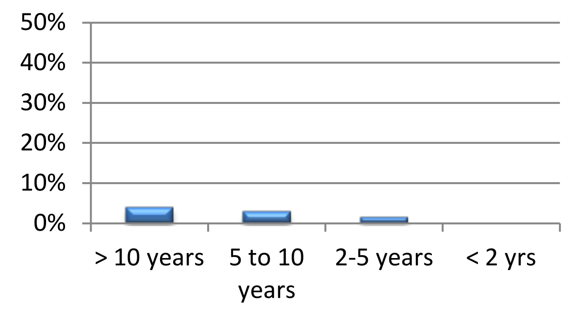
In terms of firm age, relevance data would appear highest for firms aged 2-5 years, however, the usage is highest amongst the oldest firms. In comparison to other Eurozone firms, Irish firms in the 2-5 year age bracket indicate this instrument is more relevant while start ups 0-2 years find it less relevant than the average. There is very little variation across usage with no firms in the 0-2 year age group using this source.

Figure 24: Relevance and Usage of Debt Securities Issued Amongst Irish SMEs By Age

Relevance

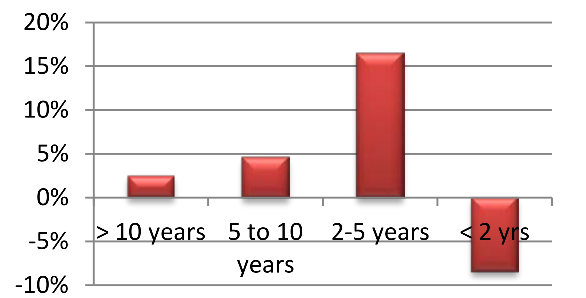


Usage

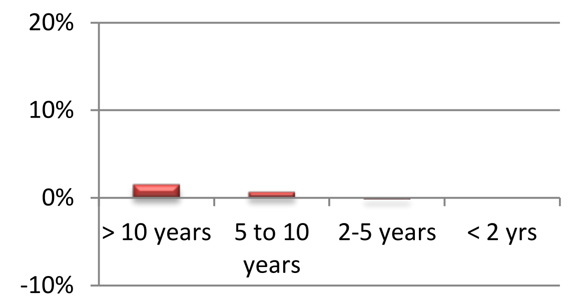


Comparison With Eurozone (Non-Ireland) Average

Relevance



Usage



Source: ESRI Analysis of ECB/EC SAFE Survey.

4.2.2 Formal Debt Policy Issues

Creation of a Mini-bond Market

One option put forward to broaden the range of funding options for SMEs is the creation of a ‘retail mini bond’ market for Irish SMEs. This is currently being evaluated under the Action Plan for Jobs 2014 and a progress report is due before the end of the year. The proposal would involve the Irish

Stock Exchange setting up a bond market that would allow investors put money directly into SMEs, and would ideally enable companies to obtain investment funds from smaller retail investors. Although discussed in terms of SME financing, this type of funding would be most applicable at the medium end of the SME market and, in its initial stages at least, would be likely to be availed of only by a relatively small number of firms.

The development of a bond market for mid-sized corporates has the potential to play a role in enhancing the funding mix available to firms, particularly if the infrastructural costs of setting up such an exchange are low given the existing expertise and systems available at the Irish Stock Exchange. It is difficult to predict *ex ante* the level of demand from either a firm or investor perspective and there are a number of fairly significant challenges that are likely to keep such a market relatively small, at least in the short term. The costs of compiling the information to comply with regulatory requirements and the level of disclosure will be considerably higher than firms of this size are currently accustomed to and this could create a major disincentive from the firm perspective. Analysing the information and evaluating the risks will also be costly on the investor side.

The size of SME bond markets in other countries gives an indication of the scope that a new market would be likely to have in the Irish context. The German retail bond market began operation in 2010 and since then has had a total of 177 bond issuances by 145 firms, with a total value issued of €9.1 billion. The default rate on these bonds has been relatively high, resulting in a considerable slowdown in placements over the last year. Issues have also arisen on the quality of the ratings attached to the bonds with multi-notch downgrades in a number of instances.

Some type of tax incentives (e.g., capital gains exemption, stamp duty exemption) would probably be needed to counteract the level of risk involved for investors and to make the operation of this type of market viable. Every effort to reduce the information costs in terms of standardising documentation and providing templates for disclosure should be made as these are likely to be significant barriers for firms using a new market of this type.

4.2.3 Developing Alternative Funds

ISIF funds

It was announced by the Irish government in June 2013 that a new fund entitled the Ireland Strategic Investment Fund (ISIF) was to be established to allow the resources of the National Pension Reserves Fund (NPRF) to be made available to provide financial assistance for Irish SMEs and mid-sized corporates. The NPRF is currently valued at €6.8 billion and resources can be shifted to supporting economic activity and employment growth.

The NPRF and the newly formed ISIF have developed a number of specific debt products for non-traditional bank financing. These are summarised in the box below:

Box 5: ISIF/NPRF Debt Funding Supports

The NPRF and ISIF have been developing a range of credit facilities for Irish firms. To date the majority of funds have been targeted at larger corporates and firms in the technology sector. Two main funding schemes are:

BlueBay Ireland Corporate Credit: This credit fund has been established to originate and acquire a range of secured term loans to mid-size Irish companies. Instruments are developed to be flexible and depend on the specific requirements per transaction. The fund's particular focuses are on growth capital, acquisition, refinancing, and ownership changes. The total fund size is approximately €450 million in which the NPRF has provided approximately €200 million. Secure loans approximate €5-€45 million. The instruments can be bespoke and cover senior, unitranche and mezzanine financing activities for up to six years. Financing will be based on cash flow lending and not on asset-backed financing. Real estate sectors are excluded.

Silicon Valley Bank: The NPRF has developed a collaborative relationship with Silicon Valley Bank to provide debt financing to technology firms in Ireland. The bank is expected to lend approximately $100 million in Ireland by 2017 to fast growing, life sciences, and venture capital owned businesses. A total of nine loan facilities have been granted to date.

Source: www.nprf.ie; NPRF presentation at launch of ISIF.

These funds are a welcome addition to the overall financing mix for larger SMEs and for firms in technology oriented sectors. Giving these groups of firms such an option to diversify their financing mix using such funds is welcome.

4.3 Trade Credit

A particularly important source of non-bank credit which is used by firms is trade credit. By trade credit, we refer mainly to the purchase of goods on credit from suppliers but it can also refer to the purchase of goods on advances from customers. It should not be confused with trade finance which is the financing of international (cross-border) goods and services trade.

A sizable proportion of small business assets are funded by trade credit. Trade credit can be a more expensive form of borrowing than bank credit but can have other benefits for firms in terms of flexibility and cash flow management. Early stage firms, who find it particularly difficult to obtain bank credit may still be able to obtain credit from suppliers.

The informational asymmetries between firm and bank that prove an obstacle to small firm financing could be less severe in a trade-credit relationship, where the supplier providing credit has experience of the firm's sector and production process. If the supplier provides an important input to the firm, they have a potentially strong threat position of withholding future supplies if not repaid on schedule. In the event of the firm defaulting, suppliers may have the option of repossessing and selling on the previously supplied goods, a course of action that financial institutions would not always have the industry-specific knowledge to undertake (Berger and Udell, 1998).

In the literature, many studies emphasise the importance of trade credit for SMEs and, in particular, highlight its role as a substitute for formal bank financing. This is particularly pertinent in periods of financial crisis (Casey and O'Toole, 2014; Love *et al.,* 2007). While specific data on applications for trade credit are unavailable from the current DoF data, we do have information on the share of working capital and investment that is financed by purchases on credit from suppliers. This data facilitates the development of two indicators: a) whether or not the firm used that particular type of financing and b) the average percentage of total funding that it accounted for. These figures are presented in Table 7 below. Approximately, 34 per cent of Irish firms used trade credit facilities to fund working capital. When used, it accounted for nearly 38 per cent of total funding. For investment, approximately 6.1 per cent of firms used trade credit and it accounted for just over 58 per cent of total funds when used.

Table 7: Overview of Trade Credit Finance for Irish SMEs

	Working Capital	
	Observations	Mean %
% of Users	2,614	34
% of Funding if Used	889	37.8
	Investment	
% of Users	916	6.1
% of Funding if Used	56	58.2

Source: ESRI analysis of Department of Finance Credit Demand Survey.

The data split by sector, firm size, age and trading status are presented in Table 8. The highest level of usage of trade credit for working capital and investment by sector is in the wholesale and retail sector. For working capital, the data indicate that trade credit usage increases with firm size, while the percentage of funding covered by the source decreases with age.

There does not appear to be a clear pattern for investment financing. In terms of firm age, the percentage of firms using trade credit appears to fall with firm age across both working capital and investment financing. Start-ups and firms under 5 years of age have the lowest percentage of funding covered by the source. This may reflect heightened firm risk in the early life cycle phases which leads to partner firms being unwilling to support large volumes of trade credit. Firms in the ICT sectors have a higher level of usage of trade credit for investment. Exporters appear to have a higher level of usage of trade credit for both investment and working capital: however, the percentage of funding covered by the trade credit if used is higher for non-exporters.

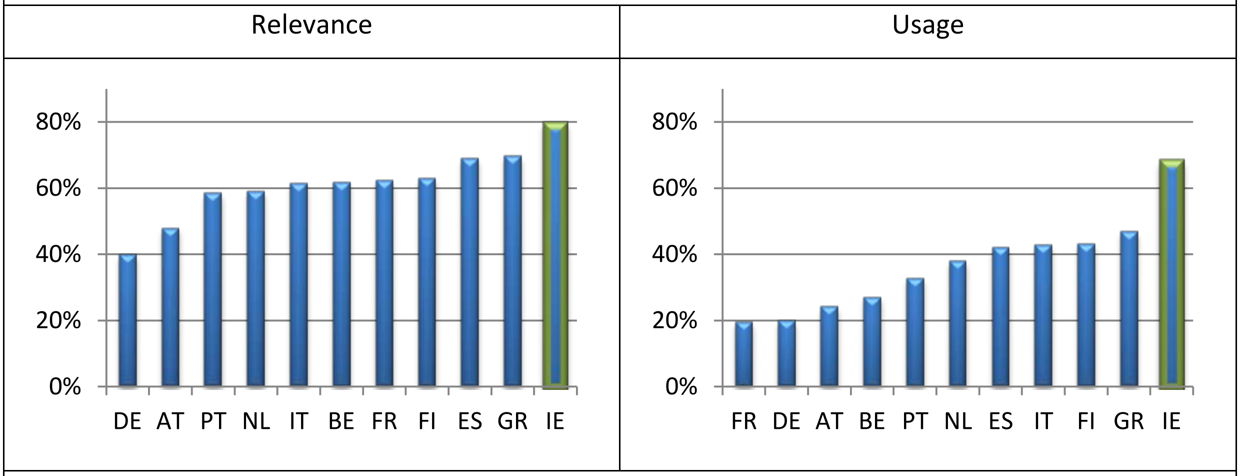
Table 8: Overview of Trade Credit Finance for Irish SMEs by Firm Groups

	Working Capital			Investment	
	% of Users	% of Mix if Used		% of Users	% of Mix if Used
	%	%		%	%
Manufacturing	38	34		7	54
Construction & Real Estate	37	44		7	54
Wholesale/Retail	42	43		9	62
Hotels	32	37		5	54
Other	25	29		4	59
Micro	31	41		7	55
Small	35	39		6	59
Medium	38	32		6	59
Less than 5 years	37	31		11	53
5 to 10 years	35	39		8	46
11 to 20 years	34	40		6	68
20 plus years	33	37		5	58
Non ICT	34	37		6	59
ICT	33	41		9	56
Non-Exporter	33	39		6	64
Exporter	40	34		7	47

Source: ESRI analysis of Department of Finance Credit Demand Survey.

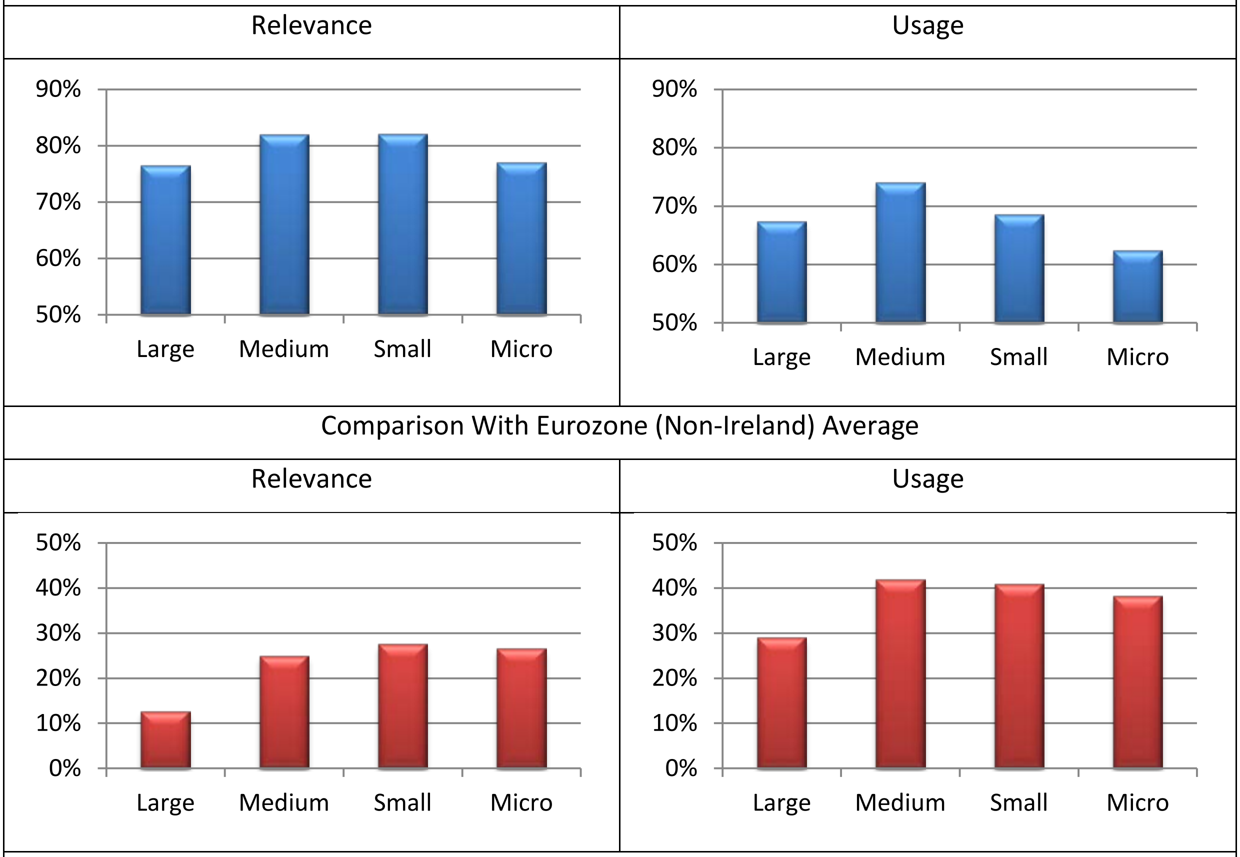
To provide an international comparison on the trade credit usage of Irish firms, the SAFE data are provided for Ireland and other Eurozone members in Figure 25. Irish firms have the highest rate of both relevance and usage of trade credit across the Eurozone. Given that the academic literature suggests that bank credit and trade credit are substitutable (Guariglia and Mateut, 2006), in particular in times of crisis (Casey and O'Toole, 2014), this may be indicative of Irish firms turning to trading partners in times of restricted bank credit. It is interesting to reflect on the absolute levels of these indicators.

Figure 25: Relevance and Usage of Trade Credit Amongst European SMEs and Large Firms



Source: ESRI Analysis of ECB/EC SAFE Survey.

Figure 26: Relevance and Usage of Trade Credit Amongst Irish SMEs By Size

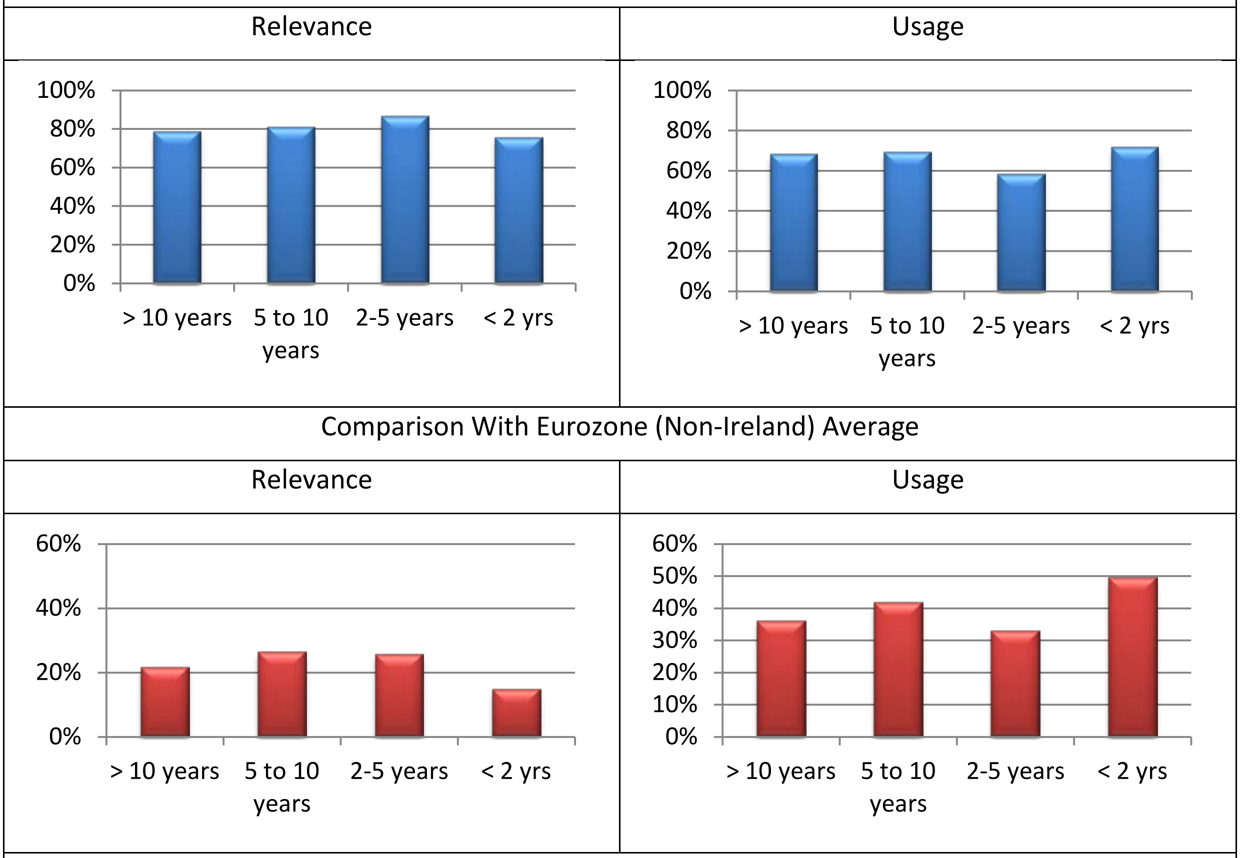


Source: ESRI Analysis of ECB/EC SAFE Survey.

Splitting the data by firm size in Figure 26, we find that the usage, and to some degree relevance, falls with size for SMEs but large firms appear to have lower levels of usage than small and medium-sized firms. Across all size classes, Irish firms have a greater level of relevance and usage of trade credit than their Eurozone peers and this is particularly acute for SMEs.

Figure 27 presents the relevance and usage of trade credit by age. While there does not appear to be clear pattern, however, it would appear that firms under two years of age have a much higher rate of usage of trade credit than their European peers.

Figure 27: Relevance and Usage of Trade Credit Amongst Irish SMEs and Firms By Age



Source: ESRI Analysis of ECB/EC SAFE Survey.

4.3.1 Trade Credit Policy Issues

These data suggest that 70 per cent of Irish SMEs and large corporates use trade credit. The numbers highlight the continued importance of this particular type of financing for firms. This is also a financing mechanism which does not receive policy attention. If there are particular market failures which arise in the provision of this credit type, then there may be a role for policy intervention.

Although trade credit is a crucial component of financing for many SMEs and disruption to the supply chain flow of payments can often be the deciding factor between solvency and bankruptcy, the role that policy interventions can play in this area is relatively limited as active involvement in restricting terms and conditions of payments runs the risk of cutting firms off from this type of funding rather than making it more accessible. A number of initiatives currently being introduced can help facilitate the smooth function of the supply chain and trade credit transactions to allow SMEs to manage their cash flows efficiently.

Rather than place stringent rules on the operation of trade credit, the focus has been on encouraging a culture of corporate responsibility for larger businesses with regards to payments to their suppliers. To promote this, a Code of Conduct on Prompt Payments was announced by the Department of Jobs, Enterprise and Innovation in 2013. It was developed with the Business Representative Bodies in Ireland, for the stated purpose of improving the cash flow among businesses. The initiative was included in the Action Plan for Jobs 2013. Signatories to the code agree to pay their suppliers on time and within the conditions of the contract, provide suppliers with clear guidance on their payment procedures, and to encourage good practice by promoting adaption of the code throughout their supply chain. To maximise the effectiveness of this Code, an awareness campaign to attract attention to firms that are participating and in compliance, similar to the use of the approved logo attached to the UK equivalent scheme (described below), would be a useful method to create an incentive for participation.

In a similar scheme to the Irish Code of Conduct, the United Kingdom established a prompt payment code to ensure that small businesses have access to a reliable cash flow within the supply chain. The Code is administered by the Institute of Credit Management on behalf of the Department for Business Innovation and Skills (BIS) and is a voluntary charter for which businesses are encouraged to be a signatory. Once a business has signed up they undertake to pay suppliers on time within the agreed terms and without attempting to change the agreed terms of payment or length of payment. They commit to provide clear and easily accessible guidance to suppliers on payment procedures, to communicate the complaints procedure to suppliers and to provide prompt advice to suppliers as to the reasons why an invoice cannot adhere to the previously agreed terms. Finally, all firms agree to encourage good practice by encouraging adaption of the Code throughout their supply chain. Once approved a logo indicating participation can appear on all company documentation and websites.

As a major purchaser of goods and services, it is extremely important that the State lead by example in the area of prompt payments and it is welcome that the government has decided to extend the 15 day prompt payment requirement for all central government departments to the State Agency Sector, as recognition of the importance of prompt payments to ensure a greater ease of cash flow for small businesses.

Finally, one of the main difficulties that smaller firms face in enforcing terms of trade credit is that they may be reliant on supplies or purchases from much larger companies with a corresponding imbalance in market power that may make them reluctant to chase payments due to the risk this would place on the continuance of the business relationship. Ensuring that this type of abuse of market power is minimised as far as possible should be an issue of concern for the Competition Authority. Further research on how trade credit relationships operate in the Irish market would be beneficial in understanding to what degree this is an obstacle for businesses, as there is currently relatively limited information available on this area.

4.4 Crowdfunding

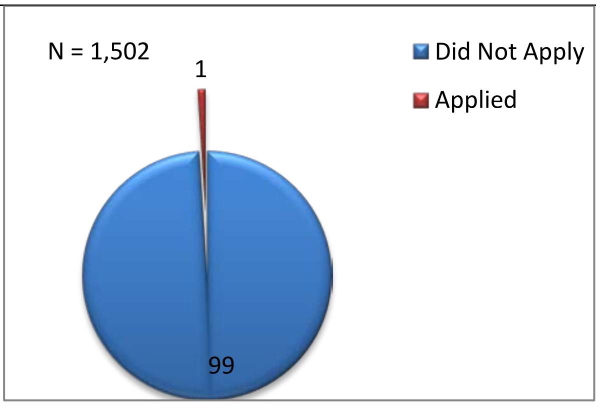
Crowdfunding can best be described as a form of market-based finance that can be used by individuals or firms to raise funds for a business, project, or loan through a web-based platform. A number of individuals can invest or lend to a business or project and the funds will then be pooled together in an attempt to reach the target amount of funds as set by the firm. This can help to provide alternative avenues of funding for SMEs and help to raise awareness of a new business or project.

The most common approach to date in Ireland is to use the Lending based model, commonly known as peer-to-peer lending, in which an individual can lend money to a business or project in return for an interest payment on their investment. There is also the equity-based model whereby investors provide funds to a business or project in return for a share of the profits generated. The less common Donations-based model represents a scenario where investors provide funds with no expectation of a monetary reward. There are currently a number of websites in which crowdfunding sources are available in Ireland including Linked finance, iFund, iCrowdFund and the US based Kickstarter which is soon to set up operations in Ireland. Since its launch in 2009, Kickstarter has funded 67,000 projects with over $1 billion pledged by 6.8 million people in the US to date.

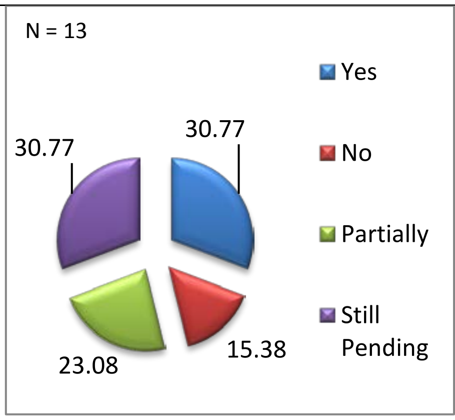
For the most recent wave of the DoF survey, questions on crowdfunding use were included and we present the data on applications and success for crowdfunding and peer-to-peer lending in Figure 28. Only 1 per cent of Irish SMEs applied for crowdfunding and peer-to-peer lending in the period October to March 2014. The success rate is approximately 31 percent with partial acceptances another 23 per cent. However, there are very low numbers of firms in this data (13) so the accuracy around these figures is questionable.

Figure 28: Applications and Success Rates for Crowdfunding and Peer-to-Peer lending Amongst Irish SMEs

Application Rate



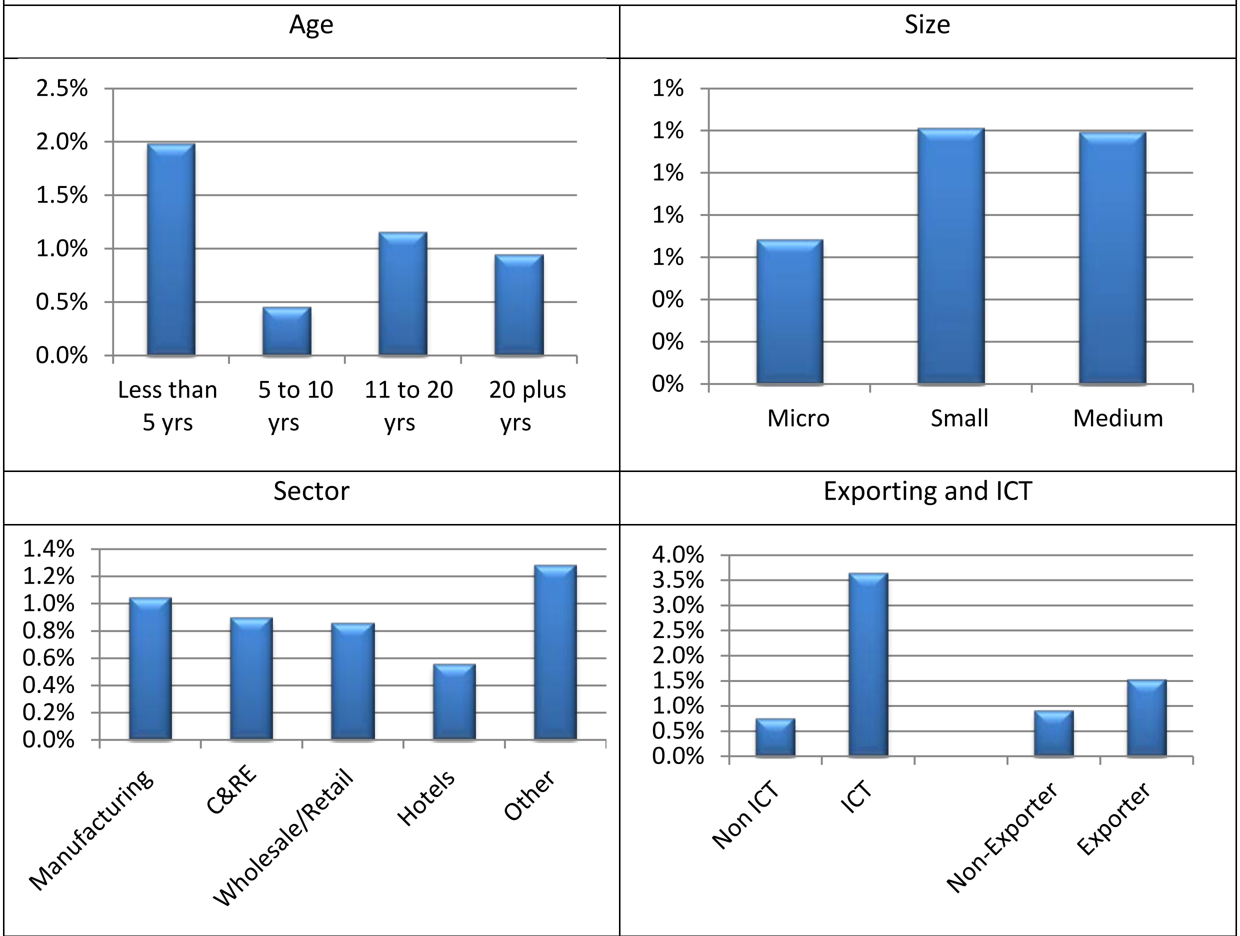
Success Rates



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

In Figure 29, the applications data are presented across firm groups. The overall application rate is higher for very young firms. This suggests that a small cohort of firms use this financing source to fund early stage activities. However, split out by size, it is the medium and small firms that make greater use of this finance than the micro firms. In terms of sectors, firms in ICT are much more likely to apply for crowdfunding.

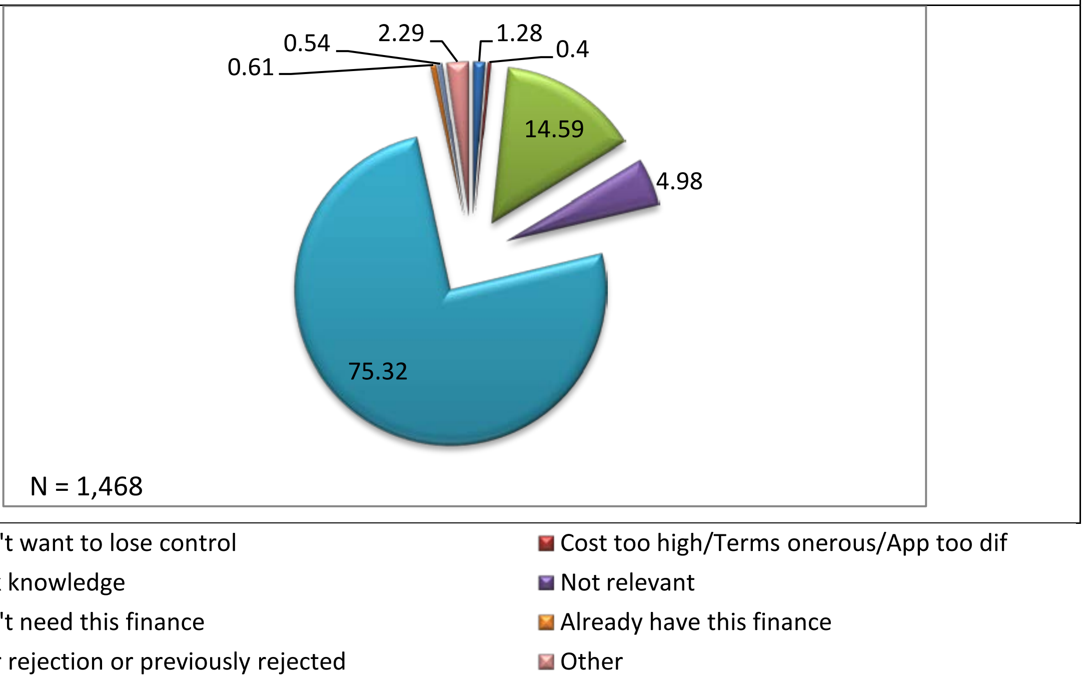
Figure 29: Application Rates for Crowdfunding and Peer-to-Peer Lending for Irish SMEs



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

Figure 30 presents the reasons for not applying for crowdfunding/peer-to-peer financing amongst Irish SMEs. While a majority of firms indicate that they just do not need this financing type, 15 per cent of firms indicated they did not apply because of a lack of knowledge. If this particular source of finance is seen as important in terms of building a diverse range of SME credit channels, improving the information flows around crowdfunding/peer-to-peer lending could facilitate greater uptake or at least stimulate more interest in terms of applications.

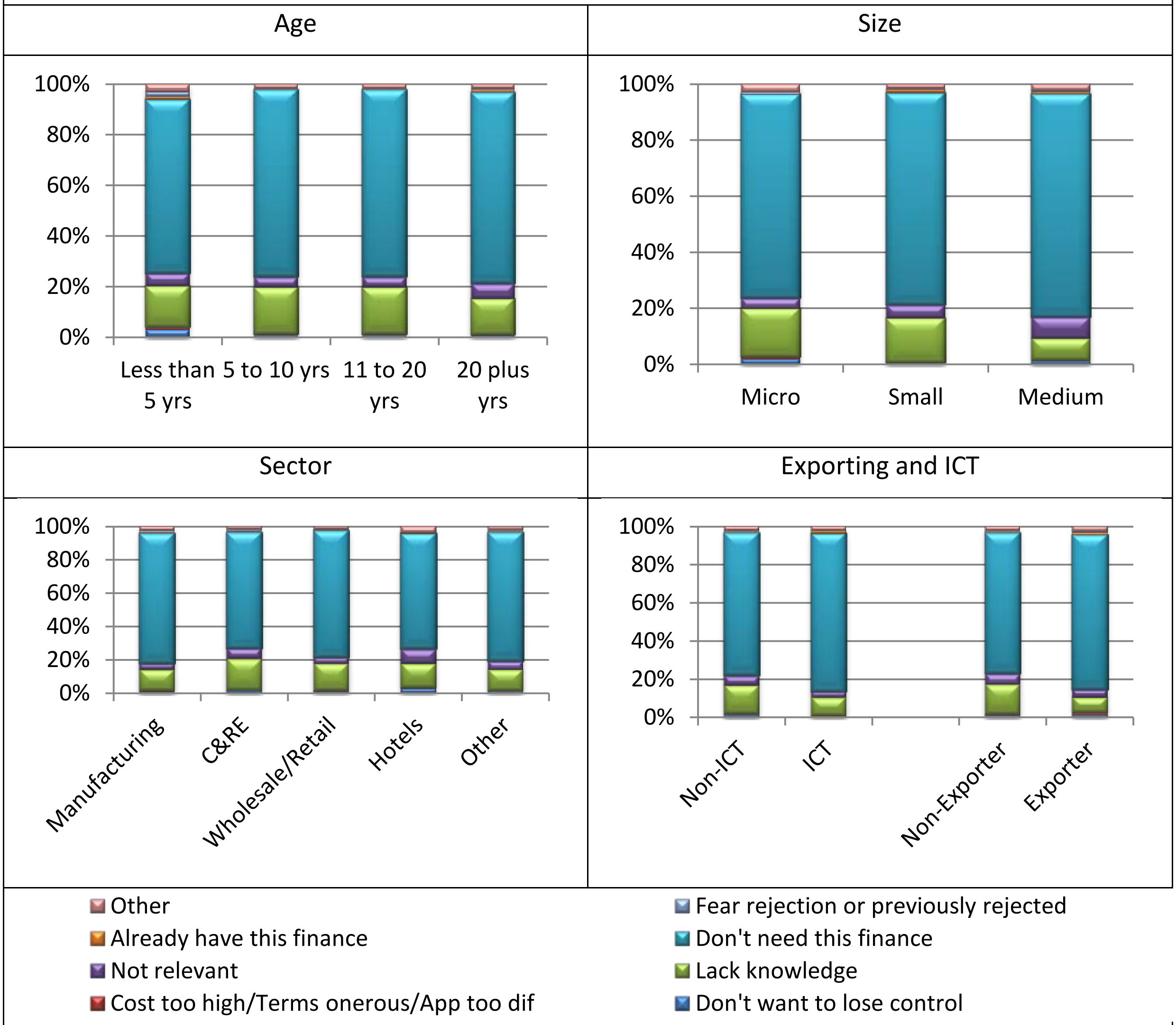
Figure 30: Reasons for Not Applying for Crowdfunding and Peer-to-Peer lending Amongst Irish SMEs



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

Figure 31 splits out the reasons for not applying by firm age, size, sector and international trading status. While all groups are dominated by firms not wanting to apply due to a lack of need for this financing type, it is clear that a lack of knowledge is restraining applications across all groups. This lack of knowledge appears highest amongst young firms and micro-sized enterprises. Firms in the construction sector, non-ICT firms and non-exporters also display higher levels of information deficits.

Figure 31: Reasons for Not Applying for Crowdfunding and Peer-to-Peer Lending for Irish SMEs



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

4.4.1 Role for Policy in Crowdfunding

There are no current policy measures in place in Ireland relating to the operation of the crowdfunding or peer-to-peer lending markets. As these are relatively novel sources of funding that many firms may be unfamiliar with, there is potential for modest amounts of government support to have a more than proportionate impact in expanding this area.

As one strand in a broad-ranging set of financial initiatives to increase lending to SMEs in the UK, the Business Finance Partnership (BFP) included £20 million in support of crowdfunding in 2013, channelled through the Funding Circle online platform.[17] Following the lending out of this initial tranche to over 2,000 businesses, which the crowdfunding firm estimates as resulting in the creation

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[17] https://www.gov.uk/government/policies/making-it-easier-to-set-up-and-grow-a-business--6/supporting-pages/encouraging-private-sector-investment

of around 6,500 jobs, a further allocation of £40 million was made earlier in 2014.[18] For each individual business applying for funding, once private sector investors had committed 90 per cent of the required amount, the government would contribute the final 10 per cent needed to fund the proposed project. The government portion has the same risk of loss as the private investment and is repaid at the same interest rate set by the private bidding on the crowdfunding platform.[19] This approach allows a significant leveraging of the government funding portion, leaving responsibility for monitoring and deciding the allocation of funds to the private investors.

Investing in crowdfunding can also be considered part of the investment against which tax relief in new companies can be claimed as part of the UK's Seed Enterprise Investment Scheme (SEIS). These include an individual tax relief of up to 50 per cent of the amount invested, a capital gains tax exemption if shares are held for over three years, a capital gains relief of up to 50 per cent of profits if shares sold before three years are reinvested into another SEIS company, or loss relief in the event that the company fails. The loss relief is equal to the initial investment minus the 50 per cent tax relief and multiplied by the tax rate. These initiatives are only available for investors who invest in companies that are part of the SEIS scheme.

Currently, the Central Bank of Ireland does not play a role in the regulatory environment for crowdfunding models in Ireland. Given its current fairly niche role in the financing market and that the main operator limits the amounts an individual can put at risk in any one investment, this absence of regulation would not appear to pose any immediate concerns. However, if this type of financing was to become more widespread and more crowdfunding platforms were to be launched, it would be important both for investor protection and to attract funding for the businesses using this finance that some standards or codes of conduct be established in this area. For example, loan-based Crowdfunding in the UK has been newly regulated by the Financial Conduct Authority (FCA) since April 2014. At the moment the FCA distinguishes between loan-based and investment-based crowdfunding with a lighter form of regulation proposed for loan-based platforms as they appear to be of lower risk than investment-based models (equity crowdfunding is not yet used in the Irish market).

Several proposals were put forward by the FCA in relation to their approach to regulating crowdfunding and these are documented in a recent consultation paper that would be a useful basis on which to examine options for implementing a Irish regulatory model.[20] Some of the most relevant proposals in the Irish context are those for loan-based crowdfunding, a regime introduced to protect investors by ensuring there are minimum prudential requirements for firms, and that certain steps are taken to ensure existing loans are managed in the event of platform failure. They also help to ensure that rules are in place to reduce the risk of loss when firms are holding client money, to help

[18] https://www.gov.uk/government/news/new-40-million-investment-by-british-business-bank-to-support-450-million-of-lending-to-smaller-businesses

[19] https://www.fundingcircle.com/blog/2014/02/the-government-backed-british-business-bank-programme-announces-plans-to-lend-a-further-40-million-through-funding-circle-2/

[20] http://www.fca.org.uk/static/documents/consultation-papers/cp13-13.pdf

resolve disputes, and that there are requirements in place for firms to report their financial position to the FCA. For investment-based crowdfunding the FCA has proposed that there should be a restriction on the direct offer financial promotion of unlisted shares or debt securities by firms that are retail clients and are either certified as sophisticated investors, certified as investors of high net worth, will receive investment advice or management from an authorised source, or are certified to not invest over 10% of their net portfolio of investments in unlisted shares or debt securities. Firms must ensure that only those with investment knowledge or experience can invest through the use of appropriateness tests.

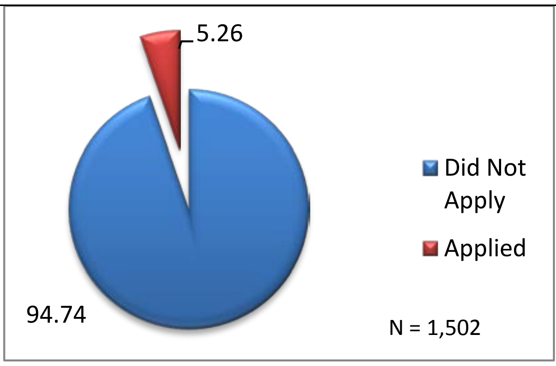
4.5 Business and Informal Market Lending

Figure 32 presents the application rates and success for family loans and loans from business partners. Approximately 5.3 per cent of Irish SMEs applied for loans from family or friends while fewer than 3 per cent applied for loans from business partners.

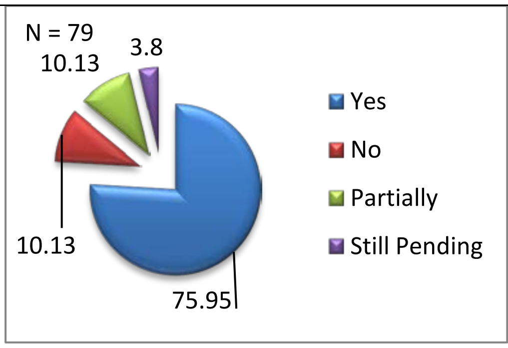
Figure 32: Application Rates and Success for Friends/Family Loans and Business Partners for Irish SMEs

Friends/Family Loans

Application Rate

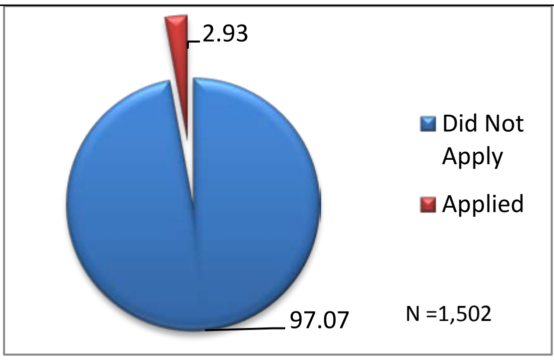


Application Success

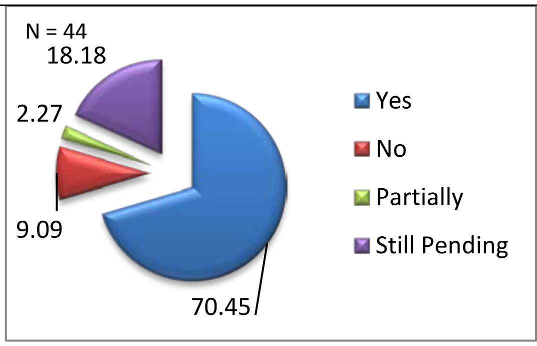


Business Partners

Application Rate



Application Success

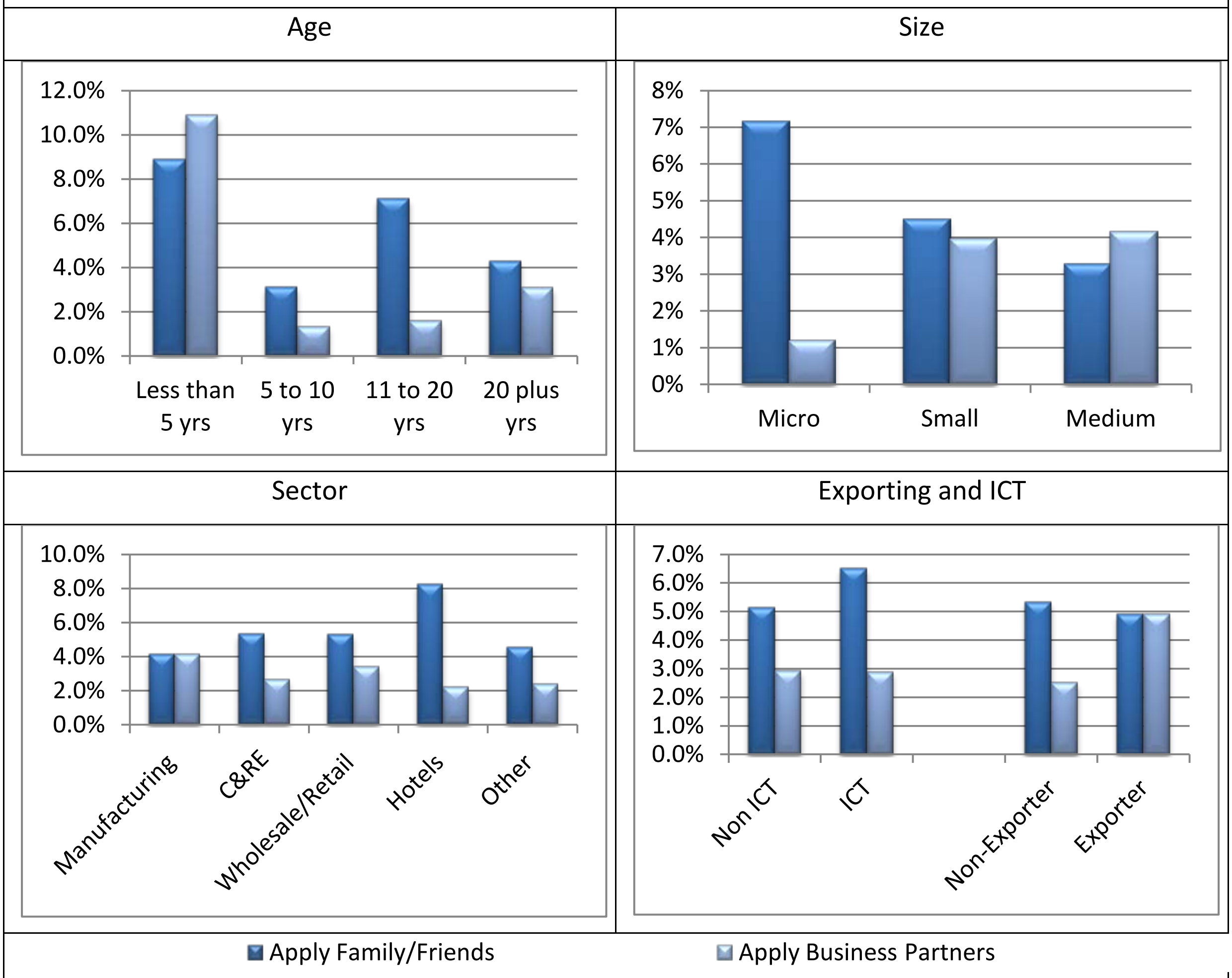


Source: ESRI Analysis of Department of Finance Credit Demand Survey.

The success rates for loans from family and friends are just under 76 per cent. The equivalent figure for bank facilities is approximately 55-59 per cent (depending on the survey wave). The percentage of partially accepted applications is 10 percent with another 10 per cent rejected. The pending rate is much lower than for bank finance which is approximately 21 per cent (DoF, 2014). In general this would point to a more accommodative credit allocation through this source relative to bank financing. The success rate for loans from business partners is again higher than that for bank loans at 70.5 percent. There is a higher pending rate at nearly 20 per cent but outright rejection rates are marginally lower than for family/friends loans.

Figure 33 presents the application rates by firm age, size, sector and whether or not the firm is an ICT or exporting firm. The cell sizes in the data are too small to provide an equivalent breakdown for success rates in the applications. A number of patterns emerge from the data. Both loans from family and friends and business partners appear to be much more important for start up firms of less than 5 years.

Figure 33: Application Rates and Success for Family/Friends and Business Partner Loans for Irish SMEs



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

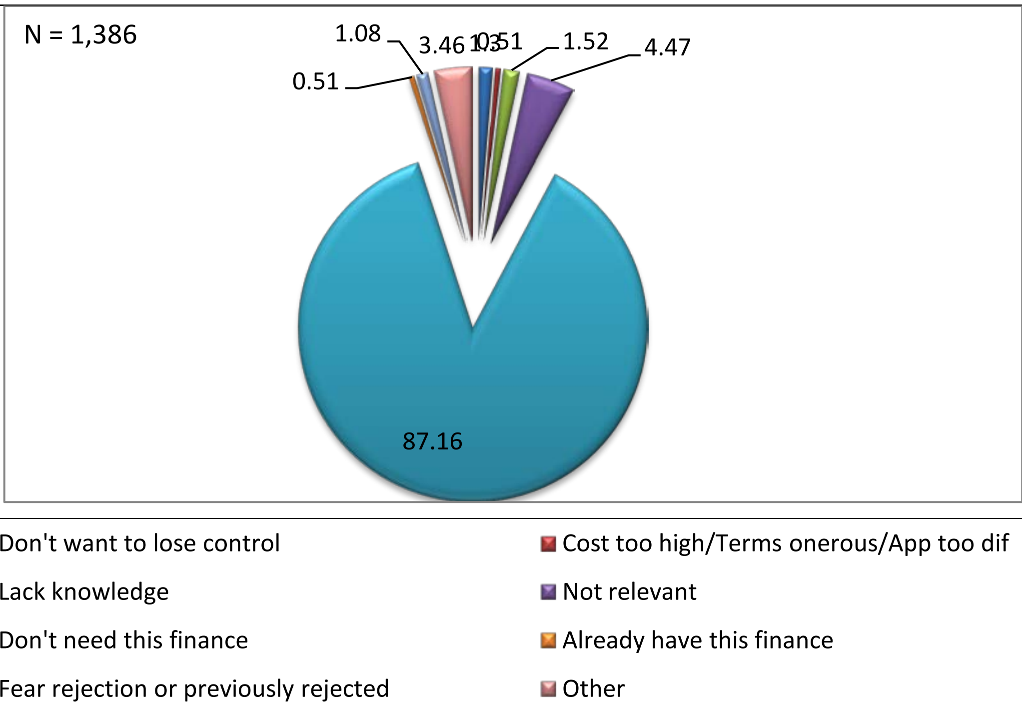
It is well know that start-ups, due to the lack of a track record and a lack of collateral can face very serious challenges in accessing external credit. Financing through personal relationships and informal sources is one potential way to overcome such informational asymmetries and obtain start up and early stage financing. However, relying on these sources can be restrictive as they can have limited volumes available with uncertain time frames.

The application for loans from family and friends is over 8 per cent for micro-sized firms. It falls for small and medium firms appearing to decline with size. However, loans from business partners appear to increase with size as they are less than 1 per cent for micro firms but increase to over 4 percent for medium-sized firms. On a sectoral basis, firms in the hotel sector have the highest rate of application for loans from friends and family, followed by wholesale and retail firms and firms in construction and real estate. Given that these sectors are very reliant on domestic demand, and the challenges they have faced since the crisis, such reliance on informal finance could be indicative of substitution from bank financing where credit constraints are heightened.

The rate of applications for loans from friends and family is higher for firms in the ICT sector. Many of these firms are potentially innovative and have business models that are opaque or difficult to evaluate. This makes such firms more likely to suffer from credit constraints from traditional lenders. If these firms are forced to use informal sources this may lead to poorer economic outcomes through investment, firm growth and productivity channels. Exporters have a higher rate of applications for loans from business partners.

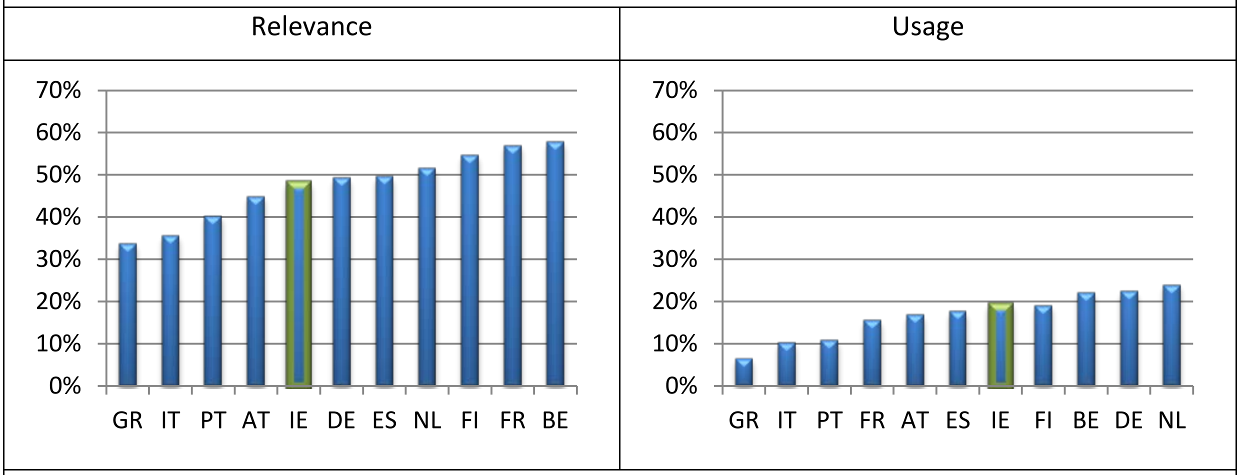
Figure 34 presents the reasons for not applying for loans from friends and family and for business partners. The data collected on reasons for no applications were composite across the two loan types so it was not possible to separate each and present them individually. The majority of firms (over 87 per cent) indicate that they just do not need this type of finance. A further 4.5 per cent indicate that it is not relevant for their business or sector.

Figure 34: Reasons for No Applications for Family/Friends/Business Partner Loans in Irish SMEs



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

Figure 35: Relevance and Usage of Other Loans Amongst European SMEs

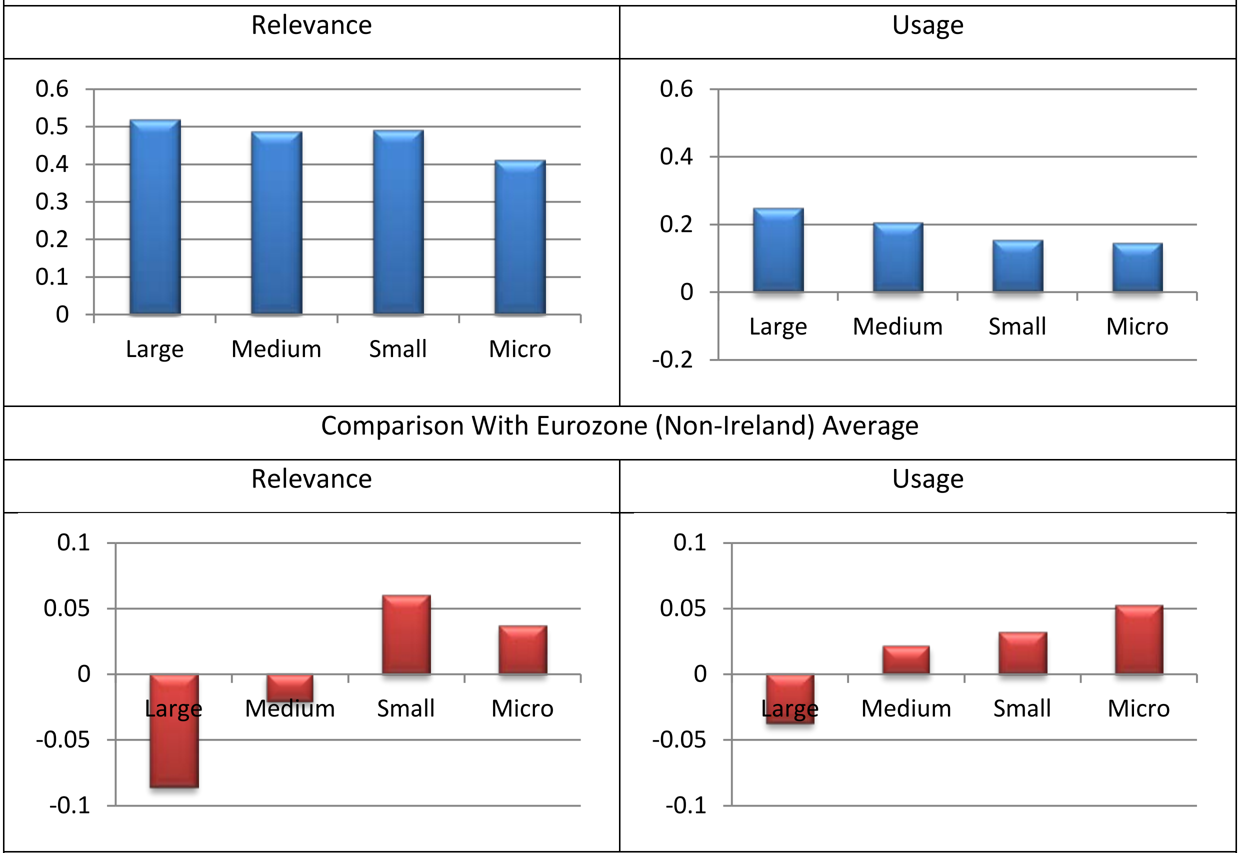


Source: ESRI Analysis of ECB/EC SAFE Survey.

To provide some international comparison for Ireland on the usage and relevance of other informal or business loans, Figure 35 presents the data from the SAFE survey for this category of loan. In SAFE, other loans relate to loans from a related company or shareholder, excluding trade credit but including loans from family and friends. It is, therefore, a broader definition than that used above so the rates of usage may differ. In general, Ireland appears to be in the lower end of the relevance distribution but the usage levels (at approximately 20 per cent) are slighted higher in the country split.

Counter to the previous data, and likely linked to the definition in SAFE, it would appear the relevance and usage decreases with firm size (Figure 36). However, the rates of usage and relevance are higher for small and micro firms relative to their European peers.

Figure 36: Relevance and Usage of Other Loans Amongst Irish SMEs By Size

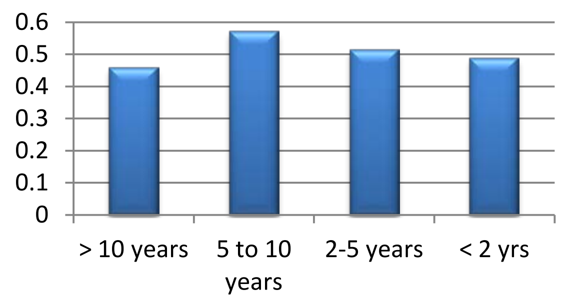


Source: ESRI Analysis of ECB/EC SAFE Survey.

In relation to firm age, the data are presented in Figure 37. No real clear pattern emerges. However, as is the case in the DoF data, it appears the usage rates are higher for very young firms and start-ups. This again may be linked to their lack of collateral and a track record in obtaining financing from a more formal source.

Figure 37: Relevance and Usage of Other Loans Amongst Irish SMEs By Age

Relevance



Usage

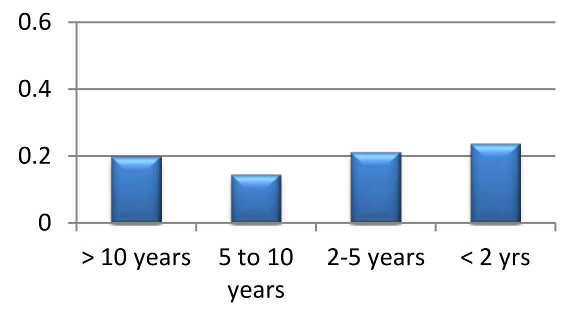
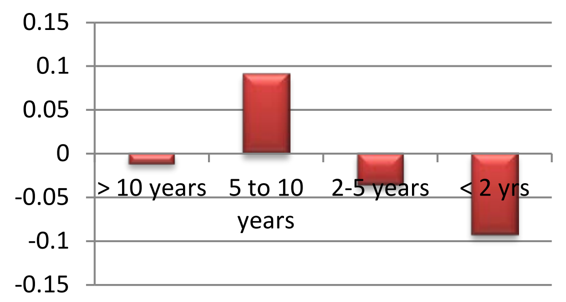
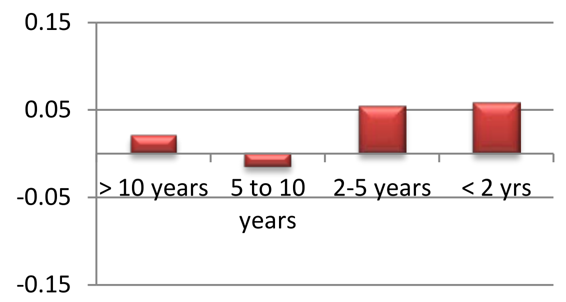


Figure 38: Comparison With Eurozone (Non-Ireland) Average

Relevance



Usage



Source: ESRI Analysis of ECB/EC SAFE Survey.

Despite the widespread use of informal loans in financing smaller business, there does not appear to be any specific policy intervention required in this type of financing. Maintaining and supporting the availability and smooth functioning of markets in more formal types of both debt and equity financing are where the policy objectives should be set.

Chapter 5

Equity Finance

Summary of Chapter Findings

- The use of equity financing is relatively widespread in Ireland, being slightly higher than the Eurozone average. Indeed Ireland's venture and growth capital ratio to GDP is above average in an international context.
- Equity usage is higher amongst larger firms. Young firms (less than 5 years) in Ireland are 20 per cent more likely to have used equity financing than Eurozone comparators.
- Looking at sources of external equity, approximately €250 million is committed from venture capital funds to SMEs annually. In each half-year of survey responses, 1.3 per cent of Irish SMEs apply for venture capital or angel financing with a success rate of around 8 per cent for venture capital and 20 per cent for angel finance.
- Venture capital applications are highest amongst young start-up firms, particularly amongst ICT and exporting firms. When firms did not use VC or angel finance, lack of knowledge was the most common reason given next to not needing this source of finance. Around 3 per cent indicated that it was due to an unwillingness to share control of their business.
- Informal sources of equity coming from friends, family and business have a considerably higher success rate at over 66 per cent compared to formal equity sources. Informal equity is particularly important for start-up firms.
- A wide range of equity funding supports are available through Enterprise Ireland schemes and a number of new financing funds (NPRF, ISIF), which are briefly outlined in this chapter.
- Mezzanine financing was viewed as a relevant source by 24 per cent of Irish firms although only 2.8 per cent actually used mezzanine instruments in the last six months. Ireland was 7^{th} of 11of the countries surveyed in the likelihood of using this finance type.
- In general the data indicate that larger firms are more likely to find mezzanine instruments more relevant as well as use them more often.

Key Policy Reflections and Recommendations

1. To increase the awareness of equity financing options and steer a cultural shift amongst SMEs towards looking for equity rather than bank credit as a source of funds, it is vital to make the process of matching entrepreneurs and investors as efficient and cost-effective as possible.
2. Policy initiatives to support financial education and advice for small business owners in

order to provide information and support on finding a wider range of financing options should play a central role if equity use is to be expanded.

3. On the investor side, active promotion of opportunities for investment in local businesses would build awareness of these options.
4. Simplification and standardisation of documentation and reductions in legal costs would make smaller investments easier.
5. The Employment and Investment Incentive Scheme (EIIS) is the main tax scheme through which equity capital injections are likely to be accessed by SMEs and expanding its use and ease of access is the most promising route towards expanding funding options. There would be benefits from more active promotion of use of the EII scheme, targeting both business owners and potential investors, as knowledge of the provisions appears to be limiting current usage.
6. The possibility and costs of offsetting losses in SME investments through the EIIS and Seed Capital Schemes against other taxes should be examined as this would have the potential to reduce downside risks for investors and increase investment rates.
7. The Seed Capital Scheme should also be expanded and made more widely known and accessible for repeat entrepreneurs.
8. Employee equity investment schemes should be re-examined as the existing schemes do not provide opportunities for firms to use them as retention or promotion devices because they cannot be targeted at key employees. Simplification and clarity on the operation of the schemes and on the tax issues could increase their attractiveness. Once the integrity of the tax system can be protected, such a scheme is desirable.
9. The capital gains tax incentive for entrepreneurship introduced in Budget 2014 is welcome and extension of this beyond its current term limit should be considered. Comparison with the UK Entrepreneurs' Relief Scheme should also be investigated to help promote serial entrepreneurship.
10. Overall, it is important that the tax system does not disincentivise productive investment. The differential tax treatment of debt and equity at the firm level should be examined and the feasibility of a move towards greater neutrality investigated.
11. For venture capital funding in Ireland, the ongoing commitment of both Enterprise Ireland and the NPRF/ISIF as cornerstone investors is crucial.
12. Developing mezzanine financing instruments in Ireland could present an opportunity to channel new funding to expanding medium-sized firms, fast growing young firms, firms going through transitions or firms reorienting their capital structure. However, very few Irish firms outside these particular groups would appear to be candidates for such investment.
13. Funds such as the Development Capital Schemes (BDO, MML) as well as ISIF funds have the potential to provide such instruments as do commitments through ISIF if demand is forthcoming.

5.1 Introduction and Chapter Overview

A well understood challenge on a Europe-wide level is trying to stimulate more equity capital flows into firms and SMEs. There are well documented challenges to developing such schemes including challenges raising investor financing, a lack of appetite on behalf of SMEs for equity injections and fiscal treatment of equity financing.

In this chapter, we provide a statistical overview of some main sources of equity financing: venture capital financing, business angel investment, equity financing from business partners and equity from informal sources (friends and family). Following this overview we provide a review of potential policy developments that could stimulate equity investment flows in Ireland. In this chapter, we also provide an overview of hybrid "mezzanine financing". While this funding source has debt characteristics, the OECD note its treatment in an economic sense is more akin to equity.

The chapter contains sections on Equity Finance Use by SMEs (section 5.2), Venture Capital and Angel Finance (section 5.3), Friends and Family Equity Finance (section 5.4), and a section on Mezzanine Financing (section 5.5), which is split into sections on What is "Mezzanine Financing" (5.5.1), What type of firms are suitable (5.5.2), and a statistical overview (5.5.3). The chapter will conclude with a section on Policy Issues for Equity Finance Use in SMEs (section 5.6).

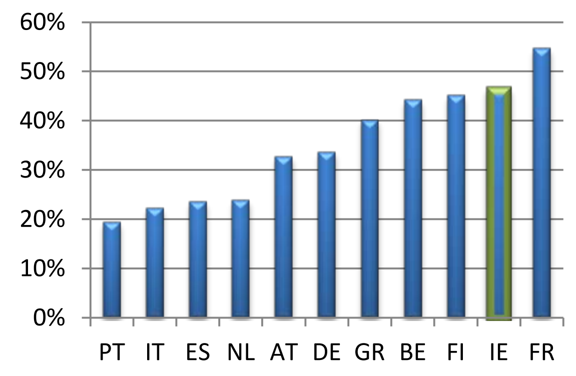
5.2 Equity Finance Use by SMEs

International evidence finds that the average firm retains all of its income, raising relatively little external finance, and there is evidence that firm growth is constrained by the amount of internal finance available. For the small pool of firms that have access to equity market funding, growth rates were far above the rates that would have been possible if they had relied on internal finance alone (Carpenter and Petersen, 2002).

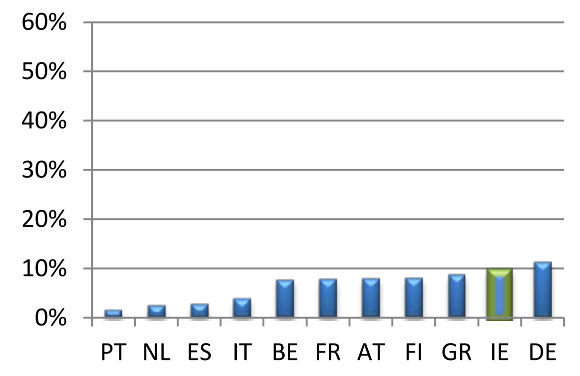
Figure 39 presents the relevance and usage of equity financing amongst Eurozone SMEs and large corporates. Ireland is the second highest country in terms of firms using equity or indicating that it is relevant to their operations. This is an important finding given the popular belief that Ireland is an internationally low equity environment. The data indicate that approximately 10 per cent of Irish firms used equity finance in the six months previous to the survey wave.

Figure 39: Relevance and Usage of Equity Financing Amongst European SMEs

Relevance



Usage

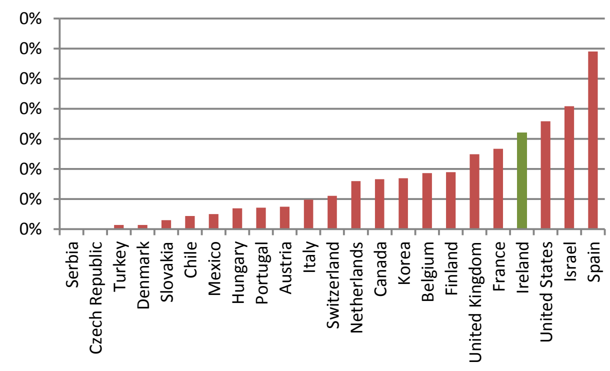


Source: ESRI Analysis of ECB/EC SAFE Survey.

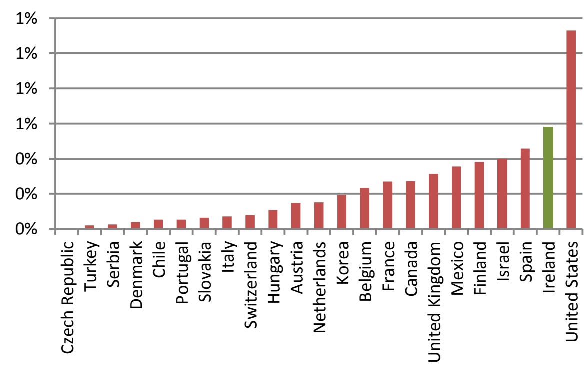
This data are backed up by OECD figures which show that Ireland is ranked highly in terms of venture capital and growth capital relative to GDP and relative to outstanding corporate loan stocks.

Figure 40: Equity to Loans and Equity to GDP ratios

Venture and Growth Capital to GDP



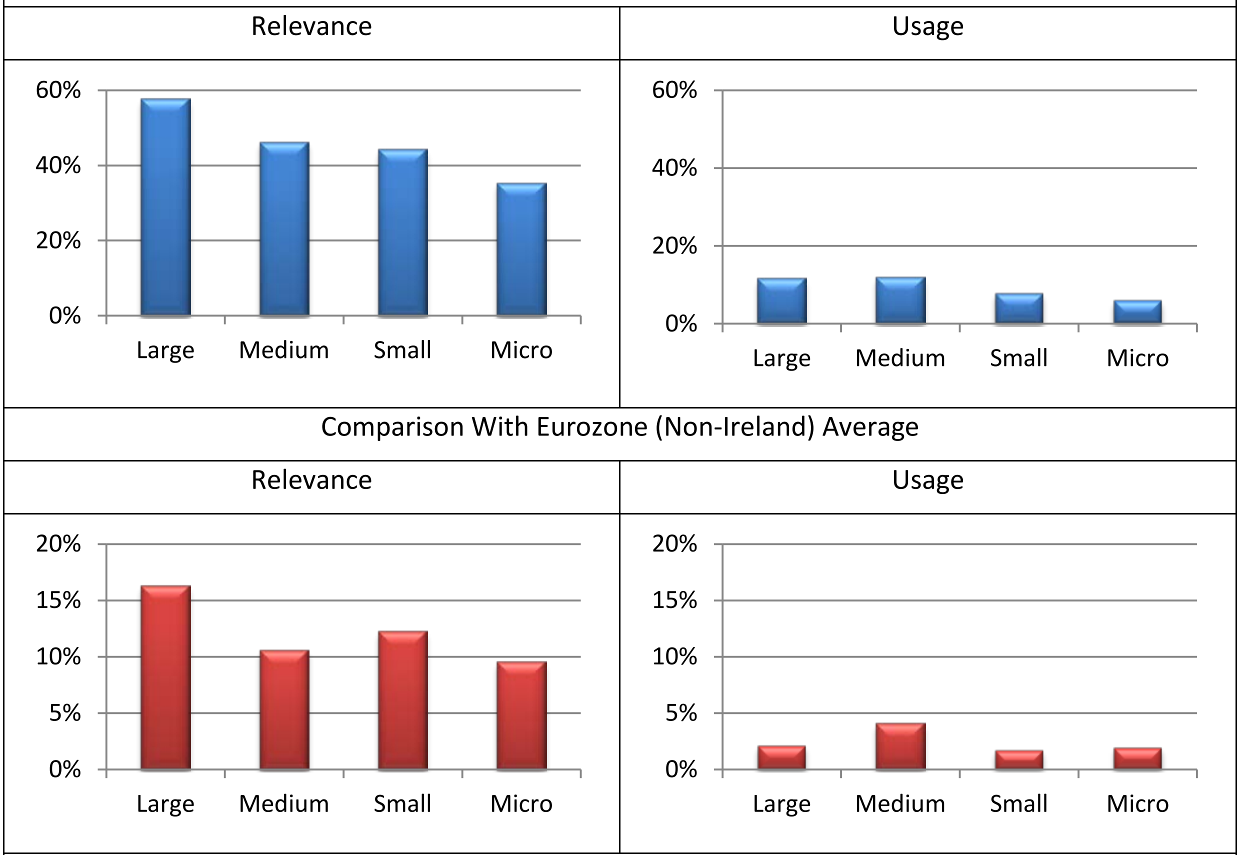
Venture and Growth Capital to SME Loans Outstanding



Source: OECD.

It is important to understand the usage of equity financing across different firms in the economy. Drawing on the SAFE data and splitting the data by firm size, Figure 41 indicates that, as expected, equity usage is higher amongst larger firms. However, over 6 per cent of micro-sized enterprises indicated that they used equity in the past six months. Relative to Eurozone peers, Ireland again has a much higher rate of relevance and usage of equity finance.

Figure 41: Relevance and Usage of Equity Financing Amongst Irish SMEs By Size



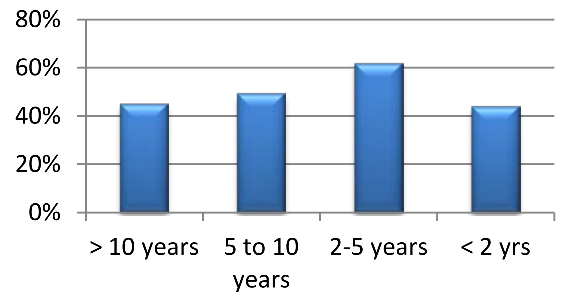
Source: ESRI Analysis of ECB/EC SAFE Survey.

Figure 42 outlines the relevance and usage of equity financing amongst Irish SMEs by age. The usage data indicate that younger firms (less than 5 years) are more likely to use equity finance. In fact relative to their European peers, the youngest group of Irish firms are over 20 per cent more likely to have used equity financing.

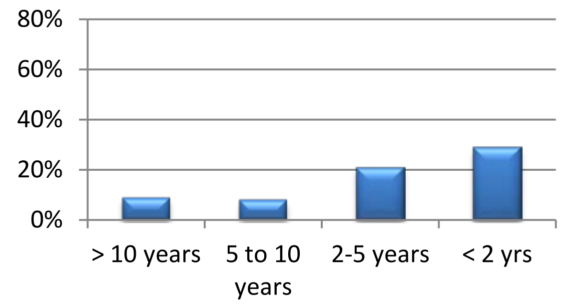
To provide more granular insight into the difference sources of equity capital, we present an overview of two market sources of funding, venture capital and business angel financing, and then outline two more informal sources of equity financing which are (i) funding from friends or family and (ii) funding from business partners.

Figure 42: Relevance and Usage of Equity Financing Amongst Irish SMEs By Age

Relevance

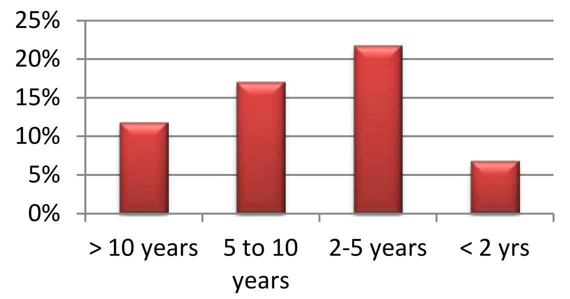


Usage

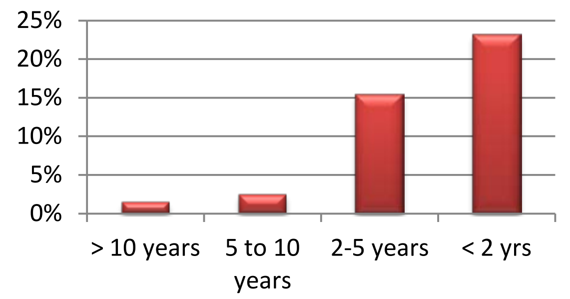


Comparison With Eurozone (Non-Ireland) Average

Relevance



Usage



Source: ESRI Analysis of ECB/EC SAFE Survey.

5.3 Venture Capital and Angel Finance

Internationally, the majority of firms with some venture capital financing were in high-technology sectors such as computing and biotechnology. These firms are characterised by high ratios of research and development expenditures relative to assets and tend to have lower ratios of debt to assets. In the US, most private equity investments are undertaken through intermediaries, which perform much of the selection and due diligence prior to investment in new projects and also perform ongoing monitoring. Intermediaries can, therefore, build up specialised knowledge of certain sectors or investment types that would be costly for individual investors to acquire.

Fenn, Liang and Prowse (1997) attribute much of the growth in private equity in the US (both venture and non-venture capital) to regulatory changes in the early 1980s. One change of particular note was a relaxation of rules on the types of investments permitted to be undertaken by pension funds, allowing them to take private equity stakes in potentially high growth firms that had previously been considered too risky.

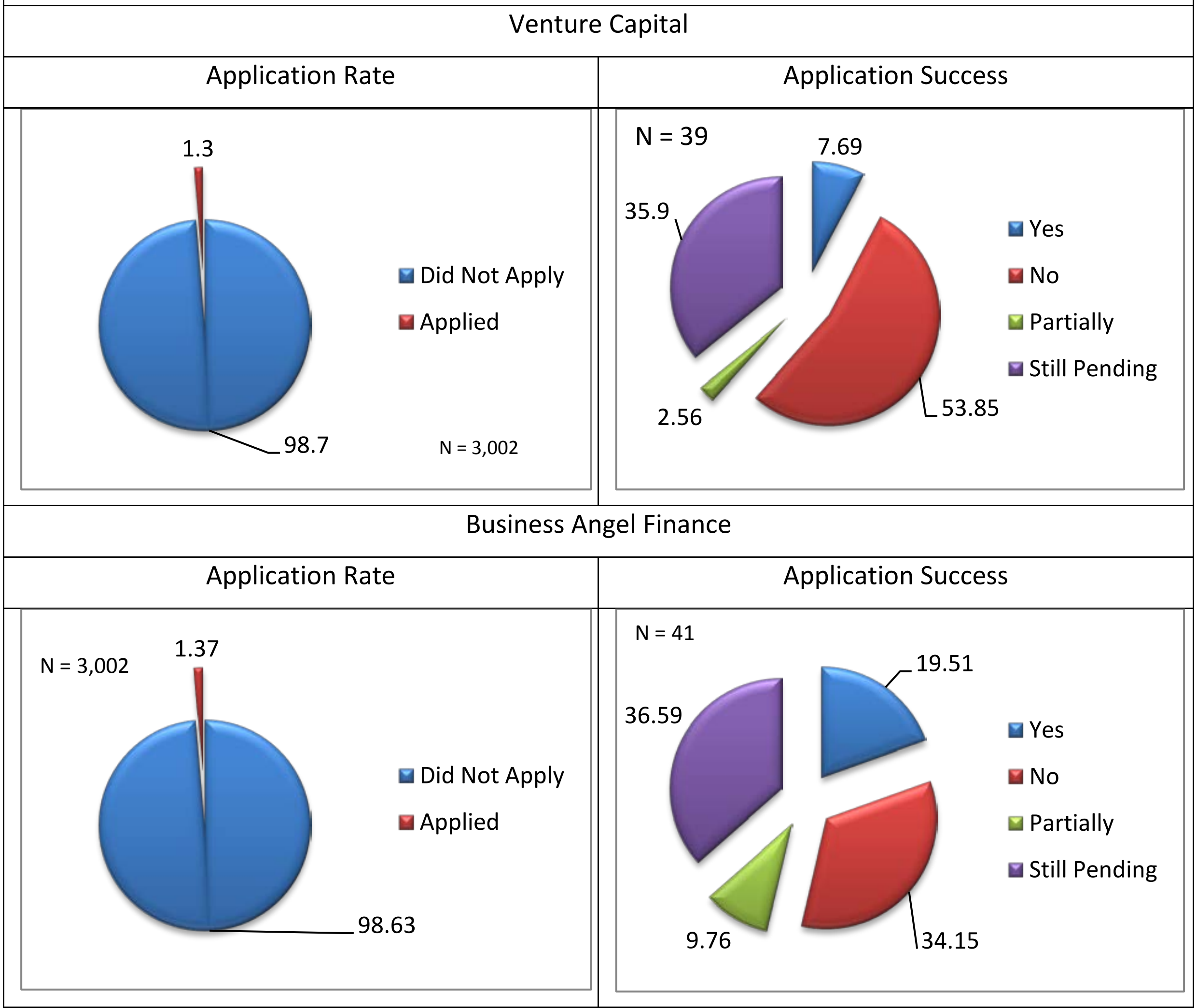
Hogan and Hutson (2004) surveyed 119 Irish new technology based SMEs, arguing that firms in this sector are particularly important drivers of innovation and growth. They report perceptions of information asymmetries as a factor preventing the firms in their sample accessing as much bank financing as they would like, but the firms report that their experience of venture capital is much less affected by asymmetries. This is likely due to the greater specialisation of venture capital in high-technology sectors (as was also the case in the US work by Fenn, Liang and Prowse, 1997). Firms regard the possession of fixed assets or cash as crucial factors in accessing bank finance whereas this was not felt to be a factor for venture capital.

The capital structure of these high-technology SMEs is quite different to that of SMEs in general, with much greater use of outside equity and less debt than is generally the case. This reflects the greater difficulty of banks relative to specialised venture capital companies in assessing the potential of new technology and also the intangible nature of the assets of this type of firm. Another possible explanation is that owners of high-technology companies are more willing to share control if doing so allows them to maximise the company's growth.

In Ireland, approximately €250 million is committed from VC funds to SMEs annually (IVCA, 2014). Drawing on data from the DoF survey, we provide an overview of enquiries for venture capital and business angel funding in Ireland as well as the application success and the reasons for not making applications. For the evaluation of applications, we combine data from two waves of the DoF survey so as to increase the sample size. The waves are: April to September 2013 and October 2013 to March 2014. The data on reasons for not applying are only available for the wave: October 2013 to March 2014. Approximately 1.3 per cent of Irish SMEs apply for venture capital or angel financing.

The success rate for VC funding is low at only 8 per cent full acceptances. In comparison with other funding sources, this highlights how much stricter VC's are in allocating capital. The rate of acceptance for angels is higher at 20 per cent. In both cases, a large number of applications are still pending.

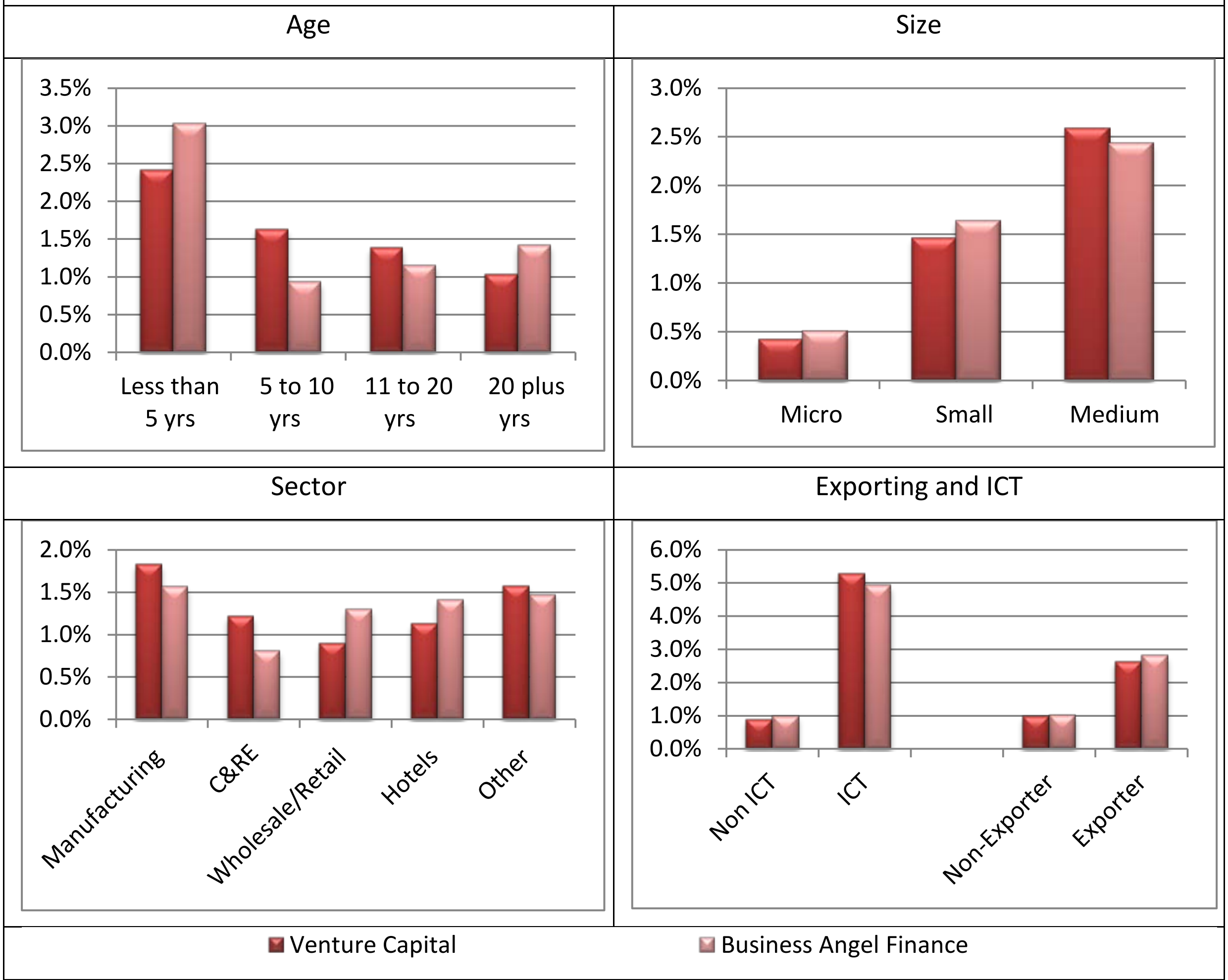
Figure 43: Application Rates and Success for Venture Capital and Business Angel Financing for Irish SMEs



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

Figure 44 presents the application rate for VC and business angel funds by firm age, size, sector and trading status. As expected, venture capital applications are highest amongst young start-up firms and decline with age. Angel investment applications are also highest for firms less than 5 years of age. However, these increase marginally with age for the other two categories. In terms of firm size, applications for both financing types increase with firm size. Again as expected ICT firms have a much higher rate of applications as do exporting firms. Manufacturing firms have a higher rate of applications relative to domestically oriented sectors such as construction or wholesale and retail.

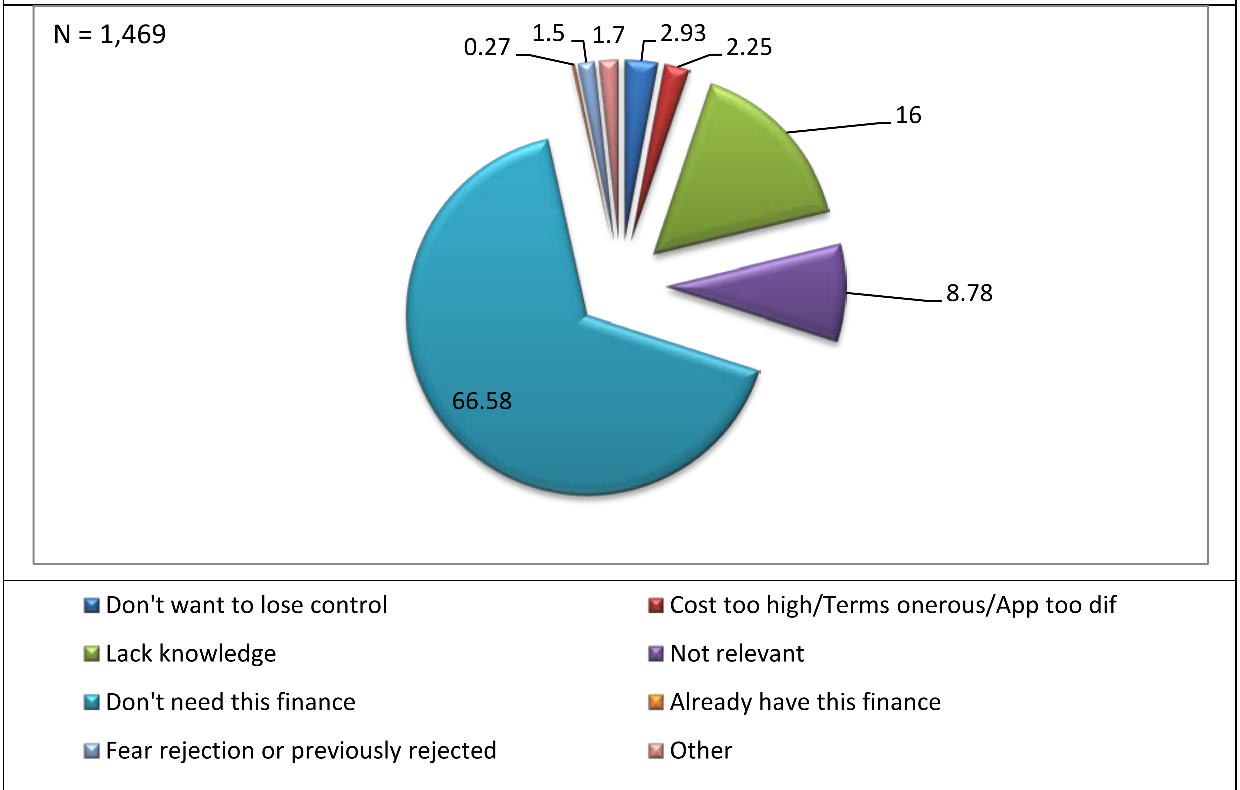
Figure 44: Application Rates and Success for Venture Capital and Business Angel Financing for Irish SMEs by Firm Groups



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

Figure 45 outlines the reasons SMEs gave for not applying to venture capital or angel finance. It is not possible to split these data out in the survey, as the question combined both financing sources. While a majority indicated that they did not need this type of finance, 16 per cent of firms indicated it was due to a lack of knowledge. A further 3 per cent indicated that it was due to an unwillingness to give up control of their business while 2.3 per cent indicated that the costs were too high, the terms were too onerous or the application process was too difficult.

Figure 45: Reason for Not Applying for Venture Capital or Business Angel Financing in Irish SMEs

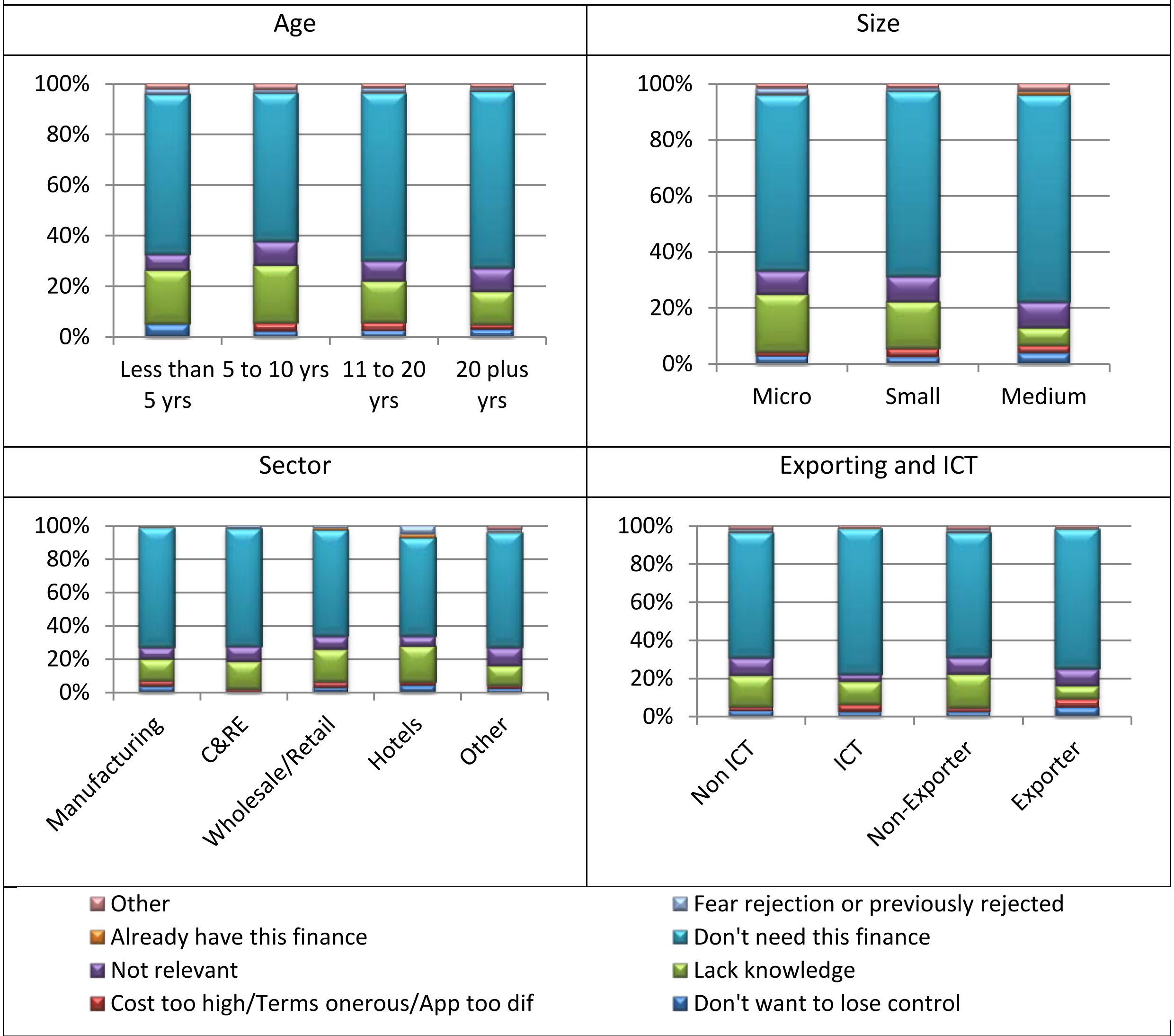


Source: ESRI Analysis of Department of Finance Credit Demand Survey.

Figure 46 splits out the reason for not applying for venture capital (VC)and business angel (BA) finance by firm group. The share of firms indicating that they did not apply due to an unwillingness to concede control is highest amongst the youngest firms, at over 5 per cent. The percentage of firms indicating a lack of knowledge declines with firm age: it falls from 21 per cent in the youngest bracket to just over 13 per cent for firms aged over 20 years. This suggests that increasing awareness of VC and BA financing amongst start-ups could stimulate additional demand.

On a sectoral basis, lack of information as a reason is highest amongst hotels and wholesale and retail firms. A lack of awareness is much higher amongst non-ICT firms which is in line with the VC focus on high-technology investments. Exporters are more likely to indicate that they do not want to concede control of the business relative to non-exporters.

Figure 46: Reasons for No Applications for Venture Capital and Business Angel Financing for Irish SMEs by Firm Group



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

There are large differences across countries in the relative amounts raised and invested in venture capital. Bonini and Alkan (2012) find that venture capital investment levels across countries are influenced by the presence of active stock markets, particularly in initial public offerings (IPO) markets, interest rates, corporate income tax rates and R&D spending. Furthermore, VC investments are shown to be strongly related to the presence of a favourable entrepreneurial environment, as proxied by measures of the transparency and efficiency of contract law and other institutional measures.

Kortum and Lerner (2000) examine the impact of venture capital on technological innovation by estimating the effect on patents across US industries over thirty years. They find a significantly positive effect of the rate of venture capital investment on patents, which is robust across a range of specifications. Specifically, they estimate that venture capital accounted for 8 per cent of industrial innovations in the decade ending in 1992 and that this ratio was increasing. A number of questions are raised as to the sources of the venture capitalists' advantage in funding innovation, in particular, if the advantage comes from better choice of projects to fund or if the effect is due to better monitoring and control.

5.3.1 Angel Funds and Firm Type

Angel finance is an informal market for direct finance where high-worth individuals invest directly in the small companies, typically through taking an equity stake. Angels frequently operate alone, but can sometimes work as an investment group. As the angel investor may have significant business expertise and connections, it has been suggested that an attractive part of obtaining such financing for a small firm lies in the advice and support that can be offered along with the finance itself. Involvement in mentoring entrepreneurs with new ideas may also be one of the attractions of becoming an angel investor rather than investing more remotely through an intermediated fund.

Berger and Udell (1998) point to some examples where attempts have been made to offer more intermediation in the angel investor market, which may be constrained by difficulties in finding good matches between investors and firms informally. One way to do this is to set up networks to ease this matching process by facilitating entrepreneurs to actively seek investment by angels who join the network. The success of these attempts to set up angel networks has however not been definitively proven.

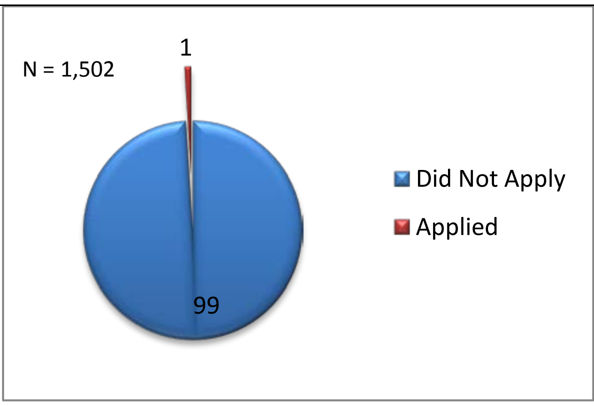
5.4 Friends and Family Equity Finance

Figure 47 presents the application rates and success rates for friends and family and business partner equity finance for Irish SMEs. Approximately 1 per cent of SMEs applied for equity finance from friends or family. The success rate is very high at over 66 per cent. This is in stark contrast to the more formal equity financing provided through VC or business angel (BA) sources which carried much higher rejection rates. It must be noted that the number of applicants is low so the data on successes may be inaccurate due to sample size issues. A slightly higher percentage of firms apply to receive equity finance from business partners at 1.6 per cent. The success rate for these applications is also high at approximately 50 per cent.

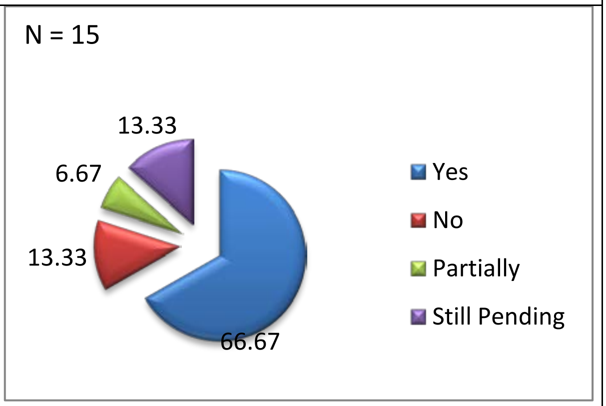
Figure 47: Application Rates and Success for Friends/Family/Business Partner Equity Finance

Friends and Family

Application Rate

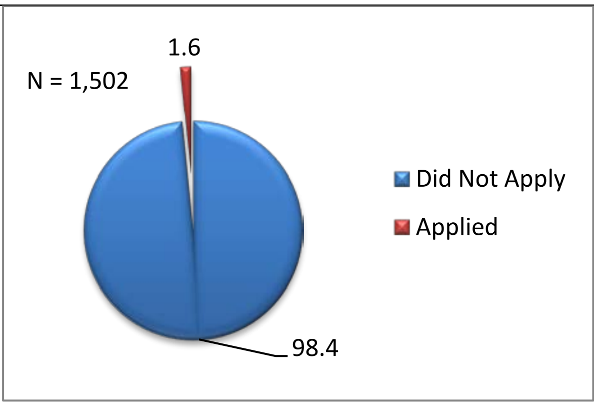


Application Success

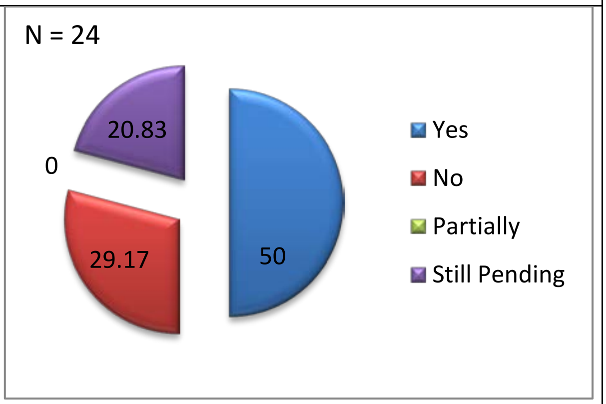


Business Partners

Application Rate



Application Success

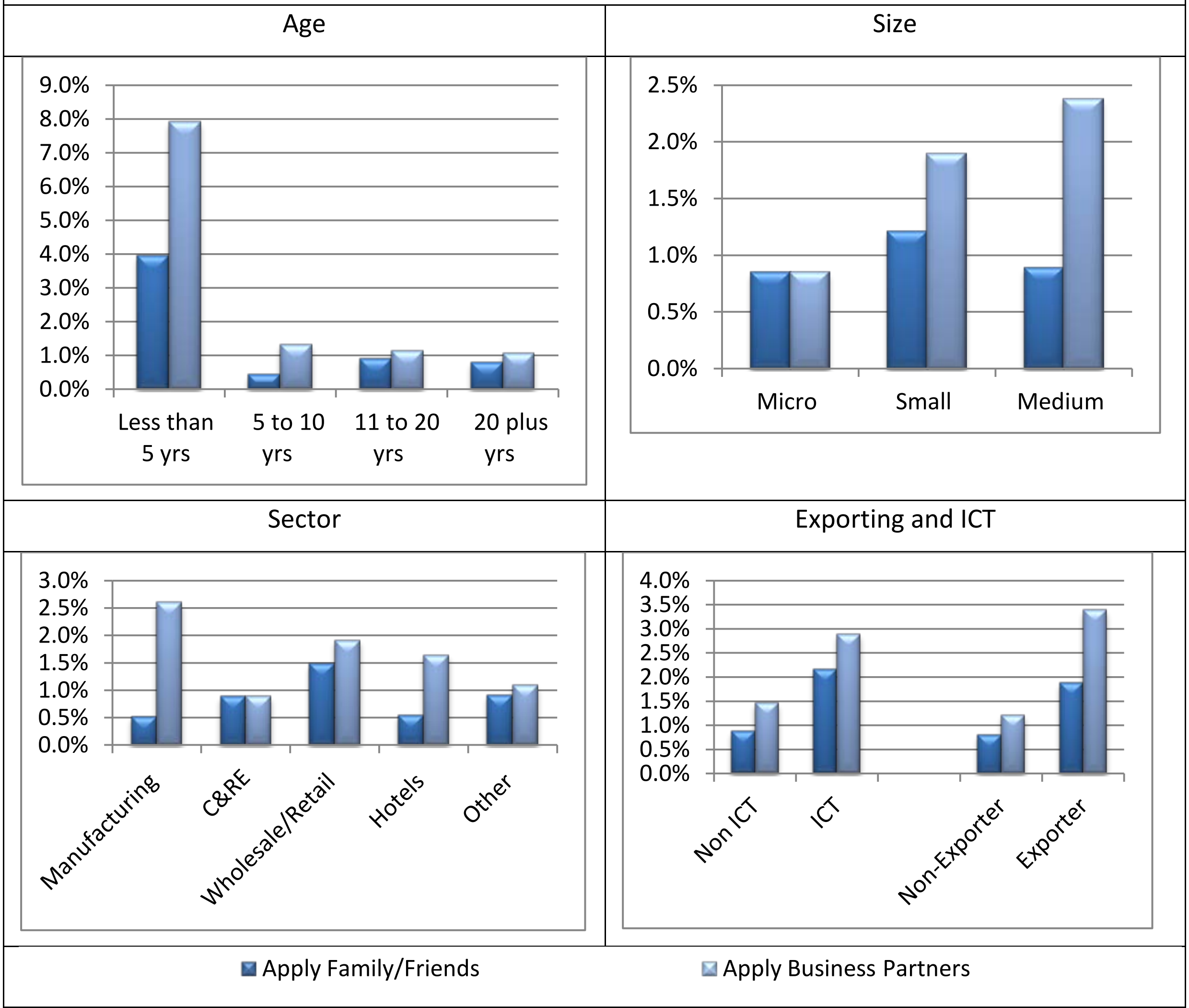


Source: ESRI Analysis of Department of Finance Credit Demand Survey.

Figure 48 presents the application rates and success rates for friends and family and business partner equity finance for Irish SMEs split out by age, size, sector and trading status. The application rates for both are very high for start up firms: for business partner equity up to 8 per cent of firms under the age of 5 years make an application. The applications for business partner equity increase with firm size; however, there is no clear pattern in applications for equity from friends and family.

In relation to equity from friends and family, on a sectoral basis, applications are highest in the wholesale and retail sector and lowest in manufacturing and hotels. Many retail outlets in particular are lifestyle type companies which, due to the difficult trading conditions and heightened bank risk appetite, may find it difficult to access bank financing. These firms may resort to informal sources as a substitute. This equity funding may also be used to match bank funding where an equity piece is required. Applications for business partner equity are highest in the manufacturing sector, followed by the hotel and wholesale/retail sector. Application rates for both equity types are higher for ICT firms than non-ICT firms and also higher for exporters than non-exporters.

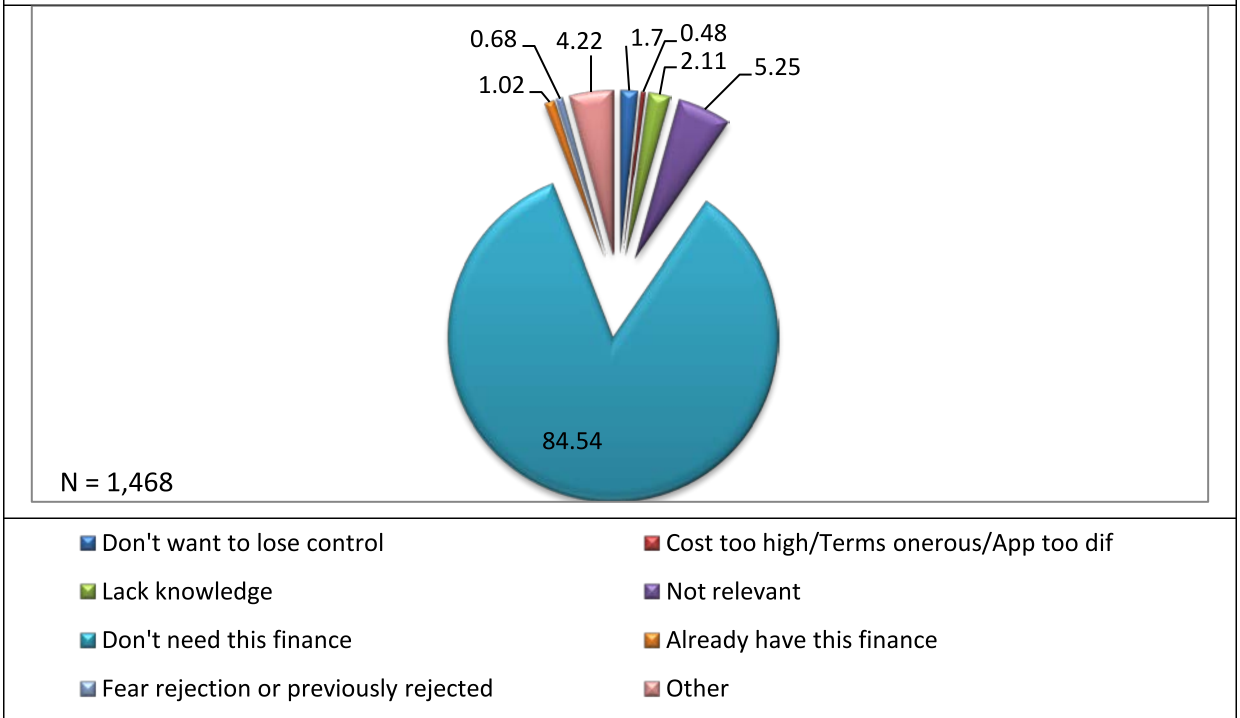
Figure 48: Application Rates and Success for Friends/Family/Business Partner Equity Financing



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

Figure 49 outlines the reasons SMEs gave for not applying for equity financing from friends and family and business partner financing. In general, the majority of firms which did not apply (85 per cent) indicate they do not need this type of financing. Neither a lack of information, nor an unwillingness to give up control of the business are heavily reported as deterrents.

Figure 49: Reasons for Not Applying for Friends/Family/Business Partner Equity in Irish SMEs



Source: ESRI Analysis of Department of Finance Credit Demand Survey.

5.5 Mezzanine Financing

Background and Context

In recent years, there has been considerable international policy focus on developing "mezzanine finance". Indeed a recent OECD report (2014) highlights the potential role that mezzanine finance can play in reducing the reliance on the banking sector. However, it also notes that "...a lack of awareness and understanding on the part of SMEs, financial institutions and governments of these alternative instruments, their modalities, and operations constitutes a major barrier to their use". Drawing on the OECD report, we provide a brief overview of what mezzanine financing is and what types of instruments are used, what types of firms it would best suit, and what is the investment structure.

5.5.1 What is "Mezzanine Financing" and What Instruments are Used?

Mezzanine financing refers to any type of financing instrument that combines the characteristics of debt and equity funding into a single investment vehicle. Mezzanine facilities are structured as investment funds with a pre-determined lifespan typically of 7 to 10 years (OECD, 2014). The investment vehicle is developed as a limited partnership, transacted on the private market and the vehicle's ownership is restricted to a limited number of sophisticated, large investors.

Mezzanine facilities are usually developed by combining a range of underlying financing instruments. The main aim is to design a facility which provides for more risk and higher cost than pure debt financing but lower cost and less risk than equity funding. This more balanced sharing of the risk and reward between investor and enterprise can be appropriate for particular types of firms, at particular stages of their lifecycle. Mezzanine finance is subordinated to other creditors in a bankruptcy setting but payouts are ahead of equity funding.

The OECD (2014) notes that a typical mezzanine facility will contain the following elements: (i) one or more categories of subordinated debt, (ii) a tranche for which the investor receives a “success fee” (i.e., a share of the firm’s earnings or profits) and (iii) an equity-related tranche in which an investor receives a payment whose value is contingent upon a rise in the value of the company, usually reflected by its share price. Box 6 below outlines the main components of mezzanine financing.

Box 6: Mezzanine Financing Instruments

- **Subordinated Loans:** unsecured loans at a specific rate of interest that are not linked to firm performance.
- **Sales or turnover participation rights:** The investor receives a payment which is based on firm performance (turnover, profitability, or earnings). Fixed interest payments can be included in this and the payment may be specific to the asset for which the finance was provided or be more general recourse to the business as a whole. Losses are not shared. These are treated in bankruptcy with other loans.
- **Profit participation rights:** provide for participation in asset profits, surplus on bankruptcy or subscriptions of new stock but do not provide ownership or voting rights.
- **“Silent” participation rights:** Equity stakes are taken but without any liability to the company’s creditors.
- **Equity “Kickers”:** Payments to the investor that reflects the increased value of the company enabled by the financing. These are most likely to be warrants which give the holder a specific purchase right over shares at a predetermined price.

Source: OECD (2014).

5.5.2 What Type of Firms are Suitable for “Mezzanine Financing”?

Research is clear that mezzanine financing is not suitable for all firms (OECD, 2014). It has traditionally been focused on medium-sized firms whose financing size is above €2 million. In general the firm (i) must have demonstrated good earning power and market potential, and (ii) should have a strong business plan, a track record of bank or other financing agreements and good management capabilities. In essence it must have overcome already many of the asymmetric information difficulties and challenges that many SMEs face in accessing finance. This financing type is, therefore, only appropriate for a limited number of established companies. The OECD has adopted the following list of groups of firms that could be potentially targeted:

- Young high growth firms that have previously used angel or venture capital financing and want to undertake capital expansion. It can be cheaper and give less control away relative to equity for these firms;
- Established companies with emerging growth opportunities;
- Companies wishing to restructure and firms going through transitional phases;
- Capital structure strengthening where leverage is excessive; and
- To complement leveraged buy-outs.

Given these characteristics, it is important that the potential benefit of mezzanine financing is not overstressed as a majority of companies do not fit these characteristics or groupings. Many of those who do are also well supplied with bank credit or internal resources. However, potential policy options can be explored to evaluate the benefit of these diverse instruments.

One difficulty with mezzanine financing is finding adequate investment funding. Traditionally investment in these funds has come through insurance companies, high net worth individuals, family offices, pension funds, hedge funds, leveraged public funds as well as banking institutions. The investors must have a longer term perspective to buy and hold for the firm to perform. One benefit of mezzanine type financing is that, depending on the structure, it does not require a costly exit or trade sale.

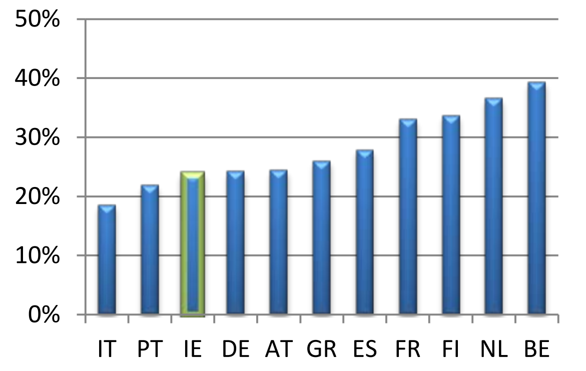
5.5.3 Mezzanine Financing: Statistical Overview

Unfortunately, there are no data available from the DoF survey on mezzanine funding. There are, however, data on this instrument in the ECB SAFE. For clarification, Mezzanine Financing in SAFE relates to subordinated loans, participating loans, preferred stocks or similar financing instruments, i.e., all types of Mezzanine which have the characteristics of debt and equity.

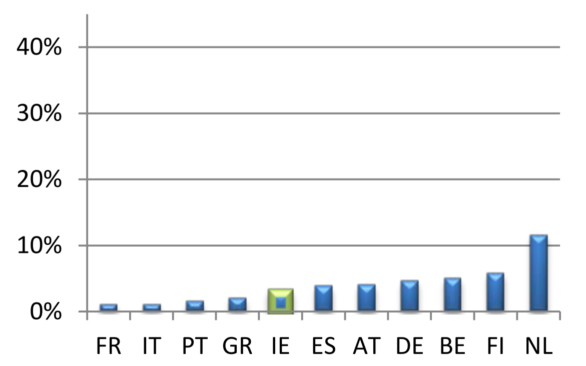
Figure 50 presents the relevance and usage statistics for subordinated loans and mezzanine financing. Ireland ranks lowly on the relevance measure. Just under 24 per cent of Irish firms view mezzanine financing as relevant to their business while only 2.8 per cent actually used mezzanine instruments in the last six months. Ireland was below average on mezzanine usage ranked as the 7th of 11 countries examined.

Figure 50: Relevance and Usage of Subordinated Loans or Mezzanine Financing Amongst European SMEs

Relevance



Usage

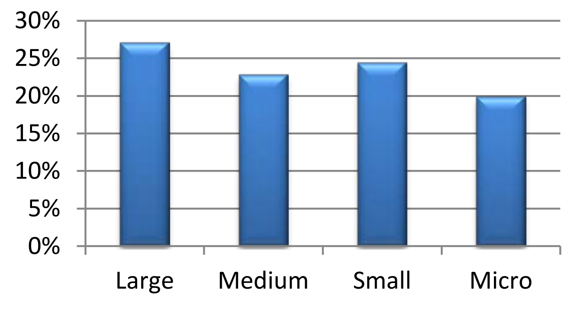


Source: ESRI Analysis of ECB/EC SAFE Survey.

Figure 51 and Figure 52 split out the data by size and age and presents them relative to the Eurozone sample average. In general the data indicate that larger firms are more likely to find mezzanine instruments more relevant as well as use them more often. However, relative to the Eurozone average, Irish large firms display a much lower level of mezzanine relevance and also a marginally lower level of mezzanine usage. This is also the case for Irish micro firms.

Figure 51: Relevance and Usage of Subordinated Loans or Mezzanine Financing Amongst Irish SMEs By Size

Relevance



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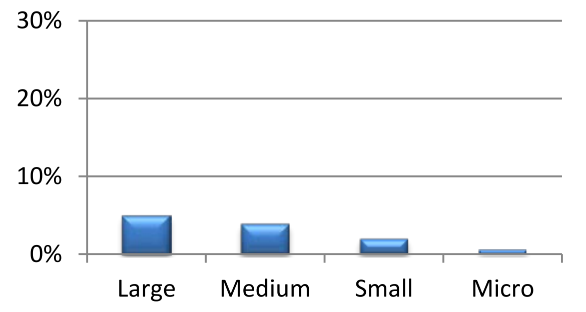
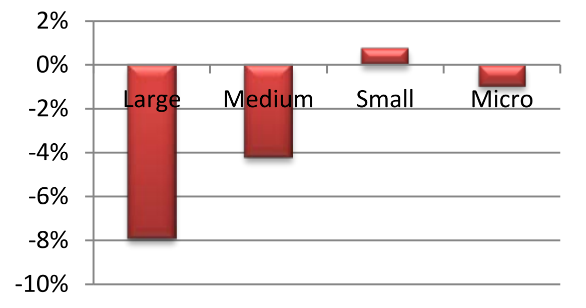


Comparison With Eurozone (Non-Ireland) Average

Relevance



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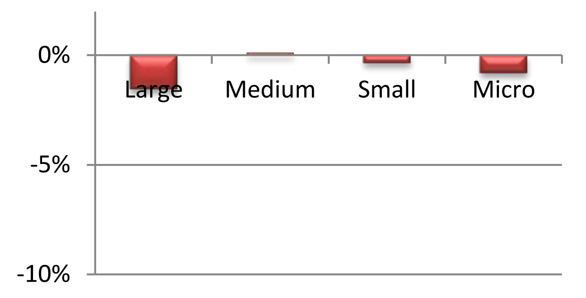
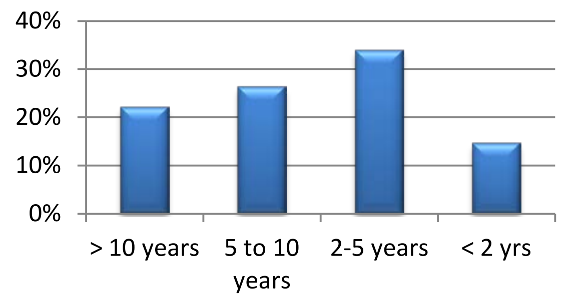


Source: ESRI Analysis of ECB/EC SAFE Survey

Splitting the data out by firm age, the group which indicates the highest level of relevance is the 2-5 year group. However, virtually no firms in this group actually used this financing instrument. Interestingly 10 per cent of Irish start-ups indicated that they used mezzanine financing in the past six months which was much higher than the Eurozone average. Nonetheless, the rate of relevance of mezzanine amongst Irish start ups is lower than the Eurozone comparator group.

Figure 52: Relevance and Usage of Subordinated Loans or Mezzanine Financing Amongst Irish SMEs By Age

Relevance



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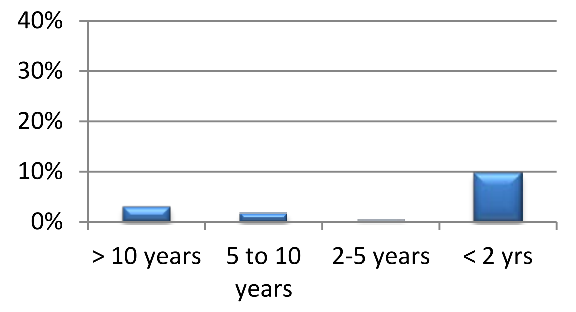
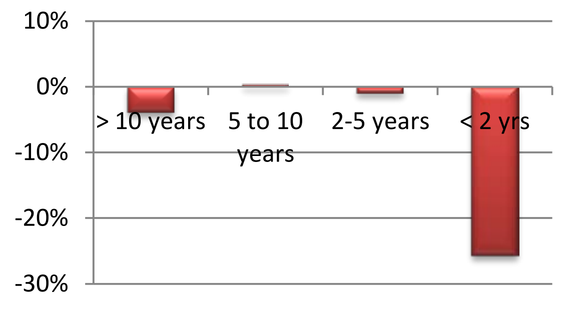


Comparison With Eurozone (Non-Ireland) Average

Relevance



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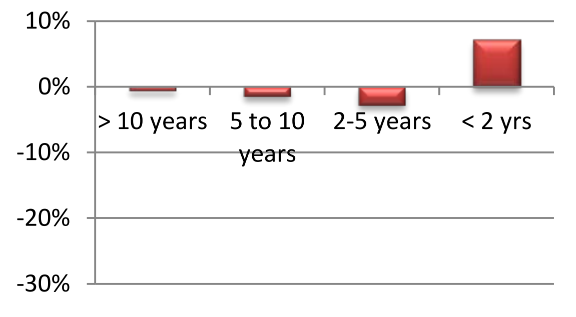

Source: ESRI Analysis of ECB/EC SAFE Survey.

5.6 Policy Issues for Equity Finance Use in SMES

5.6.1 Encouraging an Equity Culture

Before discussing individual proposals for areas where policy initiatives may have an effect on the use of equity financing of Irish SMEs, a number of broader points arising from the consultation process undertaken prior to preparing this report are discussed. These relate to the perceptions and challenges of developing an equity culture amongst SMEs and are likely to influence the effectiveness of specific policy initiatives.

The data presented in the report thus far show that debt is the dominant form of financing used by SMEs and that when external equity is sought it frequently comes from informal sources. While this may not have resulted in financing constraints during times of relatively easily available bank credit, the tightening of lending and increased risk aversion amongst banks leaves a gap in financing that could have negative overall effects on firm performance unless filled with alternative sources, of which equity is the most obvious option. There was a virtual consensus on this issue amongst all stakeholders consulted during the process. It was also pointed out by market participants that raising of debt and equity may frequently be jointly required, as bank lending extended to firms is less likely to finance the total cost of projects in the future without some portion of the risk being taken on by the firm itself or other investors.

Equity financing can, therefore, be expected to be of increasing importance to firms in the future. However, in the survey data analysed above, we saw that the majority of firms viewed themselves as not needing this type of finance and as seeing a number of other obstacles to using equity. Losing control of the firm was one of these considerations, although it was less frequently reported as an issue in the survey than might have been expected, as it was raised as a much more prominent issue in our consultations. That small firms in particular tend to be family-run and hence have decisions made "at kitchen table not board table" as one stakeholder phrased it makes it particularly difficult to involve outside investment. This goes a considerable way to explaining the dominance of friends and family as a source of external equity amongst this group of firms.

Providing information on the role equity can play and making the process of finding such investment less burdensome for both entrepreneurs and small investors are, therefore, keys to the success of growing the SME equity market over time. A number of specific suggestions as to how this can be accomplished include:

- Support of financial education and advice for small business owners in order to provide information and support on finding a wider range of financing options. Initiatives in this area such as SkillNets are welcome and should be further built upon, although some concerns were raised that the provision was currently too broad and more targeted training or mentoring would be a valuable addition. The role of the Local Enterprise Offices (LEOs) will be important in this context as the most obvious source of education and advice for firms, especially those at the earlier stages of the life cycle. The training of LEO staff to provide a high level of support to firms, particularly in terms of newer financial products, will require some investment.
- Another potential obstacle to acquiring equity, particularly relatively small amounts, is the burden of associated legal costs. The development of a range of template agreements that could be used as benchmarks for types of small equity investment could have the potential to increase transparency and reduce legal costs, thereby making small equity transactions more accessible and providing some piece of mind to both investors and firm owners that a standardised agreement is in place.
- Given the thin size of the Irish market, matching of investors and businesses is a key challenge and facilitation of this process (e.g., Halo Business Angel Partnership and Business and Innovation Centres) will be an important element of building the proportion of equity

used by firms. An active educational and publicity campaign to promote investment in local businesses would build awareness of these options.

Overall, it does appear that something of a cultural shift amongst SMEs towards looking for equity financing rather than defaulting to bank credit and also incentives to encourage small investors to look towards opportunities in the SME market are required. Increased incentives for investing in SMEs, particularly relative to those currently existing for property investment, should be considered in order to raise levels of productive capital. SME owners could also be incentivised to reinvest profits in the firm rather than to withdraw them to take advantage of tax incentives relating to pension schemes, illustrating the importance of the alignment of incentives and supports.

It is also important to make a distinction between two groups of firms: high-growth, export-oriented firms with expansion prospects and domestic-oriented firms, smaller SMES, with modest growth. Developing an equity financing landscape for these two groups poses very different challenges and may require very different suites of policy support. The first group is very much in the space of accepting traditional private equity, external angel investment or other market-oriented investment. However, the second group, which may not be as attractive to investors, account for the greater share of firms in the Irish economy and this is the group for which raising equity finance is more difficult.

5.6.2 Supports for Equity Growth Capital in Ireland

The two main state bodies which provide support for equity financing in Ireland are Enterprise Ireland and the NPRF now ISIF. Information on the supports available is well documented by these agencies so here we only provide two brief boxes to give an overview for our discussion. In general, the majority of these schemes are targeted at the first group of firms identified above. These are the firms with the most growth and export potential and their development is important for Ireland’s recovery.

Enterprise Ireland is very active in developing the equity and growth capital market in Ireland through the provision of co-investment and match-funding for a range of equity supports. While a range of supports are available, we provide a brief overview of four relevant groups of funding: Seed capital; Venture Capital Support; Business Angels; and Development Capital. Enterprise Ireland supports over €800 million of funding through angel investors, seed, and venture capital channels.

Box 7: Enterprise Ireland Equity Support

Seed Capital Funds: Seed Capital funding is a similar concept to venture capital funding with individuals providing investment into a company in return for equity. Seed capital funds usually occur during the early-stage of firm development when a firm is between angel funds and venture capital funding. Candidate firms are those that have a commercial and business record, have viable investment opportunities, have good industry contacts and could be venture capital candidates in time. Enterprise Ireland has a total of €124 million managed in supported seed capital funds and there are four main seed funds operating: the AIB Seed Capital Fund valued at €53 million, the AIB Start-up Accelerator Fund valued at €22 million, the Bank of Ireland Early Stage Equity Fund valued at €32 million, and the Bank of Ireland Start-up and Emerging Sectors Equity Fund valued at €17 million.

Venture Capital Supports: Venture capital finance supports from Enterprise Ireland are extensive and target a range of sectors and firms. A selected range of funds include:

	€mn
Atlantic Bridge Venture Fund	67
Atlantic Bridge Venture Fund II	75
Bank of Ireland Kernel Capital Partners	51
Delta Partners	105
Fountain Healthcare Partners	73
Seroba Kernel Lifesciences	75
NCB Ulster Bank Diageo Fund	75
Frontline Ventures Fund	20
SOS Ventures Ireland Fund	20

Business Angel Financing: Enterprise Ireland has worked with a number of organisations to develop a business angel financing network in Ireland. The Halo Business Angels Partnership facilitates this network of Business Angels and is supported by Enterprise Ireland and InterTradeIreland. HALO is managed locally by the Dublin Business Innovation Centre (DBIC), WestBIC, CorkBIC, and the South East Business Innovation Centre (SEBIC) and nationally by the HALO Business Angel Network (HBAN). Angel investors in many cases avail of Revenue-backed tax incentive schemes.

Development Capital for Medium Sized Firms: Enterprise Ireland currently has two funds in the market to provide tailored financing solutions for medium-sized firms. These "Development Capital Funds" aim to invest between €2 million and €10 million in equity, quasi equity and debt into export-orientated mid-sized firms. The two current funds are MML Capital Ireland fund (€125 million) and BDO Development Capital Fund (€75 million). These schemes also have the flexibility to provide mezzanine instruments.

Source: Enterprise Ireland.
Note: Enterprise Ireland also co-invests with the ISIF/NPRF in the provision of equity capital, in particular through the Innovation Fund Ireland.

The NPRF has been a provider of equity and growth capital for Irish enterprises for a number of funding cycles. However, a greater focus on SMEs and on strategic investments to support economic recovery is mandated under the newly created ISIF. ISIF has gone to market with a number of funding instruments and investment vehicles and these are briefly described in the box below.

Box 8: NPRF/Ireland Strategic Investment Fund – New Equity Supports for Irish Corporates

Innovation Fund Ireland: Innovation Fund Ireland is a joint initiative between the NPRF and Enterprise Ireland to bring to Ireland leading venture capital fund managers and to channel extra financing towards Irish early stage and high growth companies. Six investments have been made to date.

China Ireland Technology Fund: This technology-oriented fund contains approximately $100 million in equal commitments from the NPRF and the China Investment Corporation. It will target minority equity investments to Irish companies who have a presence of strategic interest in China or Chinese companies that have a presence or strategic interest in Ireland. The sectoral focus will be on core technology such as internet, software, semiconductors, and clean tech, however, technology in other sectors such as agri-food, medical devices or finance will also be considered.

Carlyle Cardinal Ireland Fund: The Carlyle Cardinal fund is a private equity fund worth between €300 million and €350 million, with €125 million provided by the NPRF. The fund will provide investments for healthy business with strong growth potential and includes firms with overleveraged balance sheets. The fund's investments are targeted at enterprises with growth equity opportunities, enterprises looking for majority and minority investments. It will also participate in leveraged buyouts and in family/founder partnership models. The average investment ranges from €2-€50 million with co-investment available for larger deals.

Venture Capital Investments: The NPRF invested €81 million across five Ireland focused VC funds in the technology and healthcare sectors between 2007 and 2010. Additional VC funding is being made available through the aforementioned funds.

The range of schemes listed above provide a variety of funds and funding instruments to support the development of Irish businesses. They are mainly targeted at the high-growth, investment-ready, expanding firms. The remainder of this chapter overviews more general policy interventions that apply across all firm types.

5.6.3 Employment and Investment Incentive Scheme (EIIS)

The Employment and Investment Incentive Scheme (EIIS) was set up in 2011 as a replacement to the Business Expansion Scheme (BES) with the purpose of providing a tax relief incentive scheme designed for investment in certain corporate trades. The aim was to encourage investment in Irish companies through income tax relief on investments that can be claimed by individual investors on investments up to €150,000 per annum until the year 2020. An initial tax relief of up to 30 per cent is available for individuals and a further 11 per cent may be available once adequate proof is provided that the company has seen sufficient employment increases by the end of the 3-year holding period or in cases where the company has invested the capital in research and development.

The qualifying company must be a micro, small or medium-sized enterprise (SME), as defined by the European Commission, and must be incorporated and a resident of the State or another European Economic Area (EEA) State. Qualifying companies can have subsidiaries provided that the subsidiaries are themselves qualifying companies and are at least 51 per cent owned by the parent company. Although the majority of SMEs qualify, a small number of trading activities are not eligible for the scheme.

The company must also be unquoted and investors must purchase new ordinary share capital in the company. Medium-sized enterprises operating in what is known as “non-assisted areas” of Ireland may only qualify for the scheme during the seed/start-up phase of development. Ireland is divided into “assisted” and “non-assisted” areas with the current “assisted” areas consisting of all of Ireland excluding Dublin, Meath, Kildare, Wicklow, and Cork city and county excluding Cork Docklands.

Although take-up of the scheme has been fairly stable since 2009, it is roughly half of the take-up figure of the previous BES in the early 2000s. During our consultations, there was a widespread feeling that there may be scope to increase take-up by targeting non-traditional and household investors who have traditionally invested in the housing sector. However, these investors are likely to have difficulty seeking suitable advice and information on investing in SMEs. In particular, smaller investors may perceive investment in SMEs to be riskier and have relatively less returns compared to housing, stocks and deposits. The structure of the EII scheme may not make the potential tax breaks clear enough to offset this uncertainty.

The EIIS is the key scheme through which equity capital injections are likely to be accessed by SMEs and expanding its use and ease of access is the most promising route towards expanding funding options. It is also the clearest way in which to formalise much of the current family and business partner funding to place it on a more secure basis, which would benefit both the firms and the currently informal investors.

Some specific proposals on increasing the use of the EIIS include:

- Directly promote use of the scheme, targeting both business owners and potential investors, as knowledge of the provisions appears to be limiting current usage.
- Streamline applications procedures and remove restrictions on types of enterprise and location (subject to EU approval).

- Remove restrictions on type of investor that can benefit from the scheme (e.g., by removing it from the high income earner restriction).
- Consider increasing limit on individual investment amounts.
- Harmonise requirements for EIIS and Seed Capital Scheme to encourage continued investment from start-up to expansion phases to occur seamlessly.
- Examine possibility and costs of offsetting losses against other taxes to reduce downside risks for investors.
- Have time-limits and regular reviews of scheme effectiveness.

5.6.4 Increase Use of Seed Capital Scheme

The Seed Capital Scheme is a component of the EIIS designed to incentivise starting a new company by allowing a refund of tax to new entrepreneurs who were formerly employed or unemployed. In the case of an employee who leaves employment, an investment by means of shares in a qualifying new venture may be eligible for a refund of income tax paid in previous years. An unemployed person may also avail of this facility based on previous earnings. The maximum investment is €100,000. The individual must possess at least 15 per cent of the issued ordinary share capital of the company in which the individual makes the relevant investment and hold the shares for a period of 3 years.

The principle of this scheme to encourage new firms is very positive and, as with the EIIS, it has the potential to be used more broadly and effectively if it was more widely known and more streamlined.

- The scheme should be more widely promoted, particularly by the Local Enterprise Offices.
- The requirements for the scheme could be simplified.
- Consider removal of the employment income restriction to allow serial entrepreneur and self-employed to use the scheme.
- Allow longer time limits between investment and the full time employment requirement.
- Allow for some outside employee income to still be earned for first months of business to ease transition.
- The limit for investment size of €100,000 should be increased.

5.6.5 Employee Equity Investment

A challenge for many SMEs in attracting equity investment is the difficulty for an external investor to have enough information on the firm to put up the required risk capital. This is one of the main reasons that equity investments in smaller firms tend to come from known or linked investors, such as family, friends or business partners who would have more detailed information, both hard and soft, on the firm's operations and prospects. Employees are another group where greater participation in share ownership could be encouraged. Informational asymmetries would be considerably lower and, from the firm point of view, bringing key employees into an ownership-sharing relationship could have important benefits, in addition to the equity injection itself, by retaining commitment and skills of key staff and enhancing productivity.

The existing schemes do not provide opportunities for firms to use them as retention or promotion devices because they cannot be targeted at key employees. Larger companies on the other hand have the potential to offer such schemes to designated groups of employees. The existing schemes are also complicated in terms of their restrictions on share buy-backs and rules on divesting; greater clarity on these as well as on the tax issues related to the schemes could make them more attractive.

Employee Share Schemes in the UK

Share schemes for selected employees include the Enterprise Management Incentives (EMI) with added tax benefits and simplified rules, and the Company Share Option Plan (CSOP) which allows UK employees to be rewarded financially without incurring PAYE for good business performance. Share schemes which are suitable for all employees include the Save As You Earn (SAYE) share option which allows employees to buy shares on a regular basis from their gross salary without incurring PAYE, and the Share Incentive Plan (SIP) which allows employees to purchase shares from gross income, through a free allocation of shares or from participation in a matching scheme.

5.6.7 Taxation of Capital Gains from Entrepreneurship

Budget 2014 introduced a new capital gains tax incentive to encourage entrepreneurs (in particular serial entrepreneurs) to invest and re-invest in assets used in new productive trading activities. This allows individuals who reinvest the capital gains they made on disposal of an asset into a new business investment to pay a lower rate on the disposal of the new investment (either reduced by the tax paid on the original disposal or 50 per cent of the new disposal). This is a welcome development and should be reviewed once the current cut-off point of 2018 is reached to examine it effectiveness and potential renewal.

In the UK, Entrepreneurs' Relief entitles entrepreneurs to tax reliefs that may reduce their Capital Gains Tax bill. Relief can be claimed on qualifying gains made through the disposal of all or any part of the business, or business assets after the business stops trading, or company shares. To qualify the individual must be a sole trader or partner in a trading business, or hold shares in their personal trading company.

5.6.8 Refocus Tax Incentives towards Business Investment

Given the risks inherent in investing in any individual or group of firms, the tax system should be careful that productive investment is not placed at a relative disadvantage. Equalising the tax treatment of funds on deposit and funds in productive investments was recommended by the

Commission on Taxation (2009) through the reduction of the tax rate on dividends received by Irish residents to the rate applying to deposit interest.

The proposals in the UK's review of its tax system – the Mirrlees Report (2011) – to introduce a rate-of-return allowance for substantial holdings of risky assets to offset tax should be analysed and perhaps used as a basis for discussion of options to refine the taxation of investment income in an Irish context.

The tax framework required for the establishment of real estate investment trusts (REITs) was introduced into legislation as part of the Finance Act 2013. A REIT is a listed company, with multiple owners, that invests in rental property, with the aim of providing investors an after-tax return along with the benefits that exist by diversifying risk. By investing in a REIT with such a diversified risk portfolio, it allows investors to make a collective investment in property assets to spread the risk, and can allow an opportunity for small investors to access returns from property assets. The REIT incentive appears to have been quite successful and research should be undertaken to examine if there is any mechanism through which a similar structure could be designed to channel investment into firms operating in a wider ranges of sectors.

5.6.9 Tax Treatment of Equity Compared to Debt

Internationally, tax systems tend to incentivise firms to fund themselves through debt rather than equity, primarily because interest payments are deductible for corporate income tax purposes while equity returns are not. De Mooij (2011) outlines the possible economic costs of this system and proposals for changing the tax balance between debt and equity to a more neutral system. The differences in tax treatment implicitly increase the cost of equity financing for firms and promote reliance on debt finance, potentially leading to an overly large banking sector.

One method recently introduced in Belgium and Latvia to establish greater neutrality of tax treatment between debt and equity is a system known as an allowance for corporate equity (ACE). This supplements interest deductibility with a deduction for the notional return on equity. Recently, this approach has been advocated by the Mirrlees Report (2011) reviewing the operation of the UK's tax system.

The Belgian system treats interest payments to a third party as a tax deductible cost with interest representing the compensation of a debt instrument. However, certain debt instruments such as profit participating, perpetual, subordinated etc., may exhibit characteristics that are associated with equity instruments. If the financing instrument could not for these reasons be classified as a debt instrument then it could be re-characterised by the tax authorities as an equity instrument, with the remuneration received in the form of a dividend which was not tax deductible. In 2006 a tax deduction became available for equity finance regardless of dividends paid which is based on the 10-year Belgian Treasury bond rate. The rate was then applied to the company's net assets.

5.6.10 Venture Capital Policy

Despite arguments that there is a market failure in external funding for start-up companies, and particularly for high-technology firms, government intervention to bridge this gap by supporting venture capital funds has not been without criticism. The main problems besetting these schemes relate to the ability of government officials to adequately identify and support potential high-growth firms and the danger that decisions on the firms to support may be taken on political rather than strictly economic grounds (Del-Palacio, Zhang and Sole, 2012). On the other hand there can be many positive externalities from the provision of venture capital funding to high-growth firms that are finding access to traditional funding sources difficult.

Del-Palacio, Zhang and Sole (2012) evaluate the performance of a number of national and regional Spanish schemes to support technology entrepreneurship, specifically through the provision of venture capital market, either directly or by providing incentives to private venture capital funds. They find that the public interventions had an overall positive effect on the number of venture capital investments being made over the decade following their introduction. However, the characteristics of the venture capital companies themselves also had an important effect, with their size and expertise being particularly significant determinants of investment being made in early-stage and high-technology firms.

The European Commission (2011) has indicated plans to set up a new European venture capital regime that will allow venture capital funds to work across all countries in the EU with simplified single registration and reporting to encourage a greater scale of venture capital, more specialisation across sectoral rather than national lines, and increased competition between funds.

Internationally, the funding environment for venture capital funds have been extremely challenging in recent years and the wider economic downturn resulted in poor performance statistics of a number of funds. Regulatory changes to pension funding risk weights under Solvency II rules limited options to invest in VC funds by the pension industry, which had historically been an important source of long-term financings. The situation in Ireland mirrors that of the industry internationally and industry participants emphasise that the long run and risky nature of VC investments require a regular stream of reliable funding support, with this reliability being more critical in allowing forward planning than the amounts available.

The tighter restrictions on pension funds, particularly defined-benefit pensions, investing in VCs generally and the specific reduction in the available funds coming from the levy on pension funds introduced by the government between 2011 and 2014 reduced available funds that could potentially have been directed into VC investments. In general, the illiquidity of VC does not work well as an investment choice for defined contribution pension funds, which are becoming more the norm; as a result the funding flow into VCs has been declining.

In continuing the viable operation of VC funding in Ireland, the ongoing commitment of Enterprise Ireland as a cornerstone investor is crucial and this does not seem to be in question. Other options for policy intervention are relatively limited. In the event of moves towards a broader auto-enrolment pension system, some design to encourage portions of the plan to be channelled into higher-risk/higher return options for younger members should be investigated as a way of increasing equity investment generally and in VCs in particular.

5.6.11 Developing Mezzanine Finance

Policy intervention in the mezzanine finance market exists in a number of countries because of its potential to provide finance efficiently to key categories of SMEs. The types of support available are classified by the OECD (ADB-OECD 2013) as:

(i) Participation in the commercial mezzanine market through the creation of investment funds that invests alongside private investors in SMEs.
(ii) Direct funding to SMEs can be provided by a special agency.
(iii) Funding of private investment companies at highly attractive terms (mainly in the United States).

The Irish government has financing available through the new ISIF structure and mezzanine financing is available through particular schemes (BlueBay). The development capital schemes run by Enterprise Ireland can also provide hybrid funding.

There may be scope to establish additional mezzanine investment vehicles over time. However, the key question is how such a vehicle would be structured given the profile of Irish SMEs. Given their lack of appetitive for other non-bank financing and low levels of investment and expansion, these schemes may not have a large demand in the current environment. This may change as recovery becomes more engrained.

However, little is known about the general Irish SME views on mezzanine financing amongst firms that would not be traditional candidates for this funding. For it to be widescale its relevance to these firms would need to grow. One proposal for future research would be to include a module on the Department of Finance Credit Demand survey which would test the appetite for these instruments amongst non traditional candidate enterprises. That said, in general, mezzanine facilities are very unlikely to be relevant for the median micro or small firm in Ireland.

Chapter 6

Policy Discussion and Conclusions

The objective of this report was to examine the current funding mix used by Irish small and medium-sized enterprises, to examine where new financing demand and opportunities might emerge and how the policy environment can help develop and support a financing ecosystem that provides firms at each stage of growth with a suitable and accessible range of products.

The SME sector makes up a significant proportion of employment. Firm size matters considerably in determining sources of financing, with SMEs relying more on loans than large firms. The greater difficulty of smaller firms in accessing credit relative to larger firms revolve around differences in risk profile and information asymmetries between the firm and lending institution. It can be difficult for SMEs to convince banks of the quality of their business plans and, for newer firms in particular, it can take a considerable amount of effort to build a reputation that signals that they are low risk. From the bank's point of view, the costs involved in assessing and monitoring SMEs act as a disincentive to funding this market. Furthermore, SMEs often have less collateral that could protect creditors.

In times of recession or crisis, SMEs are particularly vulnerable as their limited diversification and dependence on short-term credit give them much less of a buffer against demand falls than are available to larger firms. However, even in times of stable economic growth, SMEs tend to have less diversified sources of finance than larger firms and policy interest in broadening the set of financing alternatives available to SMEs is, therefore, of ongoing concern as the economy returns to growth.

This report divides the financing options for SMEs into three very broad headings – bank credit, non-bank debt and equity. Within each of the respective chapters, we detail the extent to which each of these sources, and their various sub-components, are used by firms overall and profile the type of firm most likely to avail of each finance type. We then benchmark the Irish usage to evidence from firm surveys across Europe. The set of policy supports currently in place for each broad source of finance are outlined, again with reference to some international comparators to provide evidence on best practice and to identify any potential gaps existing in the current Irish framework of supports.

Each chapter contains a range of recommendations for how the existing schemes could be extended or made more effective and on where any identified gaps could be bridged. Given the wide remit of the report and the fact that many of the policy interventions have been put in place only relatively recently, we do not carry out detailed evaluations of any individual measure. Rather the objective is to review the overall structure of the financing ecosystem and the policy supports that underlie it in broad terms.

To place these policies in context, we begin by reviewing the national and international evidence on how SMEs fund themselves across the life cycle. We then provide forecasts of the expected credit demand of Irish SMEs in the medium term, using a number of different scenarios on the speed of economic recovery. This exercise estimates that total credit stocks will return to their long-run average trend equivalent to 40 per cent of GDP. The composition of this credit is expected to change however with a rebalancing away from the disproportionately high property lending of the boom era towards expansion of credit in other sectors.

Bank credit is extremely important to Irish SMEs, who have the highest rate of usage of bank overdrafts across Europe. Banks are likely to remain the dominant source of external funding for most firms going forward. One concern in this area is that the increased concentration in the Irish banking markets may have a negative effect on the supply of credit to SMEs. Increasing competition in this area through the operation of the SBCI is an important policy initiative in this regard, above and beyond the direct lending that the SBCI will provide to the market.

Other policy recommendations in the facilitation of access to bank credit are the immediate implementation of the reforms to the Credit Guarantee Scheme, extending it to cover refinancing and working capital and to allow for longer term lengths. Reviewing the role of the Credit Review Office and potentially placing it on a permanent statutory basis as an independent mediator working with all lending institutions should be undertaken and priority given to ensuring the referral and appeal process is as clear and simple as possible.

For smaller firms, extension of the Microfinance scheme with an increase in maximum loan size and term length should be considered. Flexibility could also be added to the products offered by the scheme in terms of interest rates, payment delays or other adjustable mechanisms. Greater promotion to raise awareness of the scheme is recommended. To extend options for credit sources for smaller firms, a review should be set up to examine the possible role that credit unions might play in the business lending market.

In reviewing firm policy supports across OECD countries, one major gap emerges in the absence of provision for tailored financing for exporters. Given the importance of exporting firms for the Irish economy, an evaluation of the types of schemes in operation elsewhere and what format would be most suited to the Irish context should be carried out with a view to establishing some level of support in this area.

Turning to non-bank sources of credit, we review the current types of debt financing used by firms. Formal market debt is rarely used by SMEs, with non-bank debt typically coming from trade credit or from informal sources. Relating to formal market debt, we examine the current proposal to establish a 'retail mini bond' market. While all moves to expand the range of financing available to firms is welcome, we do note that this type of funding would be most applicable to a relatively small number of firms. Some type of tax incentives would probably be needed to make such a market successful in attracting investors and firms. Reducing compliance costs by standardising documentation and providing templates for disclosure would contribute to reducing costs for firms listing bonds and encourage the use of such a market.

The role for policy intervention in trade credit and informal lending is found to be limited. An exception in the area of trade credit is the launch of a Code of Conduct on Prompt Payments and ensuring awareness is promoted to encourage participation would help maximise the effectiveness of this initiative.

A new area of funding for SMEs has been the recent developments in crowdfunding and peer-to-peer lending. Currently, these are used by small numbers of firms but there would appear to be the potential for this to expand over time, particularly for small and early stage firms looking to raise modest amounts of capital. Given the novelty of this type of funding, the provision of information is a key element that could facilitate greater interest in this type of financing, aimed at both firms and potential investors. We also review the more direct support of crowdfunding used in the UK and suggest that this should be evaluated in more detail as a possible benchmark for Irish policy intervention.

To increase the awareness of equity financing options and steer a cultural shift amongst SMEs towards looking for equity rather than bank credit as a source of funds, the support of financial education and advice for small business owners needs to play a central role. There could also be a place for initiatives to promote investment options in local businesses aimed at potential investors.

Some more specific examples of expansion of the current Employment and Investment Incentive Scheme (EIIS) and Seed Capital Scheme are examined. These should be made as accessible as possible and some of the current restrictions on their use eased. More active promotion of both scheme should be engaged in, targeting both business owners and potential investors, as knowledge of the provisions appears to be limiting current usage. To encourage a shift towards equity financing, consideration should be given to allowing the offsetting of losses against other taxes to reduce downside risks for investors. Expansion and simplification of employee equity investment schemes should also be examined.

Moving firms towards a more diversified set of financing options and developing a culture of increased equity investment involves a long-term, structural change in the funding ecosystem. In addition to any individual initiatives to encourage the use of specific types of financing, a broad programme of training and education (both general financial awareness and more tailored assistance to individual firms) to increase familiarity and facilitate use of different types of financial product would be necessary to help guide firms towards the most suitable options for their circumstances. Moves have already been made in this direction with the SkillNets and the helpful on-line tool to direct firms towards appropriate government supports.[21]

[21] https://www.localenterprise.ie/Discover-Business-Supports/Supporting-SMEs-Online-Tool/

Moves to reduce costs of organising new types of finance to make their use as accessible as possible would also help in moving firms towards a more diversified funding structure. The cost associated with legal procedures and financial disclosure for example might be reduced through the development of standardised documentation or template agreements for different types of investment. Risk evaluation and appraisal costs can also be significant for lenders and investors in SMEs and the development of the credit register will be a central plank in reducing these costs once it is established.

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Data Appendix

Department of Finance (RedC) survey

In this research we use data from a credit supply and demand survey of Irish SMEs completed by the Irish government's Department of Finance. This survey has been undertaken on a six monthly basis since the crisis to provide an understanding of how firm access to finance and performance has developed. The questions included are similar to those of international surveys such as the ECB/EC SAFE survey and the EBRD/World Bank enterprise surveys. Information is collected on applications and success rates for bank and non-bank finance as well as a range of categorical information on firm size, sector, performance (in terms of profitability and turnover), innovation activity (product, process and organisational), whether or not the firm is an exporter and financial capacities. Additional data is also collated on whether or not the firm has missed a loan repayment in the last six months, had a formal adjustment/arrangement made to their current loans, and whether or not the timing on their accounts receivable and payables changed.

SAFE Survey

We use firm-level survey data from the ECB's Survey of Access to Finance in Europe (SAFE), which is a twice yearly survey of euro area SMEs. We use data from eight waves of the survey, starting in 2010 and ending in the October-March 2014 wave. The aim of the survey is to provide information on the financing needs of SMEs, their experience in attempting to access finance, and information on their perceptions of current economic and financial conditions. The survey also asks firms about changes in their turnover, employment, ownership type, age and sector of activity. More information can be found on the ECB website.

Table 9 lists the sixteen countries covered by the data and the number of firm observations in each country. This gives us a total number of observations over the seven time periods sampled of 51,800 firms. The table also reports a breakdown of the sample by firm size groups, showing one-third of firms are micro enterprises (10 employees or fewer), another one-third are classed as small (between 11 and 50 employees), one-quarter are medium (between 51 and 250 employees) with the remainder being larger firms.

Table 9: SAFE Data Coverage					
	Firms	% Micro	% Small	% Medium	% Large
Austria	3,209	34.6	35.3	23.3	6.7
Belgium	3,223	38.8	39.6	17.9	3.8
Cyprus	200	30.0	30.0	30.0	10.0
Germany	7,014	30.1	31.0	29.1	9.8
Spain	7,006	30.4	31.0	29.3	9.2
Finland	3,101	39.7	39.7	17.4	3.2
France	7,019	29.8	30.5	29.7	10.0
Greece	3,200	39.4	39.3	17.8	3.4
Ireland	3,102	39.7	39.6	17.4	3.3
Italy	7,004	29.9	30.5	30.5	9.1
Luxemburg	200	30.5	30.0	30.0	9.5
Malta	200	28.5	35.5	28.0	8.0
Netherlands	3,258	35.5	35.1	22.8	6.6
Portugal	3,264	35.5	35.5	22.7	6.3
Slovenia	200	30.0	30.0	30.0	10.0
Slovakia	600	28.0	30.2	31.3	10.5
Total	51,800	33.3	33.8	25.5	7.5

For each of the ten types of financing source, Table 10 shows the percentage of firms in each country that use the source currently and Table 11 reports the percentage that report having had experience of that source. Bank overdrafts and loans are familiarly used products for the majority of firms, with 42 per cent currently using an overdraft and 64 per cent saying it is a source of finance they have experience of using in the past. Trade and informal sources of finance are also extremely prevalent across all countries, with Irish firms being particularly likely to use them as sources of funding.

Table 12 and Table 13 show the patterns by firm size and age groups. Larger firms are more likely to use each of the individual financing sources, consistent with the earlier observation that they tend to have considerably more diversified financial structures. Older firms are more diversified and this extends to them having a higher probability of using (either currently or having previous experience) each of the individual sources. The only exception is for the informal loan category which is more likely to be of current use in the youngest age cohort.

Table 10: Finance Types Currently Used by Firms in Each Country

	Internal	Grants	Overdraft	Bank loan	Trade	Informal	Leasing	Debt Sec.	Subordinated	Equity
AT	42.3	21.0	38.2	39.8	26.5	18.4	49.2	2.0	4.1	9.1
BE	25.1	17.5	40.5	44.7	28.2	24.0	33.4	4.4	5.8	9.0
CY	19.1	9.7	31.9	19.2	49.4	2.8	13.7	3.6	0.2	1.3
DE	45.0	19.0	36.6	41.8	21.5	24.1	55.4	0.9	4.9	13.1
ES	28.6	24.9	39.1	39.4	45.1	19.7	32.5	2.9	4.4	3.2
FI	51.3	12.1	26.6	30.1	48.4	19.4	51.7	6.0	6.1	9.1
FR	17.2	11.7	44.4	38.5	20.8	16.7	43.7	2.3	1.3	8.8
GR	22.3	13.3	12.6	29.0	48.5	6.7	18.0	18.0	2.2	9.6
IE	40.9	15.2	60.4	35.0	68.4	20.1	35.2	3.8	2.8	9.4
IT	26.5	17.4	54.5	39.5	46.0	11.0	26.6	2.0	1.2	4.5
LU	20.6	13.8	37.5	35.3	7.8	16.7	35.2	0.7	0.3	7.8
MT	28.6	23.4	60.7	29.7	48.1	15.8	24.8	20.1	2.0	6.5
NL	26.9	7.8	51.0	36.2	40.8	25.6	47.4	1.0	12.3	2.6
PT	6.1	20.6	43.7	31.7	35.2	11.9	29.7	2.4	1.7	1.6
SI	22.9	22.9	39.0	48.3	18.9	15.1	40.3	2.2	0.7	5.3
SK	27.9	13.3	47.9	31.5	19.5	22.1	47.1	0.4	0.8	1.7
All	30.3	17.2	42.3	39.0	33.2	18.6	41.0	2.5	3.8	7.7

Source: Lawless, O'Connell and O'Toole (2014a).

Table 11: Previous Experience of Finance Types by Firms in each Country

	Internal	Grants	Overdraft	Bank loan	Trade	Informal	Leasing	Debt Sec.	Subordinated	Equity
AT	62.7	52.8	61.8	74.9	38.5	34.7	70.2	7.5	11.9	22.4
BE	52.0	46.1	68.8	80.8	56.2	52.3	58.2	21.9	30.3	36.3
CY	36.2	42.6	53.4	62.5	70.5	27.5	34.7	19.1	19.3	33.9
DE	61.9	50.3	58.5	74.2	30.3	41.1	73.7	3.7	12.5	24.3
ES	47.2	60.8	57.4	74.9	61.6	38.0	68.0	8.7	13.3	10.0
FI	68.9	36.5	43.1	72.8	56.5	46.4	68.6	12.0	22.2	35.9
FR	50.8	50.7	79.0	87.7	55.6	50.7	78.0	26.6	21.8	51.0
GR	37.2	42.7	26.8	59.6	63.9	20.3	34.6	28.3	13.6	30.9
IE	60.3	38.4	78.7	68.8	75.2	38.7	64.9	13.9	10.1	37.1
IT	48.3	52.7	69.8	74.1	54.3	24.2	57.9	7.8	5.8	13.8
LU	57.0	59.0	72.3	77.3	41.8	53.1	67.3	30.2	34.6	40.9
MT	41.3	37.5	65.7	47.4	53.6	25.0	36.0	32.8	11.7	16.5
NL	46.2	22.1	64.1	60.8	52.3	43.2	59.2	6.8	25.9	11.0
PT	19.7	47.2	61.6	64.6	52.1	30.9	61.3	10.4	10.7	11.5
SI	52.0	53.4	71.2	80.3	52.3	45.3	69.4	25.4	25.6	30.6
SK	50.8	28.1	65.3	56.6	31.6	37.7	76.8	3.2	2.5	8.2
All	51.8	49.5	64.0	75.0	49.0	38.7	67.4	11.5	14.6	24.7

Source: Lawless, O'Connell and O'Toole (2014a).

Table 12: Finance Sources by Firm Size										
Currently Using	**Internal**	**Grants**	**Overdraft**	**Bank loan**	**Trade**	**Informal**	**Leasing**	**Debt Sec.**	**Subordinated**	**Equity**
Micro	20.7	11.1	38.9	27.3	26.5	9.9	19.2	2.1	1.5	4.6
Small	26.0	15.9	43.8	38.2	29.9	13.1	41.1	1.7	2.4	7.1
Medium	33.2	20.1	41.7	43.0	34.7	20.0	52.6	1.8	4.0	8.9
Large	41.6	23.0	45.2	49.5	41.4	30.6	57.6	3.8	6.9	10.9
All Firms	30.3	17.2	42.3	39.0	33.2	18.6	41.0	2.5	3.8	7.7
Previous Experience	Internal	Grants	Overdraft	Bank loan	Trade	Informal	Leasing	Debt Sec.	Subordinated	Equity
Micro	38.0	40.9	60.2	67.5	41.8	26.3	48.5	7.4	7.9	16.2
Small	48.5	48.7	66.6	77.4	46.6	32.8	71.4	8.6	10.8	22.9
Medium	57.2	52.7	64.7	77.4	50.0	42.2	77.6	11.0	15.0	27.2
Large	65.3	57.2	65.8	80.0	57.7	53.6	79.3	17.7	23.6	33.3
All Firms	51.8	49.5	64.0	75.0	49.0	38.7	67.4	11.5	14.6	24.7

Source: Lawless, O'Connell and O'Toole (2014a).

Table 13: Finance Sources by Firm Age										
Currently Using	**Internal**	**Grants**	**Overdraft**	**Bank loan**	**Trade**	**Informal**	**Leasing**	**Debt Sec.**	**Subordinated**	**Equity**
<2	23.3	14.1	30.8	30.5	25.4	24.5	37.5	1.1	3.4	8.8
2-5	23.1	14.9	38.0	31.7	29.0	18.3	34.8	1.9	3.4	6.9
5-10	24.0	14.5	42.2	34.2	29.4	17.1	36.9	2.5	3.3	6.2
>10	31.9	18.2	42.9	40.7	34.4	18.7	42.1	2.6	3.9	8.2
All Firms	30.1	17.4	42.3	39.1	33.3	18.5	40.9	2.5	3.8	7.9
Previous Experience	Internal	Grants	Overdraft	Bank loan	Trade	Informal	Leasing	Debt Sec.	Subordinated	Equity
<2	36.2	35.5	51.6	55.9	37.5	37.8	53.0	7.8	13.1	18.8
2-5	40.5	43.0	57.6	66.2	45.9	38.2	57.0	10.4	13.2	24.8
5-10	42.5	43.6	62.6	69.3	45.4	37.9	60.8	10.0	12.3	22.5
>10	54.3	51.5	65.1	77.2	50.6	39.0	69.7	12.0	15.2	25.3
All Firms	51.6	49.7	64.1	75.2	49.4	38.8	67.5	11.6	14.6	24.8

Source: Lawless, O'Connell and O'Toole (2014a).

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