ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

OECD
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Ireland Policy Brief

OECD Better Policies Series September 2015 www.oecd.org/Ireland

Entrepreneurship

IMPROVING SMEs' ACCESS TO FINANCE TO BOOST GROWTH AND JOB CREATION IN IRELAND

- Business lending in Ireland has still not recovered to pre-crisis levels. Credit conditions remain tight, and interest rates high by Euro area standards, especially for small firms.
- The level of non-performing loans has started to drop, but remains very high, hampering banks' ability to provide loans.
- The government should take action to reduce the level of impaired loans, expand and improve its credit guarantee scheme, and increase competition in the financial sector.
- Efforts to broaden the range of financing options available to Irish SMEs should be stepped up.

What's the issue?

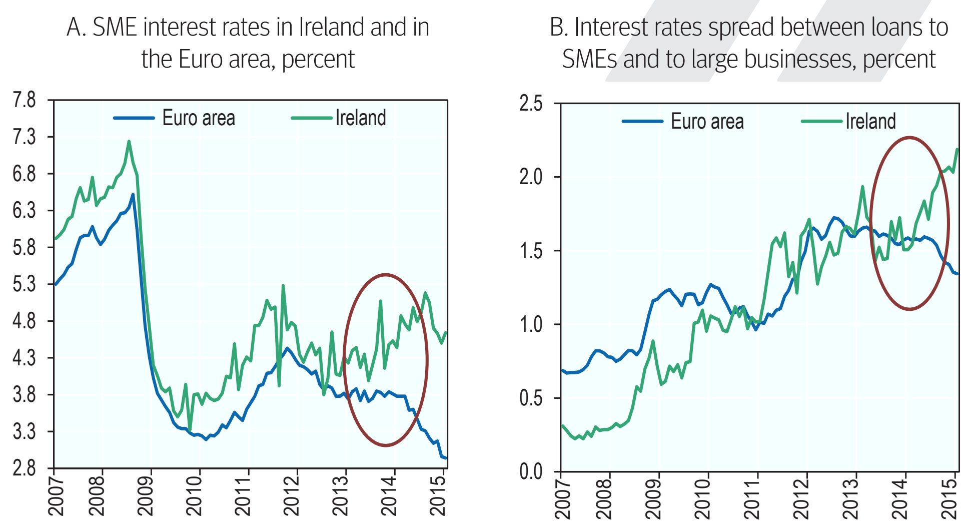
Irish banks were hit hard by the financial crisis, the government injecting fresh capital of EUR 64 billion (around 40% of GDP) to stabilise the sector between 2008 and 2010. The financial turmoil had a marked impact on SMElending, which declined by 23% between March 2010 and March 2015.

The banking sector is still grappling with a high share of non-performing loans (NPLs). Although NPLs have come down significantly since 2013, EUR 7.6 billion of SME loans remained in arrears at the end of March 2015. Around one in five SME loans remain impaired, which is higher than for all other lending categories, with the exception of commercial real estate.

In addition, many foreign financial institutions exited the Irish market in the wake of the crisis, leading to increased concentration in the banking sector.

These factors, along with a number of bankruptcies well above pre-crisis levels, explain to a large extent why Irish SMEs continue to pay high interest rates by Euro area standards. The interest rate spread between loans to SMEs and loans to large businesses widened from 28 basis points in 2007 to more than 200 basis points in March 2015, suggesting that financing constraints are

Interest rates charged to Irish SMEs are worsening, relative to their Euro Area peers



Source: ECB.

much more binding for small businesses than for large enterprises (see Figure). Over 2007-13, credit standards for Irish SMEs tightened. The trend reversed in 2014, although credit standards for obtaining a bank loan in Ireland remain strict by Euro area standards.

In an effort to boost bank lending to small businesses, the government introduced a credit guarantee scheme in October 2012, which up to early 2015 had guaranteed loans for some 156 businesses, for a value of over EUR 20 million. To build on this modest success, the Credit Guarantee Scheme was amended in early 2015 to allow for the refinancing of loans where an SME's bank is exiting the Irish SME credit market and to extend the maximum length of the guarantee from three to seven years. In addition, a Microenterprise Loan Fund Scheme was established to provide loans to small ventures with viable business plans, but which fail to meet the strict credit standards of commercial banks.

These measures, as well as the introduction of tax incentives for investors, through programmes such as "Employment and Investment Incentive" and "Seed Capital Scheme", are expected to increase the number of private-sector investors in SMEs. This should expand the opportunities for early stage and follow-on funding for start-ups and young firms. The recently established Strategic Banking Corporation of Ireland (SBCI) also aims to develop alternative products for the Irish SME sector.

There is a pressing need to diversify SME financing sources and instruments, but evidence suggests that awareness of alternative sources of funding, and of government programmes to ease access to finance, remains limited. Further action is needed on the demand side to address the SME finance capability gap. The inclusion of SMEs in the national strategy for financial education, along the lines of the OECD/INFE high-level principles, would enable more entrepreneurs to diversify their use of financial instruments.

Why is this important for Ireland?

SMEs employ 70% of the private sector labour force and contribute 48% of value added. The construction, tourism and retail industries, all sectors dominated by SMEs, are particularly important to the economic recovery. Constraints in bank lending are of serious concern given that Irish SMEs are very dependent on bank funding for their external finance needs. At the end of 2012, 94% of all external finance for Irish SMEs came from banks, a high figure by international comparison. In addition, Irish SMEs tend to rely disproportionately on short-term finance, such as overdrafts and trade credit. Capital gaps are particularly acute for innovative and growth-oriented SMEs.

What should policy makers do?

- Further expand, as appropriate, the activities of the Credit Guarantee Scheme and the microfinance programme, and strengthen their design.
- Closely monitor the evolution of impaired loans, and assess whether the new framework regarding impairment provisioning and disclosure guidelines is helping.
- Take measures to increase competition in the banking sector without jeopardising financial stability by facilitating entry, boosting financial consumer mobility and protection.
- Address the lack of financial knowledge among small business owners.
- Provide additional incentives to investors and SMEs to improve the uptake of specific instruments and address market failures, and foster appropriate ecosystems for non-bank finance.
- Evaluate the impact of SBCI and government efforts to make seed financing more widely available.
- Continue efforts to raise awareness about government support programmes in the area of SME finance.

Further reading

OECD (2015), *Financing SMEs and Entrepreneurs 2015: An OECD Scoreboard*, OECD Publishing. https://dx.doi.org/10.1787/fin_sme_ent-2015-en

OECD (2015), *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*, OECD Publishing. http://www.oecd.org/cfe/smes/New-Approaches-SME-full-report.pdf

OECD/INFE (2012), *High-level Principles on National Strategies for Financial Education*, approved by G20 leaders in June 2012. http://www.oecd.org/finance/financial-education/OECD_INFE_High_Level_Principles_National_Strategies_Financial_Education_APEC.pdf