Basel II for SMEs

And its Effect on the Advocates, Chartered Accountants, and Income Tax Practitioners in Faridabad --- What we must know about it ?

What is this ?
This is the set of International "Banking laws and Regulations", & to be complied in India also.

Why was this brought in ?
We remember, some big banks collapsed like Barings plc etc. And the economies lost Billions of Dollars. So, this is a safeguard, which if followed , then, Risk of those problems will be less

What was the target of this BASEL-2

1 Ensuring that capital allocation is more risk sensitive;
(Bank takes only that much risk, as it can afford to).

2 Separating operational risk from credit risk, and quantifying both;
(Bank must remember both).

3 Remove the difference in policies of banks in different countries - "Regulatory Arbitrage".
(Some countries have too flexible norms. The unscruplous companies may try to shift to these countries , to save them from tough standards of USA, or India)

What we (Advocates & CA's & ITP's) need to know ?

a We shall focus on the SME sector .
b This is an "imposition". But for the better future.

1) Business Strategy & Targets

a The "Project Report", we make/we guide the client to make, must have a detailed working on this.
  a) Targets should be clear = Management agrees with them . (And no conflict)
  b) Targets are SMART = Specific, Measurable, Achievable, Realistic and Timed

b PIs Cover
- Product quality (e.g. number of warranty claims or returned items)
- Service quality (e.g. number of breakdowns or disruptions)
- Process efficiency (e.g. volumes in a stated period versus cost of process
- Customer satisfaction (e.g. number of complaints or repeat orders)
- Staff satisfaction (e.g. staff turnover, training provided)
- Financial performance (e.g. sales targets; profit margins; return on capital; cash flow management; credit control)

2) Business Market & Competition

All Risks associated with the business
Customer Attractiveness
Supplier Attractiveness
Competetion
Market Growing or not ?
Product is attractive or not ?

a) make notes on them
b) Analyse data,
c) Give mitigating action plan

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3) Business Capability

1) General Management
2) Sales & Marketing Management
3) Operational / Production Management
4) Facilities Management
5) Financial Management
6) Planning & Information Management
7) People Management

a) make notes on them
b) Analyse data,
c) Give mitigating action plan

Tough work, in case of SME since all jobs by consultant

4) Business & Financial Planning

This should contain: • Purpose of Plan • Summary description of the business and any of its unique selling propositions (USP) • Overview of key aspects of the marketplace • Summary of SWOT analysis (highlighting your business attributes and and key people) • Key Business Objectives and Targets • Critical Success and Risk Factors (key issues and actions) • Financial Analysis & Outcomes of Plan (Key financial results, ratios, sensitivity tests

Effect on the Bank --> and effect on your Client

1.1 Bank Loan Rating under New Capital Adequacy Framework (BASEL II)

On April 27, 2007, the Reserve Bank of India released the final guidelines for implementation of the New Capital Adequacy Framework (Basel II) applicable to the Banking system of the country (Annexure 1).

The new framework mandates that the amount of capital provided by a bank against any loan and facility will be based on the credit rating assigned to the loan issue by an external rating agency. This means that a loan and a facility with a higher credit rating will attract a lower risk weight than one with a lower credit rating. See table below:

Illustration of capital-saving potential by banks on a loan of Rs.1000 Million

Rating		BASEL I		BASEL II		
Long-Term Rating	Short-Term Rating	Risk Weight	Capital required [1] (Rs Mn)	Risk Weight	Capital required (Rs Million)	Capital Saved (Rs Million)
AAA	P1+	100%	90	20%	18	72
AA	P1	100%	90	30%	27	63
A	P2	100%	90	50%	45	45
BBB	P3	100%	90	100%	90	0
BB and below	P4 & P5	100%	90	150%	135	(45)
Unrated	Unrated	100%	90	150%	135	(45)

* Capital required is computed as Loan Amount × Risk Weight × 9%

As a result, banks will benefit in terms of lower capital being required for loans and facilities given to borrowers with a high credit rating. Banks could also give such borrowers some additional benefits.

How to Get better Ratings ?

Non-Financial Factors
Financial Factors

Key Financial Ratios	
Current Ratio	PAT/Net Sales (%)
TOL/TNW (times)	ROCE (%) (PBDIT/TA)
PBDIT/Interest (times	INV+REC./Sales (days)

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