

# INTREPID EXPLORERS, INC.

## Basel II and Trade Credit

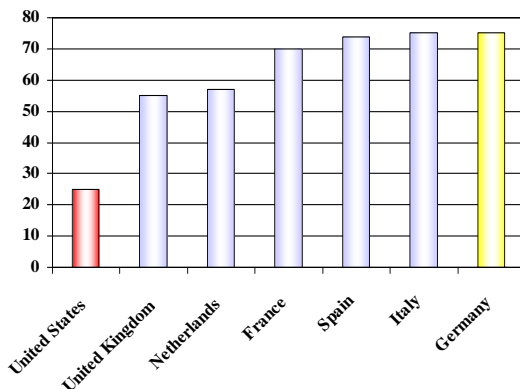
### Basel II has Become a New Risk Factor in Trade Credit Assessment

*Joachim C. Bartels*

Trade credit is the largest source of short-term capital. However, the availability of trade credit hinges on the skills of credit managers, whether extending trade credit to domestic or foreign firms. During the past 10 years credit managers had a number of new risk factors to contend with: Transition risk in Eastern Europe, the Asian Domino Effect, Y2K, and E-commerce risk. Now they have a new one to worry about: Basel II, which seems to be tightening the noose on small and medium size companies (SMEs). The Basel II Accord, initiated by the Bank of International Settlement, has the objectives to achieve a direct correlation of the true nature of risk to capital, the introduction of an independent (from loan officers) rating process, the consistent application of a standardized minimum criteria, the elimination of subjectivity in credit granting and better transparency.

The Basel II Accord on capital adequacy has triggered a fundamental change in the attitude of banks towards borrowers, especially SMEs. Banks already are reviewing their loan portfolios

**Bank Loans as a Percent of Total Financial Assets**



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Source: Bank for International Settlements

Illustration I

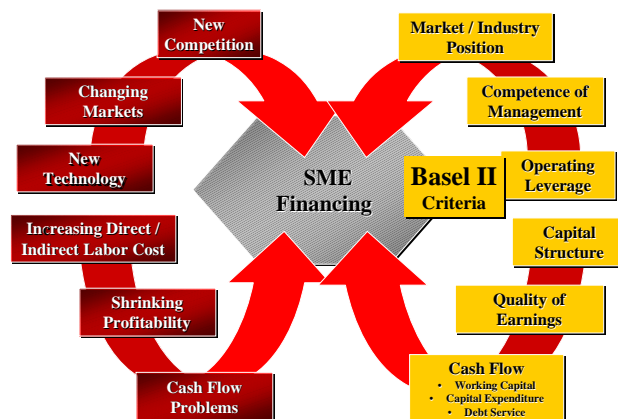
along the lines of procedures and criteria laid down by Basel II, although the accord will not go into effect before 2006. Therefore, SMEs now fear that Basel II will create difficulties for them in finding financing and many of them may be driven out of business. The latter is already happening in Germany and if that trend continues, the result will be the opposite of what Basel II had in mind. Basel II is to eliminate the possibility of large-scale loan defaults, however the trend is going into the other direction.

Germany where the debate has now become a political football. The general tenor being that Basel II is detrimental to the German 'Mittelstand', the nucleus of small to medium sized privately held entrepreneurial companies representing the mainstay of Germany's economy. Traditionally high taxation has prevented German SMEs from building up sufficient equity reserves [chronically low at 10-15%], therefore reliance on bank financing is high compared to the United States [see illustration I], where for instance none of the Basel II hype has surfaced so far.

SMEs are especially incensed that Basel II is putting them into a deadly squeeze between general economic / business

The problem seems to be especially acute in

**Challenges of Basel II for SMEs and Banking**



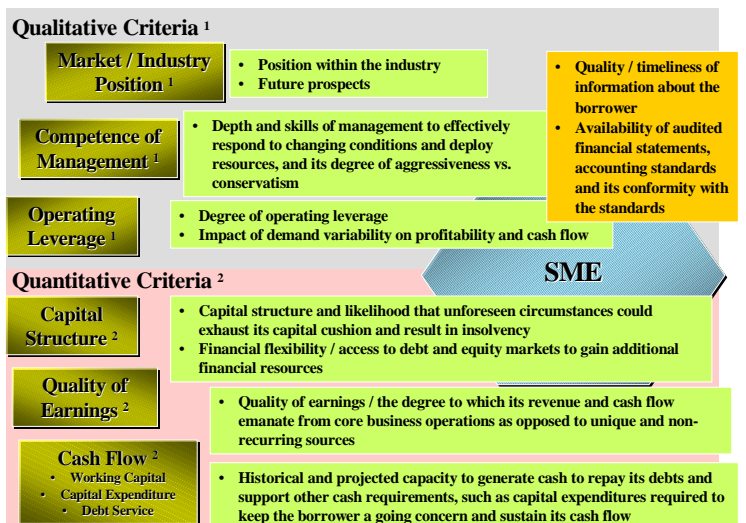
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Illustration II

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dynamics and the Basel II rating criteria [See Illustration II]. New competition, changing markets, new technology, increasing direct and indirect labor costs, shrinking profitability and erratic cash flow are ever present conditions. Basel II rating processes and criteria are now compounding these conditions, as banks are required to systematically apply a minimum of eleven qualitative and eleven quantitative factors in the analysis of a business, [qualitative (1) and quantitative (2) factors are shown in condensed groupings in Illustration III]. In order to remove subjectivity from the lending process the bank must have an independent credit review process, which assigns and monitors ratings. Thus the risk assessment and rating process is removed from

## Basel II Minimum Rating Criteria



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Illustration III

the loan officers or originators of the risk. That aspect raises the issue who in a bank has sufficient insight to accurately rate qualitative factors such as market growth / industry position, competence of SME management, SME operating leverage. Furthermore will it be possible to verify the underlying information supplied by the SME. Exhaustive surveys of SMEs conducted in Germany have revealed that a majority of the SMEs are ill prepared to present adequate and convincing documentation to their banks.

Quantitative factors derived from financial statements represented traditionally the core of the analysis. Nevertheless, most financial statements of SMEs reflect a tax avoidance strategy rather than a forward looking investment and maximizing earnings strategy. This goes hand in hand with the notorious secrecy with which SMEs tend to treat their business affairs and accounts. Transparency is an alien word missing from their vocabulary. SMEs continually flaunt disclosure rules laid down by the EU, and pay fines rather than disclosing their financial statements. This explains also the absence of valid industry benchmarks, particularly in Germany. Therefore, it will be difficult for a bank to judge the quality and validity of a SME's balance sheet ratios, earnings and cash flow.

The consequences for the SME are therefore as follows: Inadequate documentation is likely to lead to an outright rejection of an application or renewal of a loan. If a bank, nevertheless, puts the SME through the internal rating process, the lack of insight into the SME's market and business, plus the lack of applicable benchmarks, will only systematize the subjectivity in lending instead of eliminating it.

In conclusion, the objectives of Basel II is to create a safer banking world by introducing an independent, systematic rating process, which will ultimately lead to a greater degree of transparency in credit transactions. This will not only benefit the banks, but also trade credit granters. That in-itself is a noble cause. Nevertheless, until banks are able to eliminate the subjectivity in lending and SMEs get their act together in facing up to the rating process with better information about their businesses, a higher than usual amount of business failures will be inevitable.

# *INTREPID EXPLORERS, INC.*

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Background: The Basel Committee on Bank Supervision has recommended an update of capital adequacy rules for banks. The proposal commonly known as Basel II is a revision of the 1988 Basel Capital Accord, a global standard by which the financial soundness of banks is assessed. The Basel II Accord is designed to create a more competitive, albeit safer banking world. It is based on three pillars: pillar one deals with improved capital adequacy, pillar two focuses on better bank supervision and the pillar three envisions the use of a greater market discipline. It is the first pillar that causes great consternation amongst clients of banks and SMEs in particular. The first pillar deals with improved capital adequacy with the objective to achieve a better correlation between a loan portfolio's true risk and capital. The assessment of the true risk would be based either on an external or internal credit assessment, i.e. a rating. A minimum of eleven qualitative and 11 quantitative criteria will underpin the rating. The consistent, systematic and independent application of such criteria is to eliminate the subjectivity in lending, increase transparency and reliability of the underlying information about the business.