

Basel II: A new way to be a bank & an enterprise

Part II: Starting from 1 January 2008 the Basel II agreement will become effective in Hungary. With just under a year to the definitive launch, larger banks have already begun to adopt the criteria of the agreement, and companies also should seriously start to evaluate the consequences.

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Practical experience in the implementation of European Structural Funds has shown that the lack of appropriate financial planning during the planning phase of the investment - which must show the real needs of liquidity in the different steps of realisation - has generated serious liquidity problems, which have caused the breakdown of the investment while in progress.

It's important to stress that the obligation to maintain the development strategy planned lasts for the entire duration of the project and for five years following its termination.

If the applicant for the EU financing does not manage to estimate in a correct way the situation of its own company and the market, they will not be able to maintain the conditions stipulated in the financing contract. The European Union strictly controls the correct use of the funds distributed and proper adherence to the obligation assumed. In the case of unsuitable implementation there is the serious risk that the financing will be revoked and that restitution will be demanded. Therefore, the importance of the cultural jump that Basel II will impose in terms of financial planning and management also emerges in the terms of participation in the European Structural Funds.

Requirements of recapitalisation & search for the top financial opportunities

One of the main requirements that will emerge after the introduction of Basel II will be the necessity of recapitalisation for many SMEs. This

will take place above all through appropriate evaluation and management of the company's assets, following a consolidation policy. In addition, carefully estimating alternative financing instruments aimed at strengthening own capital, like for example, the participation of private investment funds (private equity) in the capital of the company and all those new financial instruments that the market will offer progressively in order to meet these new requirements.

Therefore SMEs will have to structure themselves with instruments and qualified professional contacts to find the best financial solutions and opportunities in due time. The development of the role of the financial manager in the company will become a key factor in the change and this role will necessarily increase its importance compared to other managerial areas.

New methodologies & communication between banks and companies

Basel II will lead both banks and companies to modify the traditional methodologies noticeably. Banks will have to operate with greater entrepreneurial spirit, assuming more of the risk of the financing, and not basing it mainly or exclusively on the personal guarantees of the entrepreneur, but jointly considering the feasibility of the business plan and the expected performance of the project. In fact Basel II will shift the banks from a guarantees-based system to a risk-based system.

The agreement of Basel II will produce as its primary innovation the need for an increased level of communication between banks and companies. In fact, companies and banks often do not understand each other. Often the dialogue starts when the bank no longer has any interest in financing the company. Companies must avoid some of the practices

of the past, like diminishing company profits in order to avoid taxation which stops balance sheets from being transparent, and should build good communication methodologies with banks. For this reason small and medium-sized enterprises will have to use experts that will help to change the organisation and the structure of the company to gradually have modern and effective financial management.

Part I:

- The birth of Basel II
- The criticism
- The role of finance

Part II:

- European structural fund and financial planning and management
- Requirements of recapitalisation and search for the best financial opportunities
- New methodologies and communication between banks and companies
- The financial consultant between banks and companies
- Basel II in Hungary

Basel II will even push banks to research and develop communication with the firms, because it will also be in the interest of the banks that their own customers will be in the position to be "financeable" and that they will remain this way for the future. It will be more and more a system focused on mutual clarity. The banks will be led progressively to make clear how their systems of evaluation are determined to allow companies to comply with them for greater mutual benefit.

The financial consultant between banks & companies

As already mentioned, in this context the financial manager will have a greater role in the company, but this position is frequently absent in small and medium-sized enterprises. One reason is that it can be covered by managers with consolidated and specific experience, and is often considered an excessive cost. As an alternative, this role can be covered by the financial adviser, who will support the entrepreneur and the management of the company in strategic decisions and investment and can represent the right mediator between the company and the financial institutions. They can supply the needed information related to the changes in the economic scenario and market evolution, advise the necessary action to improve the rating and support in evaluating risks. They can determine the trend of

the financial flows of the company, estimate the profitability, define periodic budgets, and create a reporting system in order to communicate the business situation to the banks properly. Ultimately, they can support the entrepreneur in coordinating the different companies and investments when they operate in different fields.

Basel II in Hungary

The Basel II agreement has been introduced in the European Union by Directive 2006/48/EC - that updates the previous one from 2000 on the banking system - which has to be approved by the parliaments of the individual member states. Based on the new directive the member states must, by 31 December 2006, adopt and publish the necessary legislative and administrative dispositions prescribed in order to conform with the European directive and the Basel II agreement.

The directive in Hungary was supposed to be presented in Parliament by December 2006, but there has been a delay and it will probably be put before Parliament by the beginning of February 2007. Then there will be a first year of cohabitation between the old and the new Basel agreements, with the possibility of choosing between the two sets of criteria. From the 1 January 2008 only Basel II will be applicable in Hungary. Larger banks have already begun to adopt the criteria of Basel II, as far as they have to operate for three years in conformity in order to obtain the less expensive options.

Therefore in one year there will be the definitive commencement of Basel II in Hungary. It's important to emphasise that companies too should seriously consider the fact that the credit merit is based also on historical evaluation and therefore on the balance sheets and the performances of previous years. Consequently, starting now, it is extremely important to evaluate carefully the strategies and the financial policies of the company.

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