



D.R. Dogra

Role of Credit Rating for facilitating institutional finance for SMEs

The SMEs play a critical role in the growth and development of the economy in terms of economic growth and job creation. The SME sector is a nursery of entrepreneurship, often driven by individual creativity and innovation. This sector contributes 7% of the country's GDP, 37% of the manufactured output and 40% of its exports. MSME sector in India consists of approximately 48 million units and produces more than 6,000 products ranging from traditional to high-tech items, providing employment to around 111 million people. Thus, SMEs are important for the national objectives of inclusive growth.

However, despite its inherent growth potential, the SME sector is severely constrained by the availability of adequate financing options. Even though SME lending is a part of the priority sector lending for banks, they are charged higher rates as this segment is considered to be relatively high – risk. SMEs need financing for two basic purposes; firstly financing the production cycle (i.e working capital financing) and secondly financing capital expenditures to expand the current business, to create new ones, or simply for maintenance purposes. Thus, to enable the sector to attain its optimal growth there is a need to develop tools that will help the sector to raise finance and meet its financial requirements.

The government towards removing the problem of financing of SMEs has enforced several policy directives. Introduction of SME rating by the credit rating agencies (CRAs) was another step for helping the SMEs out in gathering strength as a borrower.

Challenges in SME Financing

The statistics compiled in the Fourth Census of the SME sector revealed that only 5.2% of the units (both

registered and unregistered) have availed of finance through institutional sources and 2.1% from non-institutional sources, while the majority of units (92.8%) had no finance or are dependent on self – finance.

The economic literature identifies three main obstacles that may prevent SME from obtaining adequate financing,

- The existence of marked informational asymmetries between small businesses and lenders
- The intrinsic higher risk associated with small-scale activities
- The existence of sizeable transactions costs in handling SME financing

CARE SME Rating is an issuer-specific, one – time assessment of the credit worthiness in comparison with other SMEs. It depicts overall debt-management capability of the entity. The rating takes into account management capability, industry dynamics, operational performance, financial risk and future prospects for arriving at overall risk profile.

Banks play a dominant role in providing funding to the small and medium enterprise as these firms are not able to access the capital market enough. However, owing to the stringent norms associated with this mode of finance the SMEs find it difficult to abide by them, making it difficult to lend adequately to the SME sector.

As a result of these constraints, SMEs finance a smaller share of their investment with formal sources of external finance than do large firms and instead, rely more heavily on informal sources of finance, such as borrowing from family and friends or from unregulated moneylenders. However, some of the obstacles to SME financing are associated precisely to their own nature as smaller companies. This includes factors such as lack of critical economic size, and the somewhat informal and generally less sophisticated management of SMEs.

Despite the efforts of Ministry of Small and Medium Enterprises, SIDBI and support from the RBI by inclusion under priority sector, there continues to be a huge demand-supply mismatch in small enterprise financing. One of the major reasons for banks being unable to bridge this gap is the perceived credit risk involved in financing small enterprises. This is primarily on account of non-availability





of valid bills, proper accounting systems and lack of known buyers. To mitigate such credit risk, banks typically look for enhanced collateral or traditional equity, both of which cannot be brought in by most entrepreneurs. Further, due to their small size and local presence, the transaction costs involved in financing them are very high. Thus, SMEs have to rely heavily on retained earnings and other own source of funds.

How does credit rating of SME help in financing?

Credit rating agencies play a pivotal role in narrowing the funding gap for the SME segment. Firstly, it helps in reducing information asymmetry. Credit rating for an SME involves evaluating the creditworthiness of an entity and comparing them across other entities which reduces asymmetric information associated with the entities. Secondly, rating helps in capturing creditworthiness. Formal institutional lenders would scrutinize the credit rating of the SME while making lending decisions. Thirdly, credit rating makes access to credit easier and also availability of funds on better terms. A favorable rating improves the entities access to funds and also enables them to get them a lower rate. Rating also facilitates faster disbursement of funds by financial institutions and also helps in acquiring additional funding when required. Fourthly, it helps in easier access of various sources of funding. Credit rating reports help in tapping alternative financing options such as private equity, venture capital and other non – bank sources. Fifthly, rating increases visibility and credibility on the SME. Since rating is an independent third party opinion on creditworthiness, it helps in providing confidence to the lenders and various stakeholders. With higher credibility the SMEs are able to acquire funds from various avenues which otherwise would not be keen on lending.

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These credit ratings are used by various institutions and individuals like commercial banks, investment banks, investors, issuers, brokers, government and all other financial institution. The credit ratings serve as an important benchmark for banks while making lending decisions. Ratings also provide investors with better access to creditworthiness of the entities in the sector.

Role of CARE Ratings

The credit rating analysis is a continuous evolving process with factors in changing regulations, economic environment, business scenario and conditions. The rating is an outcome of overall credit risk assessment which affects the general creditworthiness of the entity. Within the credit rating product basket for SME, CARE Ratings undertakes bank loan ratings, NSIC ratings and SME ratings.

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National Small Industries Corporation (NSIC) – CARE Performance & Credit Rating is a rating service for DIC registered micro and small enterprises wherein NSIC provides a one – time subsidy to these entities to get rated. The NSIC ratings cover various indicators encompassing the financial, business, operational and management aspects of SMEs. SMEs receive a rating which highlights strength and weakness of existing operations. CARE Ratings product basket for SME segment also includes grading, due diligence, channel partner evaluation and verification services.

Concluding remarks

Credit rating has the potential to transform the way SMEs are integrated in the financial system. The credit rating agencies need to take special initiatives such as educating the SME sector on the benefits of ratings and launching outreach initiatives.

The way forward is to have a far reaching approach including all players in the financial sector to improve the flow of credit. The RBI's plan to have an exchange for trade receivables for SMEs is pragmatic as are the separate platforms for raising equity and trading the same on stock exchanges. A multi-pronged approach is a solution as all the concerned entities need to work in unison to reach a solution.

(D.R. Dogra, is MD & CEO, CARE Ratings)