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PANKAJ KUMAR GUPTA
Centre for Management Studies, JMI University, India

SANDEEPA KAUR
Centre for Manangement Studies, JMI University, New Delhi, India

CREDIT RATING FRAMEWORK FOR FINANCING OF SMES IN INDIA AND ROLE OF CENTRAL BANK

Abstract:

Small and Medium Enterprises (SMEs) are playing more and more important role in world economic development. Indian SMEs have been on the forefront of the development path. However, Indian SMEs face a host of obstacles when they try to access credit market for their financing needs. Banks do not feel confident to extend loans to the business units whose track records are not apparently known to them, nor are they easily verifiable by the banks. On one side the government assigns a target of minimum threshold level of SME financing for banks and on the other side banks are reluctant to finance because of perception of higher probabilities of credit default. A specialized and effective enterprise credit rating mechanism is extremely important for these enterprises.
In this paper we examine the major issues in the financing of SMEs in an Indian context and evaluate the flip side of the current rating mechanism. We also suggest a framework of financing these enterprises for respective sources of capital with comments on the role of the central bank in this regard.

Keywords:

SMEs, Enterprise Credit Rating, Credit Policy, Rating agencies, Credit Default

JEL Classification: E58, O23, H81

1. Introduction

The critical role of the SME[1] sector in the social and economic development of our country is well known in terms of employment generation, exports and economic empowerment of a vast section of the population. In recent years, while the Indian economy has been growing at over 6%, the production from micro, small and medium enterprises has been growing at over 11% between 2002– 2003 and 2007–2008.

The SME sector is a nursery of entrepreneurship, often driven by individual creativity and innovation. This sector contributes 8% of the country's GDP, 45% of the manufactured output and 40% of its exports. The SMEs provide employment to about 60 million persons through 26 million enterprises and their labour-to-capital ratio is much higher than the large industries. The geographic distribution of the SMEs is also more even. Thus, SMEs are important for the national objectives of inclusive growth i.e. growth with equity and inclusion.

In India, banks are the dominant channels for providing funds to industry. However their importance in funding smaller firms is even more pronounced since most small and medium enterprises (SMEs) are not able to access the capital markets for funds. In recent years, governments and policy makers have been giving considerable attention to facilitate the development of the SME sector, as a strong and vibrant SME sector provides a good foundation for entrepreneurship and innovation in the economy.

There is no denying that the economic health of our country largely rests on the wellbeing of this sector. However, the success in this direction has not been as significant as had been contemplated. SMEs face multiple hazards, the most clinching being the lack of finance. A major bottleneck to the growth of the vital Indian small and medium enterprises (SME) sector is its lack of adequate access to finance. This paper examines the major issues in the financing of SMEs in the Indian context.

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) is yet another step for helping the SMEs out in gathering strength as a borrower. The present paper further aims to delve into the domain of SME rating and to critically evaluate the flip sides of this scheme in terms of building rating capitalism. And on these grounds various alternative sources of finance for SMEs have been recommended with proper applicability testing based on the requirements of such business.

Thus, this paper is divided into two parts; Part A comprises of Major issues in financing of SMEs and Part B consists of SME rating and its critical evaluation and recommendations thereon.

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[1] In this paper the term SME is used for micro, small and medium enterprises.

2. Economic Contribution of SMEs in India

It is important to note that in addition to helping catalyze the growth of the economy, SMEs feed large local and international value chains as well as local consumer markets as suppliers, manufacturers, contractors, distributors, retailers and service providers. They account for a large share of industrial units, and contribute significantly to employment in the country (Table 1).

Table 1: Key Statistics on Economic Contribution of SMEs

Key Metrics	
Share of	Value
Industrial Units	95%
Industrial Output	45%
Exports (in value)	40%
Gross Domestic Product (GDP)	8%
Employment (In Millions)	69

Source: Ministry of MSME, Annual Report, 2009-10; RBI

Growing at 11.5 percent a year, the SME sector has been performing better than the overall GDP (8 percent growth per annum) and overall industrial output (measured by Index of Industrial Production-IIP). Current estimates of SME contribution to GDP do not take into consideration the contribution made by unorganized private enterprises, for which asset and sales data is not tracked by government agencies.

SMEs are also effective vehicles for employment generation. India’s cities have been experiencing the burden of a consistently growing population, comprising an ever – increasing proportion of migrants in search of employment and livelihood. City infrastructure is already stretched, and policy makers are seeking solutions to mitigate issues arising from migrant population growth. Rural SMEs and those based outside of the large cities, offer a viable alternative for employment to local labor, hence presenting an opportunity for people to participate in productive, non-farm activities, without needing to migrate to urban areas.

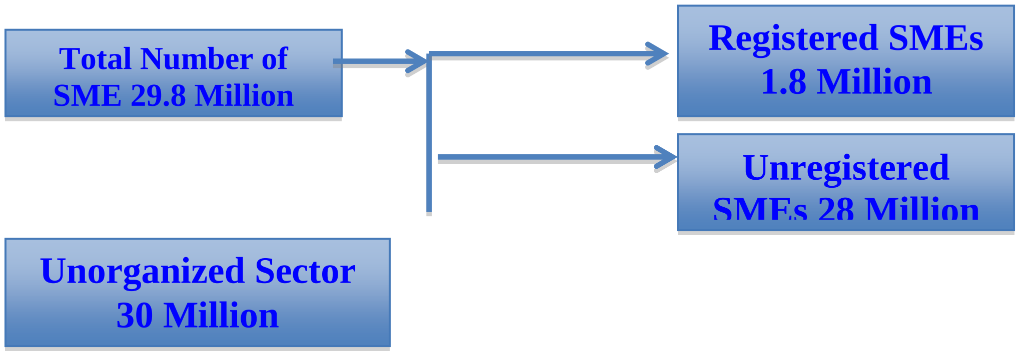
With adequate financial and non-financial resources, as well as capacity building, the SME sector can grow and contribute to economic development considerably higher than it is doing currently.

3. SME Landscape in India

In 2009-10, the Indian SME sector was estimated to include 29.8 Million[2] enterprises. In order to encourage these unorganized units to register, the Ministry of SME has simplified the registration process (replacing the earlier two-stage registration process with a one-step filling of memorandum).

The sector has been growing at an effective rate[3] of 4 percent annually[4] over the last three years from 2008-10. The share of registered[5]enterprises in the sector is estimated to be only around 6 percent, which goes to show that the sector is dominated by unregistered[6] enterprises that do not file business information with District Industry Centers (DICs) of the State/ Union Territory. In order to encourage these unorganized units to register, the Ministry of SME has simplified the registration process (replacing the earlier two-stage registration process with a one-step filling of memorandum). In addition to the registered and unregistered enterprises covered by the SME census, the sector has an additional 30 million enterprises[7] (Figure 1).

Figure 1: Broad Classification of the SMEs in India



Activities of these units are not governed by any legal provision, and these typically do not maintain any official financial accounts. Most of these can be defined as the micro enterprises.

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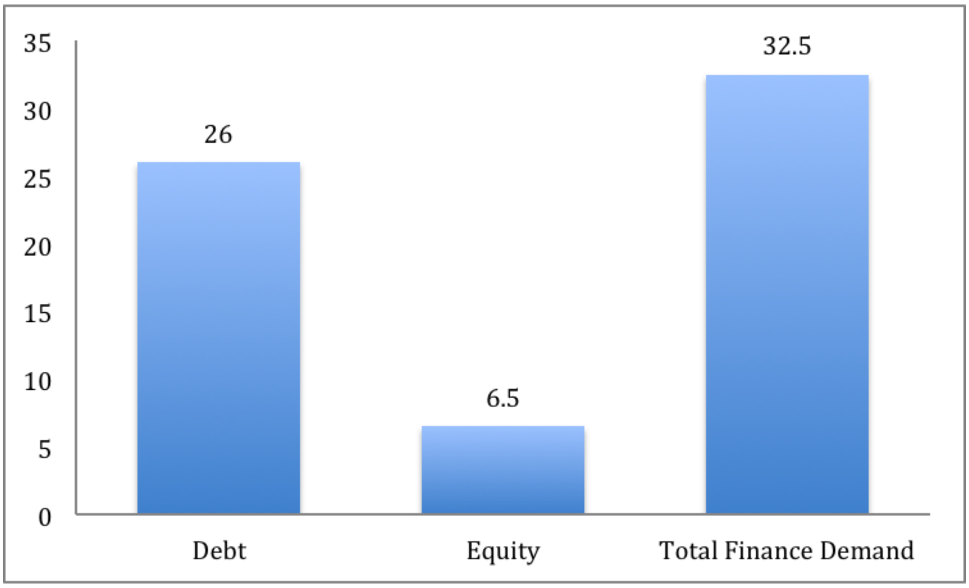
[2] Ministry of MSME, Government of India, 2009-10: The effective growth of enterprises in the sector is estimated to be 4.5 percent, accounting for permanent closure of enterprises.
[3] Accounting for enterprise closures.
[4] Fourth All India Census on MSME 2007 (MSME Census), the first survey commissioned by the Government of India to enumerate micro, small and medium enterprise, estimated the size of the MSME sector to be 26.1 million enterprises.
[5] Registered Enterprises: MSMEs that file business information such as investment, nature of operations, manpower with District Industry Centers (DICs) of the State/ Union Territory are considered as registered enterprises; The data on enterprise output and performance is periodically tracked the government agencies
[6] Unregistered Enterprises:; The data on enterprise output performance is not adequately tracked by the government agencies.
[7] The National Commission for Enterprises in the Unorganized Sector (NCEUS) pegs the number of enterprises in the unorganized sector at about 58 million, which also includes an estimated 28 million unregistered MSMEs.

4. Major issues in financing of SMEs

Overall demand for finance in SME sector

The overall demand for finance in the SME sector is estimated to be INR 32.5 trillion ($650 billion) (Figure 2). The majority of finance demand from these enterprises are in the form of debt, estimated at approximately INR 26 trillion ($520 billion). Total demand for equity in the SME sector is INR 6.5 trillion ($130 billion), which makes up 20 percent of the overall demand. The sector has high leverage ratios with average debt-equity ratio of ~4:1. But these leverage ratios are not even across the sector and variations exist based on the size of the enterprise. For instance medium-scale enterprises exhibit a more balanced debt-equity ratio of ~2:1.

Figure 2: Overall finance demand in SME Sector (in INR Trillion)*

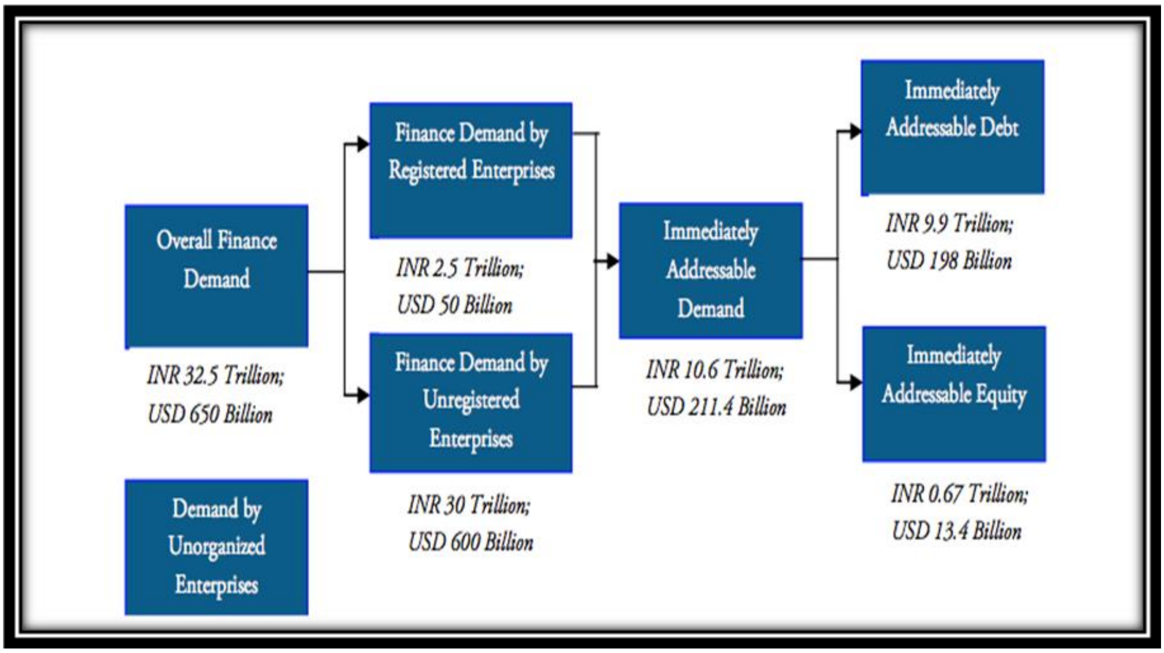


Source: MSME Census, SIDBI, Primary Research, IFC-Intellecap Analysis

The unregistered[8] enterprises, which comprise~94 percent of the SMEs, account for INR 30 trillion ($600 billion) of the finance demand. This demand estimate does not take into account the demand for finance by unorganized enterprises[9] (there are an additional 30 million such enterprises) (Figure 3).

[8] Unregistered Enterprises: MSMEs that do not file business information with District Industry Centers (DICs) of the State/ Union Territory; The data on enterprise output performance is not adequately tracked by the government agencies.
[9] Unincorporated private enterprises owned by individuals and households, NCEUS, 2007.

Figure 3: SME Finance Demand Flowchart



Estimated population of unorganized enterprises is 30 million

Financing SMEs in India: Directed lending and credit rationing

It can be seen that the overall demand for finance is very high in SME sector and the growth prospects are also very high. But, then to the supply side is very short for this sector. One of the major bottlenecks to the growth of SMEs in India is access to finance. Banks are the dominant channels for funding SMEs and in this paper; we survey some of the major issues in the financing of SMEs in the Indian context.

While banks in India are not provided with a specific target for lending to SMEs, the bank loans given to the micro and small enterprises is part of the priority sector lending. Indian banks are required to achieve a target of 40% of adjusted net bank credit to the priority sector, while foreign banks have a target of 32% exposure to the priority sector.

Bankers consider two aspects of the loan in their credit decision - the interest rate on the loan and the credit risk of the loan. However, the interest rate itself affects the risk of the loan due to two factors. First, is adverse selection; that is, only more risky projects would come forth for loans at higher interest rates; and second, moral hazard, as borrowers who have been granted the loan at a higher interest rate would undertake a more risky project in order to earn higher expected returns. As a result, at higher interest rates, the expected return from a loan would start decreasing after a point due to higher defaults. Thus, in the presence of information asymmetry in the market for loans and costly monitoring, banks would not use interest rates alone to equate demand and supply, but would ration credit.

Carbo, Rodrıguez, and Udell (2008) argue that the issue of bank competition and credit availability may matter most to SMEs for two reasons. First, SMEs are more vulnerable to information problems. Second, SMEs are much more bank-dependent than large enterprises. Carbo et al.’s (2008) study of a large number of Spanish SMEs find that there is a significant sensitivity of the extension of trade credit to bank lending for unconstrained firms.

Banerjee, Cole, and Duflo (2003), using a 1998 enhancement in investment limit as eligibility criteria for preferential bank loans for SMEs in India, find that firms that newly came under the preferential lending criteria were able to obtain more loans with a consequent beneficial impact on increase in sales, suggesting that that these firms were previously credit constrained.

The other argument is that SME firms have lower profitability and therefore banks are reluctant to lend to them. It been identified that banks are averse to lend to SMEs as they do not consider them as attractive and profitable undertakings. SMEs are also regarded as high-risk borrowers because of their low capitalization, insufficient assets, and high mortality rates.

Framework for analyzing SME financing

Berger and Udell (2006) have proposed a conceptual framework for the analysis of SME credit availability issues. They argue that in the context of loans to SMEs, two factors affect the availability of loans and the nature of the credit facility. First is the lending technology, which refers to the combination of primary information source, screening and underwriting policies and procedures, loan contract structure, and monitoring mechanisms, which are used in the lending business. Second is the lending infrastructure, which includes the information environment including the quality of accounting information, the legal, judicial and bankruptcy environments, the social environment, the tax environment and the regulatory environment in which financial institutions operate in a given country. The government policies influence the lending technology used in different countries, through the lending infrastructure.

The lending technologies employed to lend to the SME sector in India would thus be influenced by the government policies and the lending infrastructure prevalent in the country. Lending technology is categorized into two types: transactions lending that is based on ‘hard’ quantitative data and relationship lending, which is based on ‘soft’ qualitative information. Transaction lending would rely more on quantitative data such as financial statements, small business credit scoring, asset based lending, factoring, fixed asset lending and leasing.

Transactions lending and relationship lending

Petersen and Rajan (2002) find that small firms, though informationally opaque, have been borrowing from institutions further away, and they attribute this to the development of firms such as Dun and Bradsteets, which specialize in rating small businesses. The possible reason is that credit scoring helps to reduce the information asymmetry, particularly with respect to small firms and hence geographic proximity of the borrower and lender is not crucial to loan decisions. Other studies also find that credit scoring tends to enhance SME access to debt capital (Berger et al., 2005a, Frame et al., 2001 and Frame and Woosley, 2004).

The Small Industries Development Bank of India (SIDBI) in association with ten banks and Dun and Bradstreet have set up the SME Rating Agency of India Ltd (SMERA) as an exclusive rating agency for MSMEs.

Bank size and lending to SMEs

A major policy concern in recent times is the impact of the growth in size of banks on availability of credit to the SME sector. A number of studies have analyzed the relationship between bank size and the credit flow to firms of different sizes.

Berger et al. (2005b) find that large institutions have comparative advantages in transactions lending to more transparent SMEs, while small institutions have comparative advantages in relationship lending to informationally opaque SMEs, based on soft information. Competitive banking markets can weak- en relationship building by depriving banks of the incentive to invest in soft information. Therefore, less competitive markets may be associated with more credit availability (Petersen & Rajan, 2002).

The lending infrastructure in India

The legal environment is also an important factor that impacts the willingness of banks to lend to small firms. Haselmann and Wachtel (2007) find in their study of 20 transition economies that foreign banks are more inclined to lend to small and medium enterprises if creditor protection is strong. In order to strengthen the framework for tackling loan defaults and contract enforcement, India enacted the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests (SARFAESI) Act in 2002.

The availability of credit scores for SMEs in India should also help to enhance the quality and reliability of financial information enabling more lending to the sector.

In India, while the domestic banks are given a priority sector-lending target (which includes lending to the micro, small and medium enterprises) of 40% of adjusted net bank credit (ANBC), foreign banks have been set a target of only 32% of ANBC. It has been argued that both domestic and foreign banks should have the same target towards lending to the priority sector in order to provide a level playing field for all banks and to get all banks actively involved in the faster development of the priority sector.

Basel capital norms and its impact on funds for SMEs

Capital standards require banks to keep a minimum capital against their assets in order to protect the interests of the depositors and to ensure that there is adequate capital to absorb potential losses. Under Basel II capital standard, the risk weights for different classes of assets depend on the risk of the assets. Basel II capital standards allow banks to categorize the SME lending as 'retail portfolio' which would require a lower risk weight of 75% compared to 100% risk weight for a BBB rated loan (Bank for International Settlements, 2006).

The evidence so far is mixed as far as the impact of Basel II capital standards on bank loans to the SME sector is concerned. While the lower risk weight for retail portfolios should reduce the bank's cost of lending to the SME sector, the actual credit losses from the SME sector may not be significantly different from lending to the larger firms.

5. SME rating and its critical evaluation

Rationale for SME rating

There are as many as 14 lakh SME units in India but only 8.5% of them can avail bank loan. It's not that the rest 91.5% of the SMEs do not have any financing need. A vast majority of the SMEs in India are denied bank loan for a plethora of reasons. The most crippling of all is that the SMEs do not have credibility in the eye of the bankers (Khosla, 2011). Banks do not feel confident to extend loans to the business units whose track records are not apparently known to them, nor are they easily verifiable by the banks. Therefore, the SMEs with enormous appetite for funds keep fasting while the banks lose out many a good lending option. A third party intervention was badly sought after to mediate between the demand side and supply side of SME financing. Credit rating agencies emerged in this scene as filler. Rating agencies devised a rating methodology suited for the SMEs for assessing the credibility of the SMEs as borrowers. Banks felt comfortable while dealing with the SMEs with good ratings. Ratings make the selection of borrowers on the part of the banks easier. SMEs, on the other hand, get access to wider market banking on good ratings to their credit. It is beneficial for the SME sector as a whole as "ratings can provide an edge by raising standards through better financial discipline, disclosure and governance practices. It showcases transparency in the company and therefore gives them smoother access to emerging markets" (Talukdar, 2012) It is a confidence-builder, particularly when the SMEs eye for an export market. They can also use ratings as a tool to enhance their own credibility with their partners, suppliers and customers.

To give the SME sector a boost, National Small Industries Corporation (NSIC) devised a rating model that the rating agencies are to follow for awarding rating to any SME unit. All the major rating agencies now offer SME rating, while there has been a dedicated SME rating agency, SMERA. This speaks in favour of the growing popularity of the SME rating service.

SME rating: a subsidized meal

SME rating system gained ground across the globe with Standard and Poor's (S&P's) entry in this field. S&P's, the world's largest rating agency started its SME rating programme in Japan in 2005. In the same year India too witnessed her first award of SME rating by CRISIL. All the general- purpose rating agencies in India, such as, CRISIL, ICRA, CARE, Fitch India and Brickwork offer SME rating service. ONICRA, the only individual rating agency in India also rates SMEs. It is interesting to note that a new rating agency, SMERA, emerged exclusively for offering rating services to SME sector. SMERA is a joint initiative by Small Industries Development Bank of India (SIDBI), Dun & Bradstreet Information Services India Private Limited (D&B), Credit Information Bureau (India) Limited (CIBIL) and several leading banks in India. SMERA is the country's first rating agency that focuses primarily on the Indian SME segment. SMERA ratings offer SMEs DUNS number, an internationally acceptable number along with its rating reports (Dubey, 2006). DUNS stands for *Data Universal Numbering System.* It is a unique nine-digit numbering system, which is used to identify a business in a global supply chain. Under the WTO regime, new opportunities are being created for linkages among SMEs across the globe. Sectors such as biotechnology, IT and ITES etc. also have shown promising potential (Rao, 2006). Therefore, the SMEs with DUNS number find it easy to access the global market. This system has been developed by Dun and Bradstreet. Dun and Bradstreet's expertise on rating SME units is an important factor that distinguishes SMERA ratings from other ratings (Bhattacharyya, 2010).

CRISIL, the pioneer of Indian rating industry, started rating SMEs in 2005 It has already completed more than 25000 SME rating assignments. Other rating agencies are also not lagging behind. About 40 public sector banks endorse SME ratings by the approved CRAs. Nineteen of theses banks give interest rate concessions to SMEs.

To revitalize the SME sector, National Small Industries Corporation encouraged enterprises to obtain ratings, the first being subsidized to the tune of 75%. The rating agencies are empanelled by the NSIC Head Office for implementing the scheme in order to facilitate the rating process. NSIC maintains a database of the enterprises that obtained ratings from different rating agencies. To bring about uniformity in the rating methodology to be adopted by the CRAs, NSIC framed a broad outline combining performance and credit worthiness of the SME units. The rating fees to be paid by the enterprises are categorized based on the slabs of turnover(Table 2).

Table 2: Rating Fees

Turnover	**Fees to be reimbursed by the NSIC**
Upto Rs 50 lacs	75% of the fees charged by the CRAs subject to a ceiling of Rs. 25000.
Above Rs.50 Lacs and up to Rs 200 lacs	75% of the fees charged by the CRAs subject to a ceiling of Rs. 30000.
Above Rs 200 lacs	75% of the fees charged by the CRAs subject to a ceiling of Rs. 40000.

Ministry of Micro Small and Medium Enterprises.

NSIC offers subsidy to the enterprises for the first year only. Ratings are also valid for a single year. For the renewal in the subsequent years, enterprises are to pay for themselves in full.

Bank finance and SME rating

Banks' reluctance to extend loans to the SMEs is mainly due to the perceived risk in lending to a small enterprise with unproven track record and limited assets. CRAs minimize this risk by providing the banks with financial information about the SMEs. They expedite the loan processing process and help SMEs get much needed capital. CRAs not only provide SMEs access to funds but also helps bargain for the favourable terms of loan. Rupa Kudva, MD and CEO of Crisil estimated that "due to Crisil's trusted rating system, SMEs saved more than INR 1bn (US$22.5M) in interest costs and will save a total of INR5.6 (US$125m) by 2013" (Callard, 2010). Banks offer interest rate concessions between 0.25-1.25 percent to SMEs that enjoy higher credit ratings. Banks can do so because they can now price their loans based on the risks associated with them (Krishnan and Bala, 2012). Pricing of loans are therefore linked with the risk factors determined by the third part CRAs. In fact, while sanctioning loan or increasing credit limit to the SMEs, a comfort factor plays on the part of the banks. A significant benefit accruing to the SMEs is in terms of extension of credit limit by the banks. This has a compounding effect on the SMEs' turnover. By widening the credit cap to the deserving SMEs banks increase their earnings and reap the benefit of credit rating.

SME rating helps the enterprises to move out their cocoons and widen their operational sphere. A good rating serves as a passport to the SMEs for entering new domains where they had never stepped in. Ratings allow them to expand their market base and to get new contracts. It helps small enterprises in foraying into foreign markets and forming collaborations with international players.

Ratings renewal issue

The benefits of SME rating, as the CRAs claim, are quite tangible. But a big question pops up: do the SMEs really appreciate this benefit that the CRAs claim to have yielded? If the ratings really earn the SMEs substantial benefit, then why do 60 per cent of the SMEs do not come back for renewal of ratings after the first rating is assigned? According to Crisil, not all the enterprises get good ratings. So those who failed to get a good rating usually do not come back for the second time (Krishnan and Bala, 2012). Even among those enterprises, which got a respectable rating, a large section does not come for renewal. This may be due to the fact that the first rating is highly subsidized, but not the subsequent ones. Enterprises may opt for getting assessed at the expense of NSIC. They shy away when they have to bear the entire cost of renewal of ratings out of their own funds. Therefore, it may be deduced that a majority of SMEs go for rating for the first time thanks to the subsidy offered by the NSIC. There is no point in believing that the intrinsic worth of ratings causes the surge in rating requests by the SMEs. It may be argued that ratings are largely unaffordable to the small enterprises. Even if they get a good grade at the first instance, they may not go for reassessment out of sheer financial stringency. The remaining 40% of the enterprises who seek renewal of rating at the expiry of one year may do so as their financial health permit them to afford the cost or there may be definite commitments on the part of the SMEs either in terms of proposed contracts or expansion projects.

Crisil has completed 25000 SME ratings by 2012 while SMERA, the dedicated SME rating agency, has rated over 15000 SMEs in the last five years. SMERA claims that their “rating business is growing nearly 100% year-on-year” (Talukdar, 2012). All said and done, given the huge number of SMEs, these figures seem too small. There is no doubt about it that SME rating is still in its infancy. In most cases SMEs shy away from getting themselves rated due to the fear of not getting a good grade.

SMEs can access the capital market through IPO and list its equity shares in stock exchange meant for the SMEs. SEBI amended SEBI (ICDR) Regulations to incorporate “Issue of specified securities for small and medium enterprises” in April, 2010. In the preparations for the upcoming SME exchange platforms on the NSE and the BSE, an increasing number of SMEs feel the urge to be rated by a CRA to instill investor confidence in their business (Sheth, 2012). Those who will opt for getting listed, for them rating and rating renewal would be a basic necessity.

Credit Rating Capitalism

Even if SME rating is not mandatory, a sentiment prevails that a rated entity is better than a non-rated one. The government is dubbing this as NSIC itself sponsors a substantial part of the cost of rating. This is nothing but a benevolent state-hegemony in that the SMEs are to become clients of the CRAs. CRAs enjoy State patronage in terms of mandatory ratings directed by the government from time to time. This empowerment of the CRAs by the State reinforces the dominance of credit rating in all financial decision-makings. The position of power enjoyed by the rating agencies are attached with their role as ‘enforcer of discipline’ assigned by the State. The disciplining role played by the CRAs are not subject to legal prosecution for the reason that that they merely give “opinions” on the riskiness of assets or the venture.

Even in the US, CRAs are immune from legal prosecutions as they claim protection under the First Amendment as a matter of free speech and freedom of speech. The same is true in almost all other countries. Thus, the advantage without accountability ironically protected by the State makes the self-referral system dangerously powerful as the CRAs play a pivotal role in the economy.

CRAs shape the market sentiments and through their opinions they control almost every domain of economic policy making laying the foundation for “credit rating capitalism” (Raghavendra, 2013). Their power does not end in influencing market sentiments in their favour; it goes far beyond into the realm where it reshapes the politics and fiscal policy-making. The grant of subsidy by NSIC, a State-machinery, to the tune of 75% of the cost of rating may well be understood as the exercise of the same power by the CRAs. Credit rating is, after all, a business. State should delink its policy-makings from the influence of the private bodies that make profit out of this association. Particularly, no State can guarantee the authenticity and objectivity of the rating exercise of the CRAs. Government’s task ends in giving formal recognition to the CRA. Therefore, government does not have any control over the performance of any CRA. But ironically, the fate of the rated entities lies in the hands of the CRAs.

By assigning ratings whether good or bad, CRAs make a distinct divide between those who will survive and those who will die out. Rather, it is better to say, that ratings write the destiny of the SMEs. While some SMEs will encash ratings to reap a good fortune, the weaker ones with bad or no rating will find it increasingly difficult to procure finance. In effect, the poor ones may be denied institutional finance to the demise of their business. Grant of supremacy to the CRAs by the State will ultimately result in the disappearance of the small enterprises that do not qualify for institutional lending. Instead of helping them out SME ratings may oust the weaker enterprises from the system. This will grossly be against the notion of Nehruvian development model that our country had always embraced. In rating- driven capitalism fiscal decisions are largely influenced by the CRAs. Now the choice is ours.

6. Recommendations

Notwithstanding the policy support to SMEs and increase in bank credit to this sector in recent years, access to adequate and timely credit at a reasonable cost is still a critical problem for the SME sector. The credit flow to SMEs from the institutional sources is not commensurate with the economic activity undertaken by the SMEs. Statistics show that small businesses generally rely on multiple sources of financing ranging from internal sources viz., personal funds and funds from friends, to external sources, both formal and informal, which include financing from banks, NBFCs, venture capital funds, trade credit, factoring, etc.

Recourse to various alternative-financing sources depends upon the growth stage of the enterprise, the quantum of funds required, the maturity of the financial market and the policy environment. Therefore, alternative sources of finance can be very important for MSMEs.

Alternative Financing Sources

Securitization of Trade Credit

Trade credit is an important source of financing for Indian SMEs, as confirmed by studies/reports on the subject. SMEs often sell on credit to their large customers and then wait for long periods for payment. If these receivables (trade credit) could be packaged as a securitized asset, which would essentially be a commercial paper with the credit rating of the large firm, it could help SMEs reduce their investment in working capital and their need for finance significantly. The credit worthiness of a typical SME would also improve, qualifying it for greater bank funding.

Securitization of SME Credit

Likewise, SME credit could be packaged in the form of loan pools or securitized assets and sold to investors interested in such an asset class. In a recent transaction involving securitization of SME loan credit, IFMR Capital, a Chennai---based NBFC focused on connecting sectors such as SME finance with mainstream debt capital markets closed its first ever pass through certificate (PTC) securitization transaction with its partner Vistaar Financial Services Private Limited, a Bangalore---based NBFC involving an amount of Rs.77.2 million. IFMR Capital plans to follow---up this transaction with several more in this asset class and is currently in the process of building a pipeline of SME lenders.

Factoring to Tackle Delayed Realization of Receivables

Considerable delay in settlement of dues / payment of bills by the large-scale buyers to the SMEs units adversely affects the recycling of funds and business operation of SME units. Timely payments from customers will help SMEs in reducing their working capital requirements leading to lower interest costs, improved profitability and a positive impact on the long-term health and sustainability of India's SME sector. A study of 5000 SMEs by CRISIL released in December 2010 shows that high quantum of receivables is an endemic problem across industry sectors and geographies in the SME space. Smaller

SMEs, perhaps due to their lower bargaining power, are in a more disadvantageous position with weaker receivable positions.

The above problem of delayed realization of receivables can be institutionally tackled by factoring which provides liquidity to SMEs against their receivables and can be an alternative source of working capital. Factoring is a flexible alternative to traditional forms of funding. When a client makes a sale, delivers the product or service and generates an invoice, the factor buys the right to collect on that invoice and releases funds, usually 80-90% of the invoice value to the client. Factoring as a financial services product is superior to the conventional bank finance in terms of it being an easy and fast method of turning accounts receivables into cash, offering funding up to 90% of the invoice value, not restrained by geographical limits, non requirement of collateral security, offering value-added services in the form of sales ledger administration, collection and credit protection, credit screening-cum-credit monitoring and early detection and warning of customer service problems.

Leasing

Like factoring, leasing too has the potential to become an important source for SMEs in businesses such as IT equipment, cars, trucks, etc. Leasing is a transaction in which a firm can obtain the use of certain fixed assets (e.g., real estate, equipment, machinery) for which it must pay a series of contractual, periodic, tax deductible payments. The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the lessor and the lessee can be for a fixed or an indefinite period of time (called the term of the lease). The payment for the lease is called rent. For SMEs that lack the resources to purchase business assets like manufacturing equipment or production space, leasing is an attractive option that facilitates management of capital. In some cases, it offers the only practical option in acquiring access to the required assets, and in managing the financial obligation. Leasing also provides more flexibility in the event a company wishes to move to a new location or use more modern equipment. The lessee has the option not to renew the lease at the end of its term. At the same time, leasing also requires a less rigorous legal and regulatory framework vis-à-vis bank lending, since the leasing company retains the ownership of assets till the end of the lease.

Supply Chain Finance

Supply chain finance is another facility to help SMEs access more working capital from banks and non-banks. In supply-chain financing, the small suppliers to big Original Equipment Manufacturers or their suppliers can get short-term credit against the supplies while they await payment. For instance in India, HSBC, a well known foreign bank has a Distributor Finance Programme (DFP), which helps set up a financing and collection arrangement for their SME customer's delivery chain. In the DFP, the credit worthiness of distributors is established independently by HSBC and credit limits are set up on each distributor. The bank regularly send MIS to its SME clients and its distributors to ensure that the sales ledger remains updated at all times and frees the SME from reconciliation issues. This allows the SME to focus its efforts on actual sales rather than collection. Its current portfolio carries a healthy mix of clients across various industry sectors such as telecommunications, automotive components, FMCG and textiles, to name a few.

Angel Funds / Venture Capital Funds

Venture / Risk capital is often a more appropriate financing instrument for high-growth potential and start-up SMEs. However, the ability of SMEs (especially those involving innovations and new technologies) to access alternative sources of capital like angel funds/risk capital needs to be enhanced considerably. Although SMEs commonly use traditional debt, this type of financing is often not accessible for fast growth and start-up firms. During their initial phase, firms need finance to study, assess and develop an initial concept (seed phase) or for product development and initial marketing (start up phase).

Angel investors (i.e. investors who typically invest their own funds, unlike venture capitalists who manage the pooled money of others in a professionally managed fund) are increasingly becoming another alternative source of funding for SMEs in India. Entities such as Indian Angel Network, Mumbai Angels, The Chennai Angels, Nadathur Holding and Investment, etc. are well known investors who are keen on helping early stage companies with funding and mentoring.

Private Equity Funding

Private Equity (PE) investment provides another source of raising capital for SMEs. PE funds have been investing in Indian firms since 1990s. Some of the early entrants, including ICICI Venture, UTI Ventures and ChrysCapital, have built companies. PE companies are, typically focused on finding a company early, adding value to them and making an exit at a later stage. They are stable sources of capital and tend to have an investment horizon of 3-5 years looking at a multiple return on their investment.

Access to Equity Capital through SME Exchanges

In March 2012, both BSE and NSE launched their SME exchange platforms to enable SMEs to raise funds and get listed as public entities. BCB Finance Ltd. created history by becoming the first Indian SME to get listed on the BSE SME Exchange. This was an event of immense significance for SMEs as they have a huge listing potential but mostly had debt-financing options. The launch of SME exchanges will play an important role in growth of SMEs and the need of the hour is to improve the awareness among SMEs about equity capital, stock markets and funding options, other than banks. The capital markets can play a crucial role in helping SMEs improve their visibility and raise capital for their growth and expansion, offering an effective way to improve financial inclusion. They can also offer investors opportunities to invest in growing businesses at an early stage.

7. Conclusion

The SME sector in India, which includes the micro, small and medium enterprises, constitutes an important part of the economy. However, a major concern for the SMEs is the availability of an adequate amount of finances. The government has recognized the key role that the SME segment plays in creating new enterprises and in providing employment to a large segment of the population and has adopted several public policy measures to enhance flow of credit to the sector. One of the prominent measures used to ensure adequate flow of funds to the SME sector is through regulation requiring banks to provide at least 40% of loans to targeted areas which include the micro, small and medium enterprises.

The challenge for banks is to bridge the information asymmetry, an issue that plagues the systematic growth of this sector. So as to take the appropriate lending decision so that the good firms are not financially constrained, and at the same time, cut down on exposures to bad credit risks. Measures such as credit scoring and rating for SMEs should improve the quality of financial information and enable greater funding for the sector. The SARFAESI Act and the strengthening of legal provisions to take possession of assets used as security has improved the legal environment for lending in India, thus lowering the cost of lending and enforcement of contracts.

Besides this, SMEs are largely unorganized with hardly standardized operational and accounting norms. The sector is characterized by extreme heterogeneity. How far the CRAs will effectively assimilate this heterogeneity to make an unbiased assessment of the health of the SMEs is really questionable. Moreover, the small units basically stand on the feet of their promoters. Can rating models objectively accommodate the personal charisma of the entrepreneurs? Finally, the universal criticism of conflict of interest and rating inflation apply to SME rating as well. By subsidizing the initial rating fees isn’t the State legitimizing the license selling function of rating agencies? Time has come for reviewing the danger of rating capitalism hidden behind the veil of apparent benefits.

In the light of the issues related to CRAs and information asymmetry, the access to adequate and timely credit from the banking system is still a critical problem being faced by this sector. Alternative sources of finance can, therefore, step in and assist SMEs in their growth and development. In recent years, a plethora of alternative finance options have emerged and have proven to be an important source of financing for Indian SMEs. The alternative financing avenues discussed above truly have the potential to bridge the financing gap for SMEs from banks. Access to finance is essential for improving SME competitiveness, as SMEs have to invest in new technologies, skills and innovation. On their part, the SMEs should be responsible borrowers, should use the above finance in a judicious manner and take advantage of the business opportunities both within and outside the country. They should improve their governance and risk management practices, maintain proper books of accounts, submit correct information to banks and all authorities, and make their operations more efficient and productive to get easier access to finance from banks and other investors. This way the SME sector would become more competitive and efficient and contribution further to the economic development of our country.

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