Credit Rating as an Indicator for Creditworthiness of Organizations : An Emphasis on Indian SMEs

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ABSTRACT

Over the last one decade, credit rating agencies have taken a center stage in loan disbursement process for organizations irrespective of their size. With the emergence of the recent global turmoil, the coming years will see even greater role being played by these agencies in the loan sanctioning process. This research paper focuses on the efficacy of the credit ratings and also their perceived credibility, regarding assessment of firm's creditworthiness while disbursing loans. For achieving this, firstly, this research paper intends to understand the working of various credit rating agencies in India followed by a primary research carried out with major private & public banks of India to understand their perception regarding the credibility of the reports offered by the credit rating agencies to the organizations. The paper is concerned mainly with the products and services being offered by the rating agencies for the MSME sector. This research provides valuable insights relevant for organizations like SMEs, banks and also rating agencies of our country.

Keywords: *SME, Loan Disbursement, Banks, Credit Rating, Credit Worthiness*

Introduction

The economic growth of any country depends, to a greater extent, on a vibrant capital market as it facilitates the transformation of savings into investment (Bheemanagouda, 2010). It may be noted that the development of capital market depends, among other factors, on the dissemination of complete information and the existence of knowledgeable investors. The growth story of the Indian capital market started in the mid-1980s. The Indian economy has been growing fast since the adoption of the Liberalization Policy in mid-1991. At present, the Indian economy is integrating with the global economy. In tandem with the economy, the capital market is also growing fast. Over the years, various tailor-made financial instruments have been introduced in the capital market to cater to the needs of diverse investors. The growth of the capital market and increase in the varieties of instruments created not only opportunities for the investors, but also complexities in the market as, even the reputation of the issuer-company is no longer a guarantee to the quality of the financial instrument which it (i.e., the company) issues. Hence, a general caution to the customers, caveat emptor (buyer beware), is also applicable to investors. To demystify the complexity

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of the financial instruments in the capital market, to facilitate the investors to take informed investment decisions and to enable the issuer-companies/ institutions to mobilize the required funds (at reasonable cost), various agencies like Moody's Investor Services, Standard and Poor's, Fitch Ratings, etc., work in the US markets.

Credit Rating Agencies in India

The success stories of credit rating agencies in the US (particularly, in debt capital market) encouraged a few Indian and foreign financial institutions and banks to establish rating agencies in India. Credit rating in India is the brain child of CRISIL (Credit Rating and Information Services of India Limited). CRISIL was incorporated in January 1987 and commenced its rating activities in January 1988. Its first rating was released in March 1988. ICRA (Investment Information and Credit Rating Agency of India Limited) is the second rating agency established in India (January 1, 1991) at a time when the country was all set to embrace the economic liberalization policy. CARE (Credit Analysis and Research Limited)) is the third credit rating agency to be set up in India (April 1993). Duff and Phelps Credit Rating India Limited (DCR) is the fourth, but the first private sector rating agency which commenced its operations in India in 1995. Duff and Phelps, and Duff and Phelps India Private Limited merged in November 2001 to form a new entity called, Fitch India Limited, a 100% subsidiary of Fitch IBCA. Brickwork Ratings India Private Limited is the fifth credit rating agency (second private rating agency) registered with SEBI in 2007. Credit rating agencies came into being to evaluate the credit risk of the financial instruments. The basic philosophy behind assigning a credit rating is to enable the investors to take proper investment-related decisions to minimize their risk and maximize their benefits. Source: CRISIL website.

The micro, small and medium enterprises (MSME) sector contributes significantly to the manufacturing output, employment and exports of the country. One of mains constraints of development of MSME is mobilizing private funds for investment in this sector. There are banks and credit institutes which have been supplying credit to these units. 'Small Industries Development Bank of India' (SIDBI) set up in the year 1991 as subsidiary to the Industrial Development Bank of India has been providing funds to the MSME. 'State Financial Corporations' (SFCs) and 'State Industrial Development Corporations' (SIDCs) have been set up at state level to primarily cater to the long term credit needs of the small and medium scale units and to participate in the venture through equity stake. These units get refinancing from SIDBI for the approved schemes and also generate their own funds through the state government and now from the commercial borrowings from the market as well. SFCs have remained a source of credit for SMEs in general. Recently, in view of the needs for funds of MSME and their importance in the national economy the credit rating agencies have been developing their rating in order to facilitate raising finance from the market by MSME.

Research Purpose

The small and medium enterprises (SME) sector in India plays a vital role in the growth of the country. The SME sector in India accounts for around 95% of the industrial units, almost 40% of the gross industrial value-added in the Indian economy, 34% of exports and provides direct employment to 20 million persons in around 3.6 million registered SME units. The SME sector in India contributes to about 7% of India's gross domestic product (GDP). This statistic shows the importance of the MSME sector in the Indian economy. The growth of the MSME sector is one of the most important points in the Government's agenda regarding the industrial policy in India. Globalization has opened a floodgate of opportunities for the MSME sector and MSMEs in the engineering and automotive parts industries have shown a very strong growth in the recent years. But, globalization and the liberalization policy in India have also increased competition for the domestic MSME sector. To compete in this cut throat environment the MSMEs need to scale up their operations, increase their efficiency and sharpen their competitive strategies. But for all this to happen, the one thing that is of prime importance is the swift and easy availability of loans. Due to lack of cheap and adequate funds the MSME sector in India might find itself in a comparative disadvantage to its global counterparts. Hence making cheap and hassle free credit available to the MSME sector is the need of the hour. The loans granted by the banks and other non-banking financial institutions in India to the MSME companies are based on the credit ratings of these companies. These ratings may either be provided by the banks themselves or by third party credit rating agencies. The role played by the external credit rating agencies in this process is the focus of this project. The purpose of the research is to critically analyze the different products and services being offered by the Rating Agencies in India for the MSME sector and to provide a comparative analysis of the same. The research also aims to provide an understanding of the process of credit rating done by the different rating agencies for the MSME sector and to identify the key stakeholders in the process. Finally, the research emphasizes on a reality check of how credible the different rating agencies are from the perspective of banks and other financial institutions who are one of the key stakeholders involved in the process.

Research Scope

The different Rating Agencies covered in the research provide various products and services. However, the paper is concerned mainly with the products and services being offered by the rating agencies for the MSME sector. Though the research paper uses facts and figures pertaining to the Indian context, the relevance of the research is not restricted to only India but, it can be easily adapted to suit the business environments of other emerging economies similar to India.

Data Analysis

The findings presented in the research are based on both secondary as well as primary data analysis. A secondary data analysis has been conducted regarding the different products and services being offered by the major credit rating agencies in India namely CRISIL, ICRA, SMERA, ONICRA and CARE. The sources of these data have been primarily the websites of the rating agencies. A primary data analysis has been conducted with respect to the credibility analysis of the products and services being offered by the rating agencies. A survey had been conducted using a questionnaire where 12 leading public and private sector banks had shared their opinions regarding their perception about the external rating agencies. The conclusion and recommendations of this research paper are based on the same data analysis.

Findings

Comparative Analysis of the Rating Agencies

A parameter wise comparison of the rating agencies under the research is as follows –

Benefits to SMEs

One of the major advantages of undergoing rating as stated by most of the agencies and NSIC is that the SME is in a better position to obtain loan at a much faster pace and at a concessional rate. A positively rated SME finds itself standing high in the market. Both the clients and suppliers to the SME feel a level of comfort in dealing with the SME. On the other hand a negatively rated SME is able to understand the areas where it's lacking as compared to the other industry players.

On the other hand, even the lenders find themselves in a comfortable position while extending loans to a positively rated SME. A credit rating by an independent third party provides additional input to the whole process. Feeling the importance of credit rating in loan sanctioning process, government of India has made it mandatory for SME with loan requirement of more than 10 crores to undergo SME rating from an accredited agency. This helps in reducing the NPA at industry level.

Types of Rating

Across the industry, the research found two different rating scales followed by players –

NSIC rating (SE1A – SE5C): This rating scale is used for SME's which undergo rating via NSIC or SME's which are eligible for partial refund of fees as per the norms of NSIC.

Self-rating scale (SME1 – SME8): This scale is applicable for all SME who do not want to undergo NSIC rating. For SME's with turnover greater than 2 crores, this is the only available rating product.

The NSIC rating scale is more informative as compared to the self-rating scale followed by different agencies. The NSIC scale defines both financial strength and performance capability in the scale nomenclature itself.

Factors Considered for Rating

While rating any SME, most of the agencies take a holistic view of the functioning of SME rather than considering just the financial performance of the SME. The financial performance of any unit is just an indicator of current health of the organization, whereas the industry analysis, understanding organization structure, culture, strategies etc. provide a vision into the future of the company. And while providing loan to any SME, banks are more concerned about the future than about the present or past performance of the SME.

ICRA, CRISIL and SMERA had clearly stated on their websites the factors taken into consideration while rating, while the same were not explicitly available for CARE and ONICRA. SMERA has also defined a risk assessment matrix where by 5 major risks associated with any SME are assessed namely: industry risk, business risk, management risk, financial risk and project assessment risk. ICRA & CRISIL has developed an extensive set of industry specific reports to deeply understand the mechanics taking place in each of the industry.

Procedure Followed while Rating

Each of the rating agencies considered in the report follows a detailed procedure while rating any organization. Primarily each rating agency collects basic financial and legal documents from the SME. After analyzing the documents, the companies officials make a formal visit to the company where by the operational details of the company are measured. A detailed report is prepared based on the industry visit and the documents collected which is then presented to the rating committee. SMERA assigns the task of industry visit to a 3rd party which visits and sends a detailed report to SMERA. The rating committee after thoroughly assessing all the documents assigns a rating to the concerned SME. A large part of the rating process has been automated in leading agencies like ICRA, CRISIL (information based on personal interaction with bank executive). In cases of disputes or where a clear mandate is not provided by the software, decision is taken by the rating committee.

CARE is the only rating agency which specifically mentions the eligibility required for getting rated under the NSIC scheme. Any SSI with investment of less than 1 crore on plant and machinery are the only ones eligible under the scheme. All other agencies have not mentioned any specific condition.

Pricing

CRISIL being the market leader in rating industry, charges the maximum fees as compared to other players both for NSIC rating and self-rating. CRISIL also has different pricing schemes for Greenfield projects and non-Greenfield projects as analyzing a Greenfield project requires far more analysis as compared to other projects. SMERA charges the least fees among the market players. As stated on the ICRA website, the subsidy granted on NSIC-ICRA rating is available only once. While renewal of rating SME is not eligible for any subsidy. Due to some constraints the pricing information about the rating products offered by ONICRA and ICRA were not available freely.

Duration

Each of the rating agencies analyzed takes around 3-4 weeks of turnaround time after receiving all the required documents from the SME. The rating provided by any agency is valid only for 1 year if no major event takes place in the concerned industry which forces the agency to revise the assigned rating.

Credibility Analysis: How Banks & NBFCs perceive these ratings for SMEs

The research has emphasized on the analysis of amount of trust that the loan granting Banks and Non-Banking Financial Companies (NBFCs) have on the third party Rating Agencies in the event of sanctioning a loan for the SME sector. The credibility analysis done in this research is based on the responses of the major banks who grant loans to the SME sector. The responses have been collected through a survey conducted on 12 banks which include both government as well as private banks. The responses of these banks and financial institutions have been collected through a survey consisting of twelve questions which tried to critically analyze the trust of the loan granting financial institutions on the third party rating agencies and also the degree of their reliance on these ratings.

Providing Loans to SMEs

All the banks and financial institutions covered in the survey provide loans to the SME sector. This shows that the banks and financial institutions recognize the tremendous growth potential in this segment and also the fact that access to liquidity at competitive rates is crucial for the growth of the SME sector in India.

Referring Credit ratings while Providing Loans

Hundred percent of the surveyed banks and financial institutions use credit ratings as a tool to assess whether loans should be granted to the SME This shows the importance of Credit Rating in the process of granting loans to the SMEs. Though this is true for all the cases still the banks also consider the amount of security that the loan seeking SME has with the bank. Also some qualitative factors come into play during granting of the loans. But, these do not reduce the importance of the Credit Ratings given to the SMEs which are the most important criterion for granting the loans.

Agencies Mostly Used

While most of the banks and financial institutions covered in the survey have a great deal of confidence in the ratings of CRISIL which is a major player in the rating industry, many of them also consider other rating agencies' ratings on the SME sector. SMERA is coming up in a big way as an accepted rating agency, while ICRA and ONICRA and CARE are not too far behind. Again most of the surveyed banks and financial institutions use these External Credit Ratings provided by the third party rating agencies as only the first criterion to grant the loans. Majority of the surveyed banks and financial institutions have their own internal rating systems which are basically software's which are programmed to take a decision based on the financial health of the loan seeking SME. Thus the loan granting banks and financial institutions do not blindly trust the external credit rating agencies for granting the loans to the SMEs and use their internal rating procedures before they grant the loans to the SMEs. The preference of the external rating agencies differ from one bank/ financial institution to another though CRISIL and ICRA are still the most favored ones. SMERA is fast catching up with the above two rating agencies in being accepted by most of the banks and financial institutions. Some banks and financial institutions may be biased towards a particular external credit rating agency if it is related in some way with the later.

Any Difference in Lending Rates for SMEs

The banks and financial institutions under survey have different interest rates for the differently rated SMEs (Refer to Appendix1 Question-7). The interest rate differences between the least rated and the highest rated SME usually varies from one bank/ financial institution to another. While in the case of Canara Bank the difference is to the tune of 2% (SE 1A- 10.75% to SE 5A- 12.75%) in case of Punjab National Bank the difference is around 0.25% - 0.5%.

Same Process for Rated as well as Un Rated SMEs

Around 58% of the surveyed Banks and Financial Institutions follow the same process for granting loans for both rated and unrated SMEs. The rest 48% have different procedures for the rated and unrated SMEs.

Positive Rating but Loan Application Rejected

Majority of the surveyed banks and financial institutions have not rejected the application for loan by any SME that came with positive rating from any external rating agency, but, in some cases even a positively rated SME has been denied the loan. (Refer to Appendix1 Question-10) Herein lays the importance of the internal credit rating procedures of the banks and financial institutions. Although, in most of the cases a loan application is declined for a negatively rated SME (using an external credit rating agency), in rare cases the loan application might even be accepted subject to different results from the internal rating of the bank/ financial institution.

Different Ratings by Different Agencies

There have also been cases where the same SME has been ranked differently on the same scale by two different rating agencies. This might raise a few doubts regarding the credibility of the different rating agencies.

Benefits involved in being rated under the NSIC scheme

Taking the case of NSIC-CRISIL performance and credit rating scheme and the interest rates for the rated SMEs charged by CANARA BANK, the report tries to analyze the benefits of being rated by an external rating agency. The NSIC-CRISIL performance and credit rating scheme divides the SMES according to their turnover into three categories which are less than Rs. 50 lakhs, Rs.50-200 lakhs and greater than Rs. 200 lakhs. The concessional fees for rating under the scheme to be borne by the SMEs under operation are Rs. 7456, Rs. 9927 and Rs. 13236. The interest rates charged by CANARA BANK for ratings of SE 5A is 12.75% and SE 1A is 10.75%. So a company with turnover of Rs.372800 will just nullify its cost of being rated with the benefit of reducing its interest rates. Similarly, the break even points of getting rated by an external agency can be worked out for the other ranges of turnover. This will vary from one bank/ financial institution to another and from one external rating agency to another. The point to be made here is that not always is it beneficial (financially) for a company to undergo rating by an external rating agency.

Conclusion

After thoroughly studying the working of various credit rating agencies, and analyzing the responses of major Indians banks, the research concludes that the report produced by various credit rating agencies has improve the credit worthiness of MSME. SMEs not only gain fast access to capital with the help of such reports but are also able to gain an insight into their work culture and their standing in the industry vis-à-vis other market players. Banks and financial institutions in some occasion have followed simplified procedures for sanctioning loans and loans are provided at concessional rates of interests.

Recommendation

As observed during the research, each bank has a collaboration with different credit rating agency and there by attaches more weightage to the ratings given by that particular credit rating agency. Thus after deciding the bank from which an SME organization will raise the loan, should SME decide on the rating agency. In general ICRA & CRISIL have a general acceptance across the financial industry. Secondly SMEs should do a cost-benefit analysis before undergoing credit rating process as explained in the study above.

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