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CREDIT RATING FOR SMALL AND MEDIUM ENTERPRISES: PROBLEMS AND PROSPECTS IN BANGLADESH

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ABSTRACT

Small and Medium Enterprises (SMEs) are contributing in economic development worldwide. Research shows that the main challenge for getting loans is information asymmetry between external creditors and SMEs themselves. This makes SMEs investment more risky and vulnerable for the investors. In this situation, credit rating agencies play an important role by rating the SMEs that reflects overall creditworthiness of the SMEs. The aim of this paper is to identify major problems and prospects of SMEs financing and comparative rating process of SMEs in Bangladesh. Presently, credit rating agencies in Bangladesh follow the similar process as in Japan and India. A major problem arises because rating fees is the key source of revenue for credit rating agencies which infuses a conflict of interest of marking high ratings. Moreover, Bangladesh still could not establish institutions which exists in developed countries e.g., Credit Guarantee Corporations (CGC) that supports SMEs as a credit guarantor in Japan. Apart from this, Bangladesh government may encourage boosting investor pay or subsidized model (this is at practice in India) that increases SMEs rating.

1. INTRODUCTION

In the modern advanced financial system, adequate and reliable information is the key tool for making a safe investment. Gapping in information makes the investment more risky and vulnerable for an investor. By reducing the information gap, credit rating agency plays a contributory role in the advanced financial system. The role took on by the Credit rating agency (CRAs) has been stretched out due to the financial globalization and supported by the Basel II that unites the CRAs into the rules for grading for credit risk.

To fill the demand for mitigating credit risk for the current era of global economy and demand of improved financial architecture, CRAs has become an important actor. The ratings provided by the CRAs reveal the ability to pay out the debt and other debt instruments. This means the lower the credit rating the higher the risk and increases the price of debt due to higher interest rate demanded by the investors for enduring higher risk. CRAs follow up the debt instruments on a periodic interval and rate them on the basis of the shift in their financial situation. The higher the rate the better the financial posture of the company meaning secured investment. Therefore, the CRAs have got the commendation from the BSEC (Bangladesh Securities Exchange Commission) that provides them the status of being approved rating agencies by the government.

CRAs rate the small and medium-sized enterprises (SMEs) compared with other SMEs, reflecting the overall creditworthiness of the firm. Unlike the large corporate, the SMEs have its own unique specialties. The SME sector has no standardized form of industry information, market share info, market rivalry information, and management trail records. So the established rating system used for the large corporations is not effective for the SMEs and that urged for a customized and distinguished framework for credit assessment.

Between the timeframe of 2010 to 2014, the number of CRAs operating in Bangladesh has grown from two to eight. Moreover, Bangladesh Bank intends to introduce a customized rating framework for the small and medium-sized enterprises (SMEs) distinguishing the rating from conventional bank loan ratings. In the case of SMEs, access to adequate financing has always been a crucial problem in the Asian region, particularly in Bangladesh. This customized framework for rating SMEs can lead the debt financing from the collateral-based lending to the risk-based lending by fulfilling the credit information gap. In December 2007, the Capital Adequacy Framework for Commercial Banks under Basel II has been brought out that came into full swing by the year 2010. The framework urged the commercial banks to choose acknowledged ECAIs to rate the banks and their counterparties. Thus, the unrated counterparties carry riskier weight in capital adequacy that influences the clients to have a good rating. There is no broad research on SMEs rating strategy practices in Bangladesh and CRAs drift in SMEs and Bank rating practices.

The contributions of this paper are threefold. Firstly it addresses the challenges of SMEs financing through identify the major aspects that affect SMEs financing. Secondly, this paper makes a comparative study on the process of SMEs financing in Bangladesh. It compares credit rating process of Bangladesh with Japan (which is a developed country) to examine activities of rating agencies based on economic difference. This paper also compares credit rating process of Bangladesh with India (which is a developing country) to know the similarity and disparity exits in credit rating process among developing countries. These comparisons help to figure out credit rating process and positions in Bangladesh so that it will distinguish which aspects need to be improved in future. Thirdly, it identifies and elaborates the specific challenges in SMEs rating process in Bangladesh.

The study includes both primary and secondary data which has been collected in both structured and semi-structured manner. Oral interview of the responsible credit analyst are arranged by the author in different credit rating companies in Bangladesh to collect data. Author also uses annual report of different credit rating agencies in Bangladesh, SMEs rating guideline & various documents provided by credit rating agencies in Bangladesh.

2. LITERATURE REVIEW

The cost of credit and access to formal finance sources are thought by SMEs not only the great hindrance than large firms but also constraint their performance more than large firms (Beck, Demirgic-Kunt, & Maksimovic, 2008). Riskier SME also faces difficulty in borrowing money from the banker (Yoshino, 2012).

In Bangladesh, SMEs faces two major financing problem related to investment and working capital. SMEs faces some problem due to its nature of business like insufficient collateral and high mortality rate which makes the bank reluctant to provide a loan. Due to the high probability of default with the low guarantee, banks do not consider SMEs as a profitable one. SMEs in the export sector also face problems of access to working capital (Alamgir, 2015). Due to Information asymmetry between the lender (bank) and borrower (SMEs), SMEs face severe difficulty in accessing in formal financial sources. Bank can easily justify the creditworthiness of corporate firms through 5Cs formula due to the availability of information. But in the case of SMEs, there are only a few firms that maintain the audited financial report and documents. In this situation, for reducing the cost of acquiring information and bank's effort to deal with the information, CRAs plays an important role by providing cost effective access to that information (SWEWG, 2015). The financial and legal institutions play an important role in relaxing constraint and innovative financing instruments can help facilitate SMEs' access to finance even in the absence of well-developed institutions. Establishing local Credit Rationing Agencies (CRAs) would be highly efficient in increasing transparency and creating a faster formal credit allocation system. This would benefit fast-growing firms, in particular (Rand *et al.*, 2009). Credit rating agency reduces the bank burden in two ways. Firstly, it rates SMEs rigorously based on financial positions, which helps the bank to decide SME financing in the more rational way. Secondly, rating agency reduces the risk of the bank that rose from information asymmetry and a probability of default (Yoshino & Taghizadeh-Hesary, 2015). A government organization like credit guarantee system makes the process of lending loan easier to a bank. In this system, if an SME is becoming the default, then the losses of a bank would be met partially by the credit guarantee corporation as a governmental organization (Arráiz *et al.*, 2014).

CRAs suffer information and allocation related efficiency due to increased competition among CRAs (Bar-Isaac & Shapiro, 2013; Doherty *et al.*, 2012). This increased competition reduces income from rating fees that may lead to CRAs more sensitive to capture and bribery (Strausz, 2005). In this case, issuers have available CRAs to rate their firm. This availability of rating firm helps to increase rating shopping that means issuer can decide which rating to publish (Bolton *et al.*, 2012). One of the major problems of CRAs in Bangladesh is intense competition among CRAs. Because of the competition among rating companies, the fee of a rating is only one fifth in comparison of minimum rating fee of India. But for providing quality services, CRAs need to maintain training, quality research, and information (Mobin, 2015).

CRAs agency uses the different model for getting rating fee. Issuer pay model has been criticized for mainly two reasons: in this model, issuers can ultimately decide whether rating will be published or not that creates a scope of rating shopping. An issuer can take rating from several CRAs and only publicize which one is most favorable. A difficulty further arises, when CRAs might be tried to please issuer by providing a favorable rating for the purpose of capturing rating market (Jeon & Lovo, 2013).

3. CHALLENGES FACES BY CREDITORS IN CONNECTION WITH SMEs

Although Some SMEs can access in the formal source at a high cost, but most of the SMEs face severe constraint in accessing formal financial source that makes the SMEs more vulnerable. The World Bank surveyed 130000 firms in 135 countries and identifies 15 major obstacles to SMEs growth of which the first one is obstacles in access to finance. Most of the SME's financing are coming from informal sources rather than formal sources of external financing (Beck & Demirguc-Kunt, 2006). SMEs itself has the problem due to lack of critical economic size, less sophisticated management of SMEs. Major challenging of SMEs for getting a loan is information asymmetry or information gap between external creditors and SMEs (World Bank, 2015).

Another problem is that most of the SMEs could not prepare their business plan properly that needs to be attached with a loan application. In many times, after granting the loan, SMEs could not provide up to date information and progressive report on business condition to the lender. SMEs lose credibility of getting a loan from formal sources due to lack of proper collateral. This trend is severely acute in developing countries rather the developed countries. In developing countries, creditors or lenders are willing to pay short-term loan rather than the capital loan to

SMEs also charge more interest rate than the developed countries. Due to Basel II and Basel III, Bank is less responsive to finance SMEs and try to only give loan high rated company.

Credit rating agency helps to mitigate the problem of the information gap between lender & MSEs by providing a proper rating of SMEs. CRAs advise and suggest how the SMEs can arrange their quantitative data and provide a clear idea on the weakness of SMEs so that SMEs can recover the weakness. Credit rating agency also helps to know the documentation that are essentials for SMEs and try to give advice so that SMEs can make the documents available. In this situation, credit rating can play a vital role by observing the SMES credit worthiness and help the SMEs by suggesting the proper guideline

Figure-1. Major Challenges faced by the creditors in connection with SMEs
Sources: Facilitating SME financing through improved credit reporting, International committee on credit reporting, World bank, 2015.

4. PROSPECTS OF THE CREDIT RATING OF SMEs

The objectives of SME ratings far different from the corporate ratings because it does not provide only credit information to lender or borrower. It generates much awareness to entrepreneur or prompter of SMEs so that they can build their capabilities and knowledge in identifying key factors of industry and business cycles and address the problem to gain the better financial and business positions in the industry (Tsunoda *et al.*, 2013). Credit rating agency makes the ease access of SMEs for getting the fund that leads to sector growth with the better inclusive development of the economy.

Rating helps the SMEs to increase the confidence and possibility of getting access to the capital market. Providers of SMEs financing consume less time for high rated SMEs to disburse their loan. Rated SMEs also get the benefit of quick access to nontraditional sources of financing. Rating agency analyzes the strength and clarity of the business that helps to promote alliances among SMEs through business collaboration. Creditor prefers rated company over the nonrated company. SMEs gets to benefit from rating process by maintaining all documents, ensuring financial soundness, achieving strong governance to get the better rating makes the SMEs also efficient and effective (Jain, 2012).

High rated SMEs have the facility to get the loan at a lower interest rate which provides substantial benefit to SMEs. This cost reduction in capital helps the SMEs to boast up the profit in line with the growth objective. Good rating enables the organizational efficiency of SMEs with financial soundness which helps to attract prospective talent employee and ensures retention of the current employee.

The rating also helps to increase the exports of SMEs. Because rating agency judges both the customer loyalty and satisfaction that's why high rating makes the customer confident in the delivery capacity of SMEs. By this way, the high rating also helps SMEs to increase in sales volume and exports of SMEs.

Rating makes the process easy for the banker to approve the loan quickly. Without a rating, SMEs get the loan after all the process completed by the bank for getting assurance about the loan status of the borrower. This long process hampers the quick loan process and stuck the organic growth of the SMEs. Bank approaches the high rated SMEs for taking credit facility. Regular rating makes the SMEs confident to deal with the lender and control on distribution channel in line with the improvement of performance. Higher rating helps the SMEs to get fund from newly alternative sources. In generally no bank want to lose their good related customer and the bank wants to lend more money to high rated company. This tendency helps the SMEs to negotiate with the bank for a reduction in interest rate (Dorga, 2016).

Rating helps the bank to shift form an individual's opinion based credit review process to scientific and systematic process focusing on objective inputs, more accurate and faster information gathering and tracking system and timely decisions for credit decisions to manage the risk properly. It increases the awareness of commercial bank about automated data processing, credit orientation and approval (Tsunoda *et al.*, 2013).

5. COMPARISONS OF SMEs RATING PROCESS OF BANGLADESH WITH JAPAN AND INDIA

5.1. Japan Credit rating Agency limited (JCR), (Japan)

JCR provide rating on SME to provide credit assistance for SME in Japan. JCR also publishes rating for corporate, local governments and other interested parties. Japan Credit Agency Limited use sophisticated procedure to make the rating of SMEs. In generally, the owner of the SMEs at first applies for the rating with minimum fee after that Japan Credit Agency Limited (JCR) assigns responsible analysts to collect and analyze the data. Analyst request SMEs to submit necessary data. After getting the data analyst analyze the submitted data outlined the point that need to be cleared through further clarification. Then analyst send questionnaire and arrange an interview with the manager for further clarification. Then analyst prepares the proposed rating and discusses with the rating committee and determines the rating. After that rating agency notify the rating to the SMEs with rational explanation. After that credit rating agency finally declared the rating after payment of rating fee by the SMEs. Credit rating not only rates the SMEs but also surveillance the SMEs for specified period for which rating prevail (SWEWG, 2015).

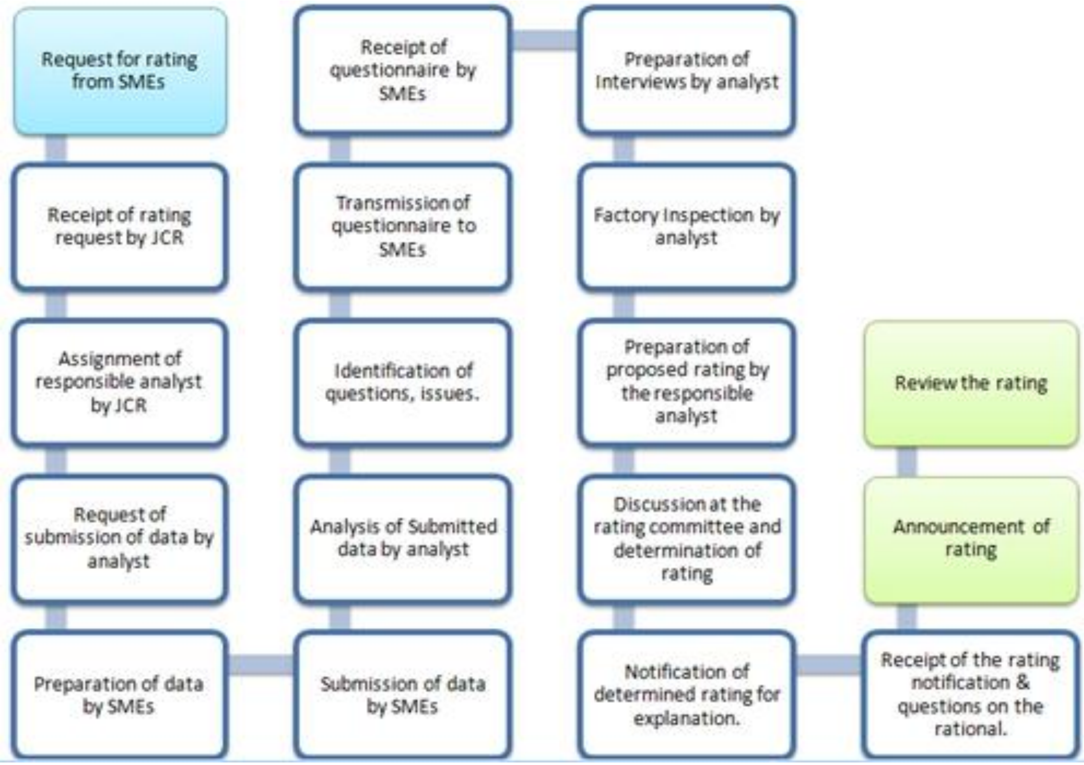

Figure-2. Business process of JCR

Source: www. jcr.co.jp

JCR mainly focuses on three important points of SMEs; assessment of credit strength, default rate estimation of SMEs, guarantees. JCR assess whether SMEs has the stability in profit and cash inflow. JCR also critically analyze the relationship between cash flow and obligations. JCR also analyze the default profitability of SMEs based on its financial information. Best practice of JCR that it has the specific department named information service department that handles all by responding to clients. All complaints and comments on JCR rating will carefully review by responsible analysts in JCR rating division. For assessing credit worthiness, two aspects are critically evaluated by JCR for evaluation of SMEs- Business foundation and financial foundation.

Table-1. Parameter of credit rating of SMEs of JCR

Business Foundation	**Financial Foundation**
Properties of the industry (Industry Trends)	Capital composition:
Position in industry and competitiveness	Liquidity
Properties of corporate entities:	Stability
History	Funding
Management	
Shareholders & affiliation	
Employees	
Sales composition	
Products and sales conditions	
Status of the capital investments	
Technology level and research and development capacities	
Subsidies and affiliation	
Management plan	

Source: www. jcr.co.jp

5.2. SME rating agency of India limited (SMERA), India

SMERA registered in 2005 as a credit rating agency in India for SMEs rating. SMERA associated with National Small Industries Corporation to issue SMERA-D&B- NSIC micro & small enterprise ratings for MSE in India. SMERA follows the same process as JCR to provide a rating to the SMEs.

SMEs first submit the request for the rating to credit rating agency through rating agency officer or website. After reception of application form, supporting documents and the rating fee, the SMERA will start their rating process. At the initial stage, analyst arranges a site visit and interview with the owner and key personnel of the SME. In this process, a questionnaire is needed to be filled by the analyst with the assistance of the applicant. After that, credit rating agency analyzes the financial and nonfinancial factor about the credit worthiness and financial condition of SME. In generally, SMERA shall complete the rating process within 30 days after receiving the all related documents.

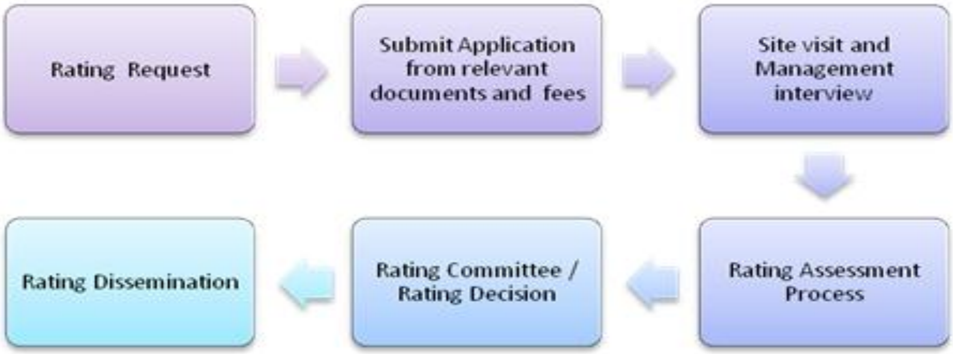

Figure-3. Business process of SMERA

Source: www.smera.in with author elaboration

SMERA rating mainly based on a number of financial and non-financial parameters of the SMEs vis- a- vis the other peers in the industry in the same line of business and size criteria. And SMERA also considered macroeconomic factor's influence on the performance of the SMEs.

Table-2. Parameter of SMEs rating

Financial Parameter	Non- Financial Parameter
Solvency Ratios: (e.g. Debt Equity)	Management Quality
Liquidity Ratios: Current Ratio	Location Advantage
Profitability Ratios: RONW	Marketing Network
Activity Ratios: Asset Turn Over	Legal Issues
	Industry and Macroeconomic Assessment

Source: Developing an ASEAN Benchmark for SME Credit Rating Methodology, SWEWG 2015

The fee for rating is not only based on the type of rating or principles amount of the rating issuance but also depends on various factors like complexity of business, industry positions. Table 3 consists of only the initial rating price of SMERA. After that annual surveillance fee is payable by the issuer to Rating agency.

Table-3. Fee structure of SMEs rating of SMERA

Category	Rating Fees $	Service Tax $	Total $
Less Than (5 million INR or $ 77519)	621	77	698
Between 5 INR to 20 million INR ($77519 to $310078)	698	86	784
More than (20 million INR or $ 310078)	930	115	1045

Source: www.smera.in with author elaboration

5.3 Credit rating agency of Bangladesh Limited (CRAB), Bangladesh

In Bangladesh, most of the rating agency follows the process as like as JCR & SMERA. After analysis the SMEs rating process of Credit rating agency of Bangladesh (CRAB), it has been found that CRAB follows mostly follow the same rating process of JCR or SMERA. But fee payment of SME rating in Bangladesh is different from the SMERA or JCR. Because in India, they follow investor pay model and subsidized model to pay the rating fee of SMEs, whereas Bangladesh focuses only borrower pay model.

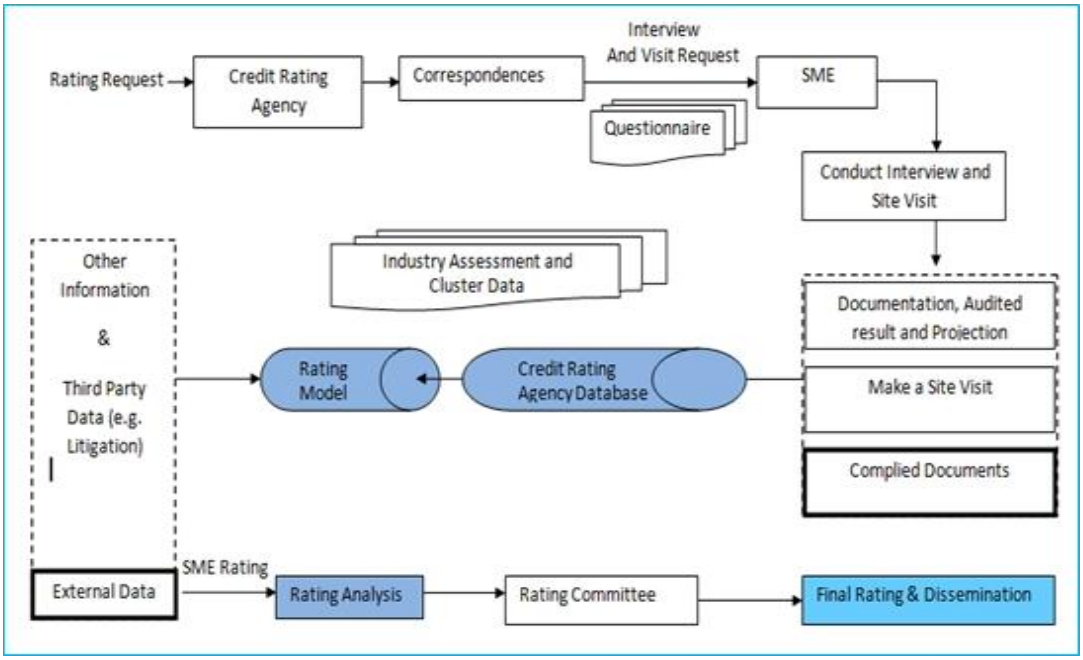

Figure-4. Credit rating process of CRAB as like as Indonesian proposed credit rating model

Source: Author Elaboration

CRAB uses their robust framework for credit assessment of SMEs, reflecting the learning gained from rating agency's rating and research experience of about a decade. While rating SMEs (including Micro Enterprises), Credit rating agency evaluates factors such as the candidate SME's – management, ownership, organizational structure, key human resources, business environment, relationship with trade partners, financial strength, operating efficiency & capabilities, other non-financial parameters.

Among other things, SME Rating helps to reduce the information gap between lender & borrower and ease the lender process to make the loan decisions quickly. In generally, rating agency's rating scale is linear to the bank's rating scale so that bank or lender can easily understand the credit worthiness and financial soundness of SMEs. Most of The rating agencies in Bangladesh follow a comprehensive methodology that covers five broad categories: (a) Industry (b) Business & Operation (c) Management and (d) Financial along with (e) Project specific assessment. The risk may vary based on the industry and or cluster it belongs, where Credit rating agency will adjust the parameters accordingly.

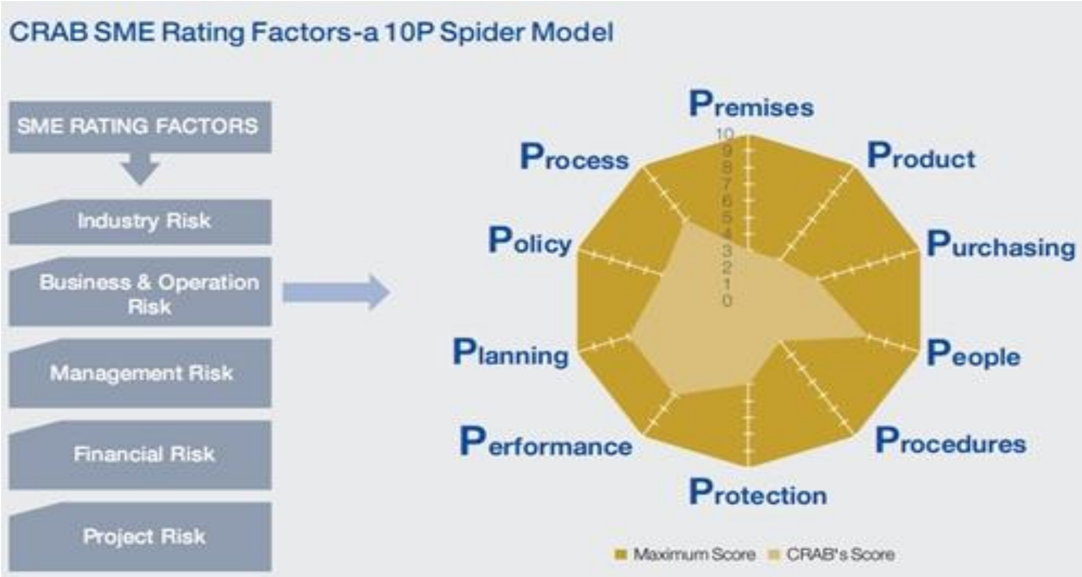

Figure-5. SME rating factors of spider model of CRAB

Source: SME rating brochure of CRAB

In Bangladesh, due to intensified competition in credit rating agency to capture the market, Association of credit rating agencies in Bangladesh (ACRAB) fixes the price of rating fee for its entire member rating agency. ACRAB requests their member not compete with other members unfairly and suggests their member make 10% higher price to the client who changes the rating company without completion previous contract of rating with other rating company.

Table-4. Fee structure of SME's rating in Bangladesh

Bank Exposure (Both Funded and Non Funded)	Minimum Rating Fees $	VAT 15%
Up to $ 62500	125	144
Above $ 62500 and up to $ 125000	188	216
Above $125000 and up to $ 250000	250	288
Above $ 250000 and up to $ 625000	313	359
Above $ 625000 and up to $ 875000	375	431
Above $ 875000 and up to $ 1250000	438	503
Above $ 1250000 and up to $ 1875000	500	575
Above $ 1875000 and up to $ 2500000	563	647
Above $ 2500000 and up to $ 3750000	750	863
Above $ 3750000	875	1006

Source: SME rating brochure of CRAB with author elaboration.

6. CONCERNING ISSUES OF THE SME RATING

6.1. The credibility of the agency

It includes the issues typically involve related to sources of information in the rating model, independency and objectivity of agency, rating methodology used by the agency. Credible SME rating agencies use not only the sound rating methodology but also use reliable, valid & sufficient information. Rating agency needs to be worked in an objective manner and with independence. Rating agency must take registration from the regulator to operate their service. Every rating agency needs to use transparent rating process, methodology & fee structure for the user so that they clearly understand the implications of a rating agency.

6.2. Payment of rating fees and intensified competition

The new concerning issue of rating agency relates to payments of rating that means who should pay SME rating fee and how much the fee. Credit rating industry still now relies on borrower pay model. In the borrower pay model – rating agency gets a fee from the firm which is rated by the rating agency. A major problem arises because rating fee is the major sources of revenue for rating agency which may create a conflict of interest to rating agency by making objectively high rating to SME so that rating agency could not lose the revenue. Although fee structure of SMEs rating in Bangladesh formally published in rating agency's website, but the reality is that rating agency frequently uses negotiated price for the frequent user or capture the market.

One of the major problems faced by DCRA operating in Bangladesh is intense competition. United States of America a country with GDP of $16.722 trillion (2013) has 10 nationally recognized credit rating organizations 17 whereas Bangladesh with a GDP of $161.76 billion has 8 nationally recognized credit rating agencies. Even though BSEC has the regulations for credit rating in 1996, credit rating is still fairly a new concept and many finance profession still does not understand credit rating properly (Mobin, 2015).

6.3. Rating process

A problem in rating process is related to two important issues – In what process rating agency conducts their rating and how long does it take. The most time-consuming process in SME is collecting the necessary information from different sources because data of SME are not well organized like corporate firm. Credit rating agency requires both financial and nonfinancial information for SME rating. The process of a rating is in generally difficult & time consuming when data are not well organized. A large number of rating agencies as the comparison to the economy like Bangladesh creates bad competition to capture revenue. This tendency of getting quick and more revenue within short term by doing more rating leads to the poor quality of rating. Another fact is that the revenue coming from the SME rating is comparatively lower than the costing of SME rating in Bangladesh due to a bad competition of capturing client by offering a low-cost rating.

7. CONCLUSION

Recently due to rating compulsion in Basel II accord, SMEs try to improve the existing position to high range to get the good rating to enter in the formal financial sector. Rating helps the SMEs to rethink and maintain the decent financial discipline to get financing and that ultimately leads to the quality improvement of the whole sector. Through rating agency, it will be possible to encourage this sector to work more qualitatively and efficiently. This encouragement will certainly make the sector capable of gaining and creating new era in Bangladesh economy.

BSEC and Bangladesh Bank's supervision can make the rating process of CRAs more credible. At the first stage, credit rating agency only rates the firm/ SMEs without any subsequent surveillance. In 2009, BSEC introduces mandatory subsequent surveillance credit rating agency. To remove the rating shopping, BSEC provides a rule that an issuer must enter a rating contract with the rating agency at least for three years with the surveillance. BSEC also suggests rating agency follow the IOSCO code of conduct for the operation of rating agency (Tsunoda *et al.*, 2013). But problem is that Bangladesh still could not establish institutions like Credit Guarantee Corporations (CGC) in Japan. Credit Guarantee Corporations (CGC) in Japan is a public institution that supports SME as a credit guarantor so that SME can borrow money from a financial institution for their business operations. Bangladesh should introduce credit database center like credit risk database association in Japan.

BSEC already gave permission eight rating agency as ECRI for rating Bangladesh that increases the bad competition among the rating agency to capture customer although no specialized rating agency for SMEs like SMERA in India. Due to intensified competition, now it is essentials for

BSEC to ensure the quality rating for SMEs. And only borrower pay model's practice for SME hinders the SMEs to get the rated by CRAs or leads the CRAs to give the high rating to capture client. This kind of practices may lead the rating practices vulnerable and less acceptable by the financial institutions and create more problems to SMEs to access the formal financial sources. Before registration of Credit Rating Agency, BSEC should focus on the credit rating agency's director affiliation with other financial institution. For this reasons, credit rating agency wants to make rating in more quantity irrespective of quality to keep them in industry. Borrower pay model leads the rating agency in dilemma to provide right decisions on SMEs. So government needs to encourage or take a step to boosting investor pay model or subsidized model to increase SMEs rating with credibility. In India, NSIC (National Small Industries Corporation) provides immense support for SMEs which have less than 2 cores turnover. NSEC reimburse the money which is spent by the SMEs to make the firm rated. This reimbursement of fees by NSEC provides the opportunity to SMEs to get the firm rated with minimal cost. Most of the credit rating agencies still don't publish their rating report on their website; BB should take enough steps that lead to publishing rating agencies' report on their website.

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