
ENSURING FAIR ACCESS TO FINANCE: A LEGAL CRITIQUE OF CREDIT RATING PRACTICES FOR SMALL AND MEDIUM ENTERPRISES (SMEs)

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ABSTRACT

Small and Medium Enterprises (SMEs) play a critical role in India's economic development, yet they face persistent barriers to formal credit access. To have wide access to finance they approach Credit Rating Agencies to get their Enterprise level ratings to attract investors. A key structural obstacle lies in the credit rating methodologies employed by Credit Rating Agencies (CRAs) such as SMERA, CRISIL, ICRA & CARE. CRISIL evaluates small and medium enterprises using an eight-level rating system, where SME 1 reflects the strongest credit profile and SME 8 denotes the weakest. Agencies provide Credit Rating based on Financial Performance, Operational Efficiency, Management Capability, Industry Risk, Credit History, Customer and Vendor Longevity and Satisfaction and Regulatory Compliance. They rely more on collateral securities to assess the extent of risk involved in a SEBI and CRAs adopt regular parameters that more suitable for large, stable firms with better financial background, but these parameters are highly unfit for smaller, newer enterprises. Hence, SEBI should introduce SME-specific regulations to ensure fair assessment and better access to credit facilities. SMEs overcome the lower credit ratings, the CRAs can adopt SME's specific rating methodologies tailored specifically for them like considering the credibility of the promotor, recognizing sector specific and regional realities, and examining order book position to anticipate future cash flows.

Keywords: Small and medium enterprises, credit rating agencies, Inaccurate or lower ratings.

INTRODUCTION

Small and Medium Enterprises (SMEs) contribute significantly to the overall development and expansion of the economy and contribute significantly in creation of job opportunities. They are vital for innovation, industrial development, regional development, and contribution to the GDP. Despite their importance, their access to the finance is limited due to the Credit Rating methodologies and parameters followed by the CRAs, which are often suitable for the large and stable firms with better financial background and it is highly unsuitable for the small scale and new enterprises. This research examines how CRAs assess and rate SMEs, highlights the regulatory gaps and aims to identify approaches for fairer and more inclusive credit rating evaluations.

STATEMENT OF PROBLEMS

Small and Medium Enterprises (SMEs) are relatively new to the market and small scale in nature therefore, they often have shorter performance track record and operating histories and have incomplete financial records and SMEs are sensitive to market fluctuations and supply chain disruptions. These factors challenge the CRAs assessment. Limited collateral securities and weaker capitalization often add to the problem. Moreover, CRAs adopt credit rating parameters that are generic in nature and are more suitable for large well-established stable firms with good financial background. This often challenges the evaluation of SMEs creditworthiness.

RESEARCH QUESTIONS

1. Whether the parameters of the CRA in assessing the Creditworthiness is suitable for SMEs?
2. Whether the ratings provided by the CRA to SMEs are accurate?

OBJECTIVE

- To identify the challenges faced by SMEs due to the Credit Rating methodologies adopted by the CRAs for evaluating the Creditworthiness of the SMEs and assess their impact on SMEs.

- To examine the Credit Rating methodologies and parameters adopted by the CRAs for assessing creditworthiness of the Small and Medium Enterprises (SMEs).

METHODOLOGY

This study adopts a qualitative doctrinal research approach to examine the credit rating practices followed by Credit Rating Agencies (CRAs) with respect to the Small and Medium Enterprises (SMEs) in India.

The research is entirely based on secondary sources, including statutory provisions, relevant case laws and academic literature like articles, published reports from CRAs and journals.

The study involves content analysis of the current credit rating parameter and procedures adopted by the CRAs and the regulatory framework i.e., SEBI (Credit Rating Agencies) Regulations, 1999, to examine its applicability on SMEs.

REVIEW OF LITERATURE

Shankar, Savita, *The Role of Credit Rating Agencies in Addressing Gaps in Micro and Small Enterprise Financing: The Case of India*, ADBI Working Paper No. 931 (Mar. 14, 2019).

A major hurdle for MSME financing is the information opacity prevalent in the sector as many of the units do not have complete accounting records, audited financial statements, or well-articulated business plans. This makes credit assessment by potential lenders very difficult. Lenders may need to help the enterprises put together these documents, which may again increase transaction costs, especially relative to the small ticket nature of such loans.

Even when accounting records and financial statements are available, MSMEs sometimes have trouble accessing institutional finance. This is because volatility and risk levels are considered to be higher in the MSME sector than among large corporates as often MSMEs are dependent on very few partners and contracts, especially as suppliers to larger companies.

Development Facilitators, *Study of the “Performance & Credit Rating Scheme for Micro & Small Enterprises”* (Nat’l Small Indus. Corp. Ltd. 2012).

Out of the 742 responses received, it was noted that 42% (312) suggested that rating process should be simpler and easy to comprehend, 28% (208) stated the process should be made faster,

25% (186) suggested that rating should consider non-financial aspects and only 5% indicated that a standard procedure should be followed by all rating agencies.

While some of the interviewed MSEs directly told us the changes/modifications they wish to propose for improving the efficacy of the scheme, others shared their problems and complaints with us which give important cues for necessary changes required in the quantum of ‘financial assistance’, ‘procedures’, etc. When asked for suggestions, an MSE said, “Rating agencies should have a separate methodology for SMEs and some preferential treatment should be given to small industry. A practical approach should be followed for rating rather than the financial ratios and other bookish methods.”

Ashwini H. A. & M. G. Krishnamurthy, *Credit Rating for SMEs: A Bridge Between Indian SMEs and Industrial Finance*, JJEM J., JNNCE, Vol. 2, No. 2,(2022)

Most of the SMEs in the country lack professional management set up hence do not maintain the adequate documents needed and information necessary to obtain credit rating.

Pavneet Kaur, *Empirical Study on Functioning of Credit Rating Agencies in India*, 6 JETIR 641 (2019)

Rating Methodology refers to the use and application of tools in the rating .Rating is undertaken by four different agencies in India, namely, CRISIL, ICRA, CARE and Fitch India, with minor differences in the four, the basic parameters of all of them remain the same. However, presentation of each category has its own value and implication. In addition, it is observed that all rating agencies in India more or less follow similar methodology, which is based on international practice of their counter parts. The methodology encompasses all the key factors for rating assessment and assignment. Rating agencies focused on wide range of factors ranging from macro level factors to micro level factors. The both qualitative as well as quantitative factors are considered by the agencies before assigning any ratings. The common and important factors are considered and analyzed in rating methodology by different rating agencies. These agencies follows typically CRAMEL model to evaluate the debt servicing capabilities of banks and institutions. CRAMEL stands for Capital adequacy, Resources, Asset quality, Management quality, Earnings potential and Liquidities.

Nilendu Chatterjee and Dipak Kundu, *Performance of Credit Rating Agencies in India and*

Their Impact on Business Growth – An Econometric Analysis, 12 J. Bus. Mgmt. Com. & Res. 185 (2025)

Credit ratings are subjective and can be influenced by various factors, including the methodology used by CRAs. This has led to concerns about the consistency and accuracy of ratings. While CRAs are expected to provide accurate assessments of credit risk, there have been instances where their ratings have been found to be inaccurate. In such cases, CRAs have faced criticism for failing to hold themselves accountable for rating errors, which can undermine confidence in their ratings

Brickwork Ratings India Pvt. Ltd. v. Sec. & Exch. Bd. of India, Appeal No. 694 of 2022 (Securities Appellate Trib. June 6, 2023).

SEBI's supervisory authority over credit rating agencies extends beyond technical compliance with specific regulations to encompass the substance of rating processes. While SEBI cannot dictate specific ratings, it can examine whether: (a) the rating process adhered to disclosed methodologies; (b) material information was properly considered; (c) reasonable analytical rigor was applied; and (d) appropriate documentation was maintained to support rating decisions.

ORIGIN

SMEs emerged in India as Small-Scale Industries (SSIs) which were formally recognised under Industrial Policy Resolution, 1951. This recognition aimed industrial decentralization and promoted balanced regional development and employment generation. Around 1980's SSIs gained Institutional support from Small Industries Development Organisation (SIDO), National Small Industries Corporations (NSIC), Small Industries Development Bank of India, 1990 (SIDBI).

India's first Credit Rating Agency is CRISIL established in 1987 and was promoted by ICICI Ltd and Unit trust of India. Followed by ICRA & CARE was established in the year 1991 and 1993. CRAs were established to provide independent and standardized assessments of creditworthiness, helping investors and lenders make informed decisions. SEBI introduced

SEBI (Credit Rating Agencies) Regulations, 1999 to regulate the functioning of CRAs in India.

SSIs TRANSITION INTO SMEs

The government over the period classified SSIs into MSMEs under the Micro, Small and Medium Enterprises development Act, 2006 (MSMED Act). The Act laid down measures to support their growth and protection such as easier access to credit, incentives, and institutional help.

PERFORMANCE AND CREDIT RATING SCHEME

Performance and credit rating scheme was launched by NSIC in the year 2005. The scheme was launched by Ministry of Micro, small and Medium Enterprises which aimed at assessing the creditworthiness and performance of the SMEs to identify their strengths and weaknesses and help in accessing the formal source of credit.

CRA started assessing the creditworthiness of the SMEs in 2005, Following the scheme leading CRAs, CRISIL, ICRA, CARE etc, started assessing the creditworthiness of the SMEs and awarded rating to the interested SMEs. These Ratings were awarded to help SMEs to avail credit at more favourable terms and to expand their enterprises.

The definition of Micro Small and Medium Enterprises (MSMEs) under the Micro Small and Medium Enterprises Development Act, 2006 “(i) a micro enterprise, where the investment in Plant and Machinery or Equipment does not exceed 2.5 crore rupees and the turnover does not exceed 10 crore rupees; (ii) a small enterprise, where the investment in Plant and Machinery or Equipment does not exceed 25 crore rupees and the turnover does not exceed 100 crore rupees; (iii) a medium enterprise, where the investment in Plant and Machinery or Equipment does not exceed 125 crore rupees and the turnover does not exceed two hundred and 250 crore rupees.”¹

Credit Rating Agencies (CRA) are regulated under the SEBI (Credit Rating Agencies) Regulations, 1999, which clearly defines the ““Credit Rating Agency” as the body corporate which is engaged in the business of rating of securities that are listed or proposed to be listed on a stock exchange recognized by the Board.”²

¹ Revised Criteria for Classification of Micro, Small and Medium Enterprises, Gazette of India, Extraordinary, pt. II, sec. 3(ii), S.O. 1364(E) (Mar. 21, 2025) (India).

² Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, Reg.2(1)(h)

BARRIERS FOR SMES IN OBTAINING CREDIT RATINGS

The CRAs assessment with respect to SMEs were not easy. SMEs faced quite a few challenges, rating methodologies or the parameters adopted by the CRA are not suitable for the SMEs. As CRISIL, CARE, etc were established in the 1990's therefore their parameters are generally more suitable for large well-established firms, as they began rating SMEs around 2005. Agencies provide Credit Rating based on Financial Performance, Operational Efficiency, Management Capability, Industry Risk, Credit History, Customer and Vendor Longevity and Satisfaction and Regulatory Compliance. They rely more on collateral securities to assess the extent of risk involved in a particular company. SMEs limited collateral security, lacking of financial History etc were the barriers that challenged CRAs in providing accurate ratings which indeed affected SMEs in accessing formal source of credit and hampered their growth and sustainability as the parameters adopted by CRAs have ignored the realities of SMEs.

EMERGENCE OF SME SPECIFIC CRA

The need for SMEs specific assessing methodology emerged. SMERA was established in 2005 as a joint initiative by the Small Industries Development Bank of India (SIDBI), Dun & Bradstreet, and several public and private sector banks. It was the world's first credit rating agency focused specifically on Micro, Small, and Medium Enterprises (MSMEs) in India.

In spite of it being specifically created for SMEs, the parameters are not completely SME specific and they still face challenges with inaccurate or lower ratings awarded by the CRAs limiting their access to credit and financial growth opportunities.

ISSUES IN EVALUATING SME CREDITWORTHINESS BY CRA

Small and Medium Enterprises (SMEs) are significant contributors to Indian economy by generating employment, attributing innovation, and stimulating industrial growth. Despite their Significance, SMEs have difficulties in accessing finance. SMEs still encounter challenges in accessing funds from financial and non-financial institutions. To have wide access to finance they approach Credit Rating Agencies (CRAs) to get their Enterprise level ratings to attract investors. CRAs assess the creditworthiness of the SMEs and rate them.

Say CRISIL assess overall creditworthiness by analysing industry risk through Industry outlook, demand and profitability of the industry. Business risk via Track record of business,

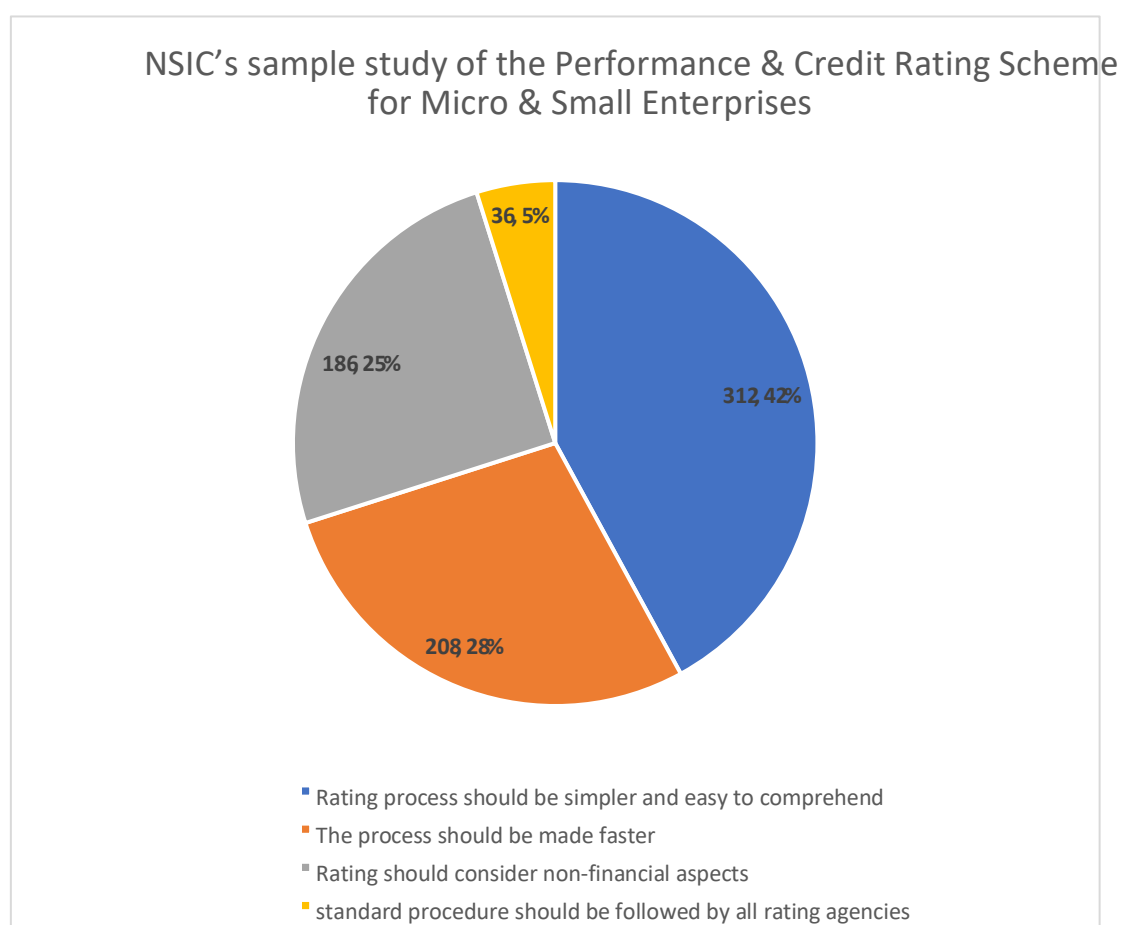
customer profile, relationships with stakeholders and quality of facilities and technology. Management risk is assessed through Promoter competence, Succession plan and Business certainty. Financial risk is evaluated via Profitability, Debt-protection matrix, Working-capital management, and financial flexibility.³ Even though the methodology was adopted to assess the SMEs and seems to be SME specific, the realities of the SMEs were not considered much. Agencies provide Credit Rating based on Financial Performance, Operational Efficiency, Management Capability, Industry Risk, Credit History, Customer and Vendor Longevity and Satisfaction and Regulatory Compliance. They rely more on collateral securities to assess the extent of risk involved in a particular company. SMEs often face huge challenge in maintaining long term operational or financial track record as they are relatively small and new to the market. Being relatively small and new they are sensitive to market fluctuations and disruptions and they have a small customer base unlike large well-established firms.

A notable challenge in financing SMEs is lack of information, Many of these enterprises lack comprehensive financial documentation, verified audit reports, and clearly defined business strategies. This challenges the credit assessment. However, SMEs are highly volatile and risk level is also higher when compared to large corporates as they rely on few partners and contracts for their operations. Incomplete financial records and shorter performance track record often adversely affect the CRAs to assess the profitability and creditworthiness of the SMEs accurately. Despite, the availability of the financial documents, SMEs operational reliance on the limited number of clients and suppliers makes them vulnerable to fluctuations and disruptions, making income patterns irregular and operational planning uncertain. Limited collateral and weaker capitalization often act as a hindrance for the credit rating. Eventually making it difficult for CRAs to accurately evaluate their profitability and creditworthiness with limited Data.

SMEs in the absence of professional management setup often, they do not maintain adequate document which are needed and required information that are necessary for credit rating. This creates a systemic barrier to credit rating eligibility. However, lack of documentation often questions the credibility of the ratings awarded by CRAs. The absence of a documents such as audited financials, compliance records, and business plans and the exercise of professional judgment by CRAs in the assessment of risks becomes speculative rather than evaluative, potentially misrepresenting the true creditworthiness. Regional realities usually influence the

³ CRISIL Ltd., CRISIL's Performance Rating Methodology for Small and Medium Enterprises (July 2018)

enterprises operations, say some regions are industrial hubs where the manufacturing units are predominant whereas, there are regions which are dependent on agriculture and some are service sector. Local market demand and costs of inputs are also the key factors that affect the business. Availability of skilled labour, infrastructure and connectivity that is access to ports, roads, airports, and railways often influence the enterprise's operations. Electricity stability and internet connectivity also determines the efficiency of the enterprise. Other factors like entrepreneurial culture, consumer preferences and workforce skills, further affect business performance. Additionally, geographic and environmental conditions, such as climate, resource availability and exposure to natural disasters, pose regionspecific challenges. Therefore, regional realities must be considered before considering the factors to assess the creditworthiness of the SMEs.



The NSIC's Performance and Credit Rating Scheme closely mirrors framework of CRAs in terms of approach and goals but is tailored specifically for India's MSEs. It provides an independent evaluation of an enterprise's credit profile while also offering financial support to help small businesses access the rating process more easily. In an interview with MSEs notable

suggestion given by one of them was the preference for a separate methodology and preferential treatment for small industry and need for practical approach for rating them rather only considering traditional financial methods and other theoretical methods Some MSEs suggested specific improvements to enhance the scheme's effectiveness, while others highlighted issues pointing to needed changes in financial assistance and procedures.⁴ This highlights a strong demand for a specific methodology or parameters that recognizes the sectors realities and clearly shows the clear gap between how the rating methodologies are designed and how SMEs function and many of which operate informally and lack the resources to navigate complex rating procedures. The demand for simple parameters or methodologies, speedy rating process, and inclusion of non-financial indicators along with the demand for a separate, more practical approach emphasizes the need for a differentiated treatment after recognizing the constraints of SMEs.

SEBI's supervision of credit rating agencies extends beyond mere regulatory compliance. While SEBI does not intervene in determining the ratings themselves, it verifies that agencies adhere to their declared methodologies, evaluate all necessary information, exercise sound analytical judgment and maintain comprehensive documentation. CRAs should carefully consider all the relevant material information. Thorough analysis is required and overlooking or not considering certain factors which are SME specific factors like qualitative factors may lead unfairly lower ratings which affects SMEs access to formal source of finance.

Need for a Distinct and Practical Credit Rating Framework for SMEs

In the IL&FS case it was found that CRAs failed to exercise independent professional judgment and maintain objectivity while rating IL&FS and its instruments, and neglected to monitor factors affecting the issuers' creditworthiness. Case demonstrates CRAs failure to exercise professional judgment, without considering all the relevant factors after understanding the realities of SMEs that would misrepresent their true creditworthiness.

Credit ratings are provided by CRISIL, ICRA, CARE and Fitch are following broadly similar methodologies based on international practices. Their rating processes consider both qualitative and quantitative factors, from macro-economic to micro-level aspects. Commonly, agencies use the CRAMEL model which stands for Capital adequacy, Resources, Asset quality,

⁴ Development Facilitators, Study of the "Performance & Credit Rating Scheme for Micro & Small Enterprises" (Nat'l Small Indus. Corp. Ltd. 2012).

Management quality, Earnings potential, and Liquidity.⁵ As above mentioned all the rating agencies follow very similar methodologies whereas, SMEs often operate in local, niche, or informal markets, where macro-level trends may have limited predictive value. Many lack formal accounting systems, audited financials, and long business track records, making it difficult to apply quantitative parameters accurately. Key metrics such as capital adequacy, liquidity, and asset quality are often hard to measure as SMEs may have few fixed assets and informal financial arrangements. Management quality and earnings potential are typically owner-dependent, highly variable, and subjective. As a result, SMEs may be undervalued because qualitative strengths such as strong customer relationships, niche expertise, or innovative capabilities are ignored. While rating methodologies like CRAMEL consider qualitative factors, they rely heavily on quantitative data and are primarily designed for banks, large corporates, or financial institutions with formal structures, multiple departments, risk management systems, and governance frameworks. Applying such methodologies to SMEs may not fully reflect their true creditworthiness. Credit ratings are subjective and influenced by methodology used by CRAs, raising concerns about their consistency and accuracy. Instances of inaccurate ratings have drawn criticism for lack of accountability, undermining confidence in the agencies assessments. CRAs have been criticised in certain instances for providing inaccurate assessments and SMEs are highly vulnerable because methodologies and parameters adopted by CRAs are not suitable to their realities which indeed misrepresents the assessment of the SMEs creditworthiness. Additionally, the incorrect assessment and lack accountability further burdens SMEs limiting their credit access.

When assessing the creditworthiness of the SMEs United Kingdom agencies like Experian, Equifax, and TransUnion adopt traditional methods of assessment which include assessing the financial background, credit behaviour and business background but along with this they have also adopted a conventional parameter that is sustainability through environmental, social and governance factors. For example, Experian's ESG Insight tool helps lenders understand a small business's environmental and social impact, adding an extra layer to traditional credit evaluations. In India, agencies like CRISIL, SMERA focuses more on quantitative factors such as revenue, profitability, operational efficiency, management quality, industry risks, and past borrowing behaviours ignoring the quantitative factors. UK approach is more dynamic and comprehensive including the qualitative factors to assess the creditworthiness of the SMEs

⁵ Pavneet Kaur, Empirical Study on Functioning of Credit Rating Agencies in India, 6 JETIR 641 (2019)

whereas India's approach is still relying on the traditional financial and sectoral data.

CONCLUSION

Traditional credit rating methodologies often fail to capture the true creditworthiness of SMEs due to their short operating histories, limited financial records, and informal nature of many small businesses. Standard metrics heavily reliant on financial ratios and historical data, may underestimate the sustainability and growth capacity of such enterprises. To address this gap, CRAs must adopt SME-specific rating frameworks that incorporate both qualitative and quantitative factors, reflecting the unique realities of small businesses. Promoter credibility, sectoral and regional dynamics, operational track records, and indicators such as order books, production capacity and planned expansions should play a central role in evaluating SMEs. Simple factors such as timely payments to suppliers, transparency in business operations, adaptability to market changes, and strategic communication with stakeholders can reveal managerial discipline and operational stability. Where formal records are insufficient, CRAs can rely on alternative data sources like GST filings, e-invoices, utility payments, trade references, and supply chain transactions. Incorporating digital footprints, transaction histories, and business network relationships can further enhance the reliability of SME ratings. Providing guidance and feedback to SMEs during the rating process can also help them improve governance, financial discipline, and reporting practices, ultimately increasing their credibility. Adopting such tailored methodologies would not only provide a more accurate reflection of an SME's creditworthiness but also strengthen investor confidence and facilitate better access to credit for deserving enterprises. In the long term, this approach would promote the growth and sustainability of SMEs. Alternative data can be inconsistent, and qualitative judgments may introduce subjectivity if not guided by clear and transparent criteria. CRAs must therefore ensure that their models are rigorously back-tested, periodically reviewed, and clearly communicated to market participants. It is also important to acknowledge that tailored methodologies carry their own challenges. Alternative data can be inconsistent, and qualitative judgments may introduce subjectivity if not guided by clear and transparent criteria. CRAs must therefore ensure that their models are rigorously back-tested, periodically reviewed, and clearly communicated to market participants. Striking a balance between flexibility and consistency will be essential to preserve the credibility and comparability of ratings across enterprises and sectors.

In conclusion, SMEs are the backbone of economic growth, employment generation, and industrial diversification, and their financial inclusion cannot be left to frameworks designed for large corporates. By combining quantitative rigor with qualitative insight and leveraging alternative data and digital footprints, credit rating agencies can bridge the gap between the potential of small businesses and their access to formal finance. A fair, transparent, and inclusive rating ecosystem will not only unlock capital for deserving SMEs but also foster entrepreneurship, strengthen market confidence, and support sustainable and inclusive economic development in the long run.

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MSME - <https://msme.gov.in/>

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