

Recovery Ratings – Rating Methodology

Background

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was enacted to facilitate Banks to recover their non-performing assets without the intervention of the Court. The Act provides three alternative methods for recovery of non-performing assets, namely securitisation, asset reconstruction and enforcement of security without the intervention of the Court. This facilitates resolution of long-drawn legal matters in recovery cases and involves professional expertise by way of involving securitisation companies (SCs) / asset reconstruction companies (ARCs) in the recovery process.

Security Receipts (SRs) are instruments issued under ‘The SARFAESI Act’ by SCs/ARCs (against the acquired financial assets) after acquisition of assets to Qualified Institutional Buyers (QIBs). RBI has issued guidelines for declaration of NAVs on these SRs issued by SCs/ARCs with the objective of enabling QIBs value their investment in SRs in accordance with the applicable guidelines. For the purpose of arriving at NAV, the rating serves as an important objective tool.

Recovery rating is based on the ‘recovery risk (probability of recovery)’ and not the ‘default risk (probability of default)’. Value of underlying security and its recoverability is of prime importance in recovery rating, whereas, cash flow adequacy and future volatility in cash flows hold significance in credit rating including various other financial parameters.

Rating Methodology

CARE vets the assumptions made by the SC/ARC in arriving at valuation of SRs and modifies these wherever required. CARE arrives at Present Value of all cash flows from SRs till their maturity. CARE uses an indicative yield as the discounting rate for valuation of SRs. Once CARE arrives at an expected valuation, it assigns appropriate recovery rating (the ratings gives the range of recovery possible), which indicates the recovery expected from the underlying loan (and SRs), with respect to the face value of the SR, within a predefined band. CARE considers the following criteria for arriving at the rating of SRs:

- Resolution strategy adopted by SC/ARC and its capability to implement the same
- Parameters related to non-performing account eg: reasons for delinquency
- Nature & composition of the assets
- Industry prospects and existing management
- Legal status
- Estimated timeframe for resolution
- Expected cash-flows

Methodology for rating pooled assets

At times, the SC/ARC bundle more than one small loan from different accounts into a portfolio and issue SRs common to the whole portfolio. At the time of valuation of SRs issued under such portfolios, valuation of all individual assets in the portfolio is required to be done. Based on these individual valuations, weighted average valuation of SRs is arrived at and the recovery rating of the SRs is determined accordingly.

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