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Banks to move towards expected loss-based rating for infra projects

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The EL rating methodology factors in probability of default as well as recovery prospects post occurrence of a default

Banks are weighing the possibility of embracing the ‘expected loss’ concept for rating infrastructure projects in the backdrop of the big infrastructure push being given by the government.

The ‘expected loss’ (EL) concept-based ratings take into account both timely debt servicing/repayment (probability of default/PD) and recovery potential of an infrastructure project after a default occurs (loss given default/LGD).

Since EL based ratings are holistic, the capital burden on banks vis-à-vis their exposure to infrastructure projects and funding costs for project developers could come down, according to experts.

The Indian banking system currently follows traditional PD based guidelines whereby credit rating agencies downgrade the debt of a company or infrastructure project to the default category even if there is "a single day, single rupee delay" in payments of principal/interest. This requires banks to make credit loss provisioning.

However, the EL rating methodology factors in PD as well as LGD (the recovery prospects post occurrence of a default) components .

Lower funding costs

Referring to the possibility of implementation delays, cost and time overruns, and volatility in cash flows associated with infrastructure projects, a senior public sector bank official observed that these factors lead to lower rating of their debt/ financial instruments under PD based rating, resulting in higher funding costs for developers.

But as EL based rating also incorporates the LGD component, which takes into account cash flows over the project's entire life cycle, long-term arrangements (such as power purchase agreements), concession agreements, escrow structures, and post-default recovery potential, among others, the funding cost for project developers could come down, he added.

Mehul Pandya, Executive Director, CARE Ratings, said, "Infrastructure projects generally have a long gestation period. These projects generate free cash flows slightly later and in the intervening period, there could always be some implementation risks which could impact them.

"So, when the probability of default (PD) concept is applied to project stage companies, they are either on the lower side of investment grade or less than investment grade."

Potential recovery

But when a project is rated based on EL methodology against PD methodology, even if the free cash flow generation is delayed, banks don't lose 100 per cent of the money on the project.

"EL takes into account the possibility point that an asset may get into distress. So from that point on, based on the future long tail of the project, it assesses how much potential recovery it could have.

"So recovery can never be zero. Even for the worst projects, recovery can never be zero...Step by step we see greater acceptance of this (EL) concept," said Pandya.

Under the National Infrastructure Pipeline (NIP), the government has envisaged an infrastructure investment of ₹111 lakh crore spread over 9,000 plus projects covering 34 infrastructure sub-sectors from FY20 to FY25.

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