Independent Credit Evaluation of Residual debt as per Resolution plan for stressed assets

(Issued in July 2019)

Background:

The Reserve Bank of India (RBI) had introduced various schemes from time to time aimed at resolution of stressed assets in the economy. (e.g. Corporate Debt Restructuring, Revitalising distressed assets – JLF and CAP, Flexible restructuring of long term project loans, Strategic debt restructuring etc.) With introduction of the Insolvency and Bankruptcy Code, 2016 (IBC), all the previous circulars / schemes were substituted with a simplified generic framework for resolution of stressed assets.

Further, as per its circular dated June 7, 2019, RBI has introduced 'Prudential framework for resolution of stressed assets'. The framework applies to a larger universe of lenders, including NBFCs and small finance banks. It is now voluntary for lenders to take defaulters to the bankruptcy court. As per the circular all lenders must put in place Board-approved policies for resolution of stressed assets, including the timelines for resolution. In case a borrower is reported to be in default by any of the lenders, lenders shall undertake a prima facie review of the borrower account within thirty days from such default. Also disincentives such as additional provisioning for resolution delays, penal provisions have been introduced for lenders.

In the same circular, it has been stipulated that for the Resolution Plan for stressed accounts having exposure in excess of Rs.100 crore, which involve restructuring or change in ownership, the banks would have to get an independent credit evaluation (ICE) of the residual debt by an authorized Credit Rating Agency (CRA) and cases where the exposure is over Rs.500 crore the ICE has to be done by at least two CRAs. CARE Ratings has been authorized by RBI to undertake ICE for stressed assets under the framework.

This paper explains CARE Ratings' approach for arriving at rating as per the prescribed scale for the residual debt in the resolution plan for stressed assets.

Rating scale and definitions:

CARE Ratings assigns ICE ratings as per the RBI prescribed scale given below:-

ICE Symbols	Definition
RP1	Debt facilities/instruments with this symbol are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such debt facilities/instruments carry lowest credit risk.
RP2	Debt facilities/instruments with this symbol are considered to have high degree of safety regarding timely servicing of financial obligations. Such debt facilities/instruments carry very low credit risk.
RP3	Debt facilities/instruments with this symbol are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such debt facilities/instruments carry low credit risk.
RP4	Debt facilities/instruments with this symbol are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such debt facilities/instruments carry moderate credit risk.
RP5	Debt facilities/instruments with this symbol are considered to have moderate risk of default regarding timely servicing of financial obligations.
RP6	Debt facilities/instruments with this symbol are considered to have high risk of default regarding timely servicing of financial obligations.
RP7	Debt facilities/instruments with this symbol are considered to have very high risk of default regarding timely servicing of financial obligations.

Methodology:

Traditionally, credit analysis of an entity begins with a review of the Economy/Industry in which the entity operates along with an assessment of the business risk factors specific to the entity. This is followed by an assessment of the financial risk factors and quality of management of the entity. For project stage entities/ entities undertaking large projects, project risk is also analyzed for arriving at the entity’s credit rating.

For the purpose of independent credit evaluation (ICE) broadly the same methodology is used to assess with industry specific factors pertaining to the sector in which the entity is engaged in. (Refer http://www.careratings.com)

However, the main difference between traditional credit rating and ICE is that, ICE is based on the 'plan' of turning around the unit which then will generate sufficient cash flow for timely servicing of the debt. Typically, the resolution plan is drafted by lenders / committee of creditors based on techno economic viability, quantum of sustainable debt (residual debt) which the operational cash flow business (as well as extraordinary cash flows out sale of non-core assets, recovery of debtors / claims etc.) can comfortably service on time without default. It is important to note here that, similar to debt instruments and bank facilities' rating, one day missed payment is treated as default.

The following table brings out comparative features of traditional credit rating and ICE

Comparison of features in normal credit rating vis-à-vis ICE for residual debt :

Particulars	Conventional credit rating	ICE for Resolution Plan
Period	Credit rating is assessing credit worthiness over life of instrument	ICE of the residual debt considers timely payment over resolution period after implementation of resolution plan.
Continuous review	Ratings are under surveillance till full repayment of that debt	One time exercise
Scale	CARE AAA to CARE D	RP 1 to RP 7
What does it indicate	Probability of default	Viability of the unit and adequacy of cash flow to timely service residual debt during resolution period
Rating Agreement	Rating agreement is signed by CARE with the entity to be rated	Rating agreement is signed by CARE with the lender
Information sourcing	Information sourcing is from the entity rated/to be rated	Information sourcing is generally from the lenders with limited access to the entity to be rated

Approach:

Keeping in view of the nuances of ICE explained above, CARE Ratings considers the following aspects.

1) Analyzing why default occurred and how those factors are now addressed :

   It is important to probe into the reasons why the asset turned defaulting asset in the first place, before slipping to NPA or stressed asset. It could be due to various reasons viz. industry (down turn in industry cycle), business (availability of raw material, utilities, competition), or financial factors (capital requirements, skewed capital structure). CARE considers how those factors are addressed in the Resolution Plan so that the entity does not encounter the same problems again.

2) Management capability to turn around :

   If the failure of the business was NOT due to existing management, and the lenders are working out turn around / restructuring plan with the same management, it is important to examine the resourcefulness and risk appetite of management to turn around the operations. In such case, the resolution plan may include covenants pertaining to ensure commitment of promoters e.g. equity contribution, DSRA, etc.

3) New management's competence, relevance, resourcefulness:

   The turnaround strategy may be based on change in management. In such case, the relevant experience of the new management in the industry / sector is examined. The strategic importance of the business to the overall business philosophy of the new management, their commitment to bring in required resources etc. are also factored in.

4) Stress testing of the cash flows as per resolution plan:

   The various assumptions underlying the financial projections and cash flows are sensitized keeping in view the current scenario and it is critically analyzed whether the same can be considered realistic over the period as per resolution plan.

5) <u>Liquidity backup :</u>

The Resolution plan which stipulates maintenance of Debt Service Reserve Account (DSRA) and provision to top it up in case of utilization, provides liquidity cushion to withstand unforeseen cash flow volatilities. The DSRA is built up in funded manner or as non funded Bank guarantee or promoter support.

Periodic monitoring of ICE

ICE of the Resolution Plan for the stressed assets is done as a one time exercise to be used by the lenders. As such these ratings are not reviewed subsequently.

Conclusion

The ICE outcome is ultimately an assessment of the various assumptions underlying the resolution plan and the likelihood of successful implementation of the same. CARE Ratings analyses each of the factors covering industry, business, management and financial factors and their linkages to arrive at the overall assessment of credit quality for the residual debt as per Resolution Plan of the stressed asset.

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CARE Ratings Limited
(Formerly known as Credit Analysis & Research Ltd.)
4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022.
Tel: +91-22-6754 3456, Fax: +91-22- 6754 3457, E-mail: care@careratings.com