Rating Methodology: Recovery Ratings

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CareEdge RATINGS

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 the 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. However, the recovery process has evolved over the past few years, especially after the enactment of The Insolvency and Bankruptcy Code, 2016 (IBC). The IBC consolidated the laws related to insolvency with an aim to resolve insolvencies in a time-bound manner.

Security Receipts (SRs) are receipts or securities issued under 'The SARFAESI Act' by SCs/ARCs (against the acquired financial assets) to qualified buyers, after the acquisition of distressed assets from the lenders. RBI has issued guidelines for declaration of Net Asset Value (NAV) on these SRs issued by SCs/ARCs to enable the qualified buyers (financial institutions, insurance companies, banks, state finance corporations, state industrial development corporations, trustees or ARCs, etc.) to value their investment in SRs in accordance with the applicable guidelines. According to the guidelines issued by RBI, the SRs are required to be rated on a defined recovery rating scale (given below) and this recovery rating is to be used for arriving at the NAV.

Recovery Rating (RR)	Definitions
RR 1+	Present value of expected recoveries is more than 150% of the face value of outstanding SRs.
RR 1	Range of the present value of expected recoveries is more than 100% and upto 150% of the face value of outstanding SRs.
RR 2	Range of present value of expected recoveries is more than 75% and upto 100% of the face value of outstanding SRs.
RR 3	Range of present value of expected recoveries is more than 50% and upto 75% of the face value of outstanding SRs.
RR 4	Range of present value of expected recoveries is more than 25% and upto 50% of the face value of outstanding SRs.
RR 5	Range of present value of expected recoveries is upto 25% of the face value of outstanding SRs.

Recovery rating (RR) 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 vis-à-vis debt obligations holds significance in credit rating, amongst various other risk parameters. The recovery rating assigned to SRs is based on the net present value (NPV) of the cash flows expected from the recovery strategy, stated as a percentage of the outstanding face value of the SRs. The recovery rating assigned to SRs is essentially based on the probability of recovery from the assigned loans within the time frame of five years which may be further extended by three years (after approval from the Board of Directors of the SC/RC) as per RBI guidelines. Recovery ratings are reviewed bi-annually as per RBI guidelines. On the expiry of the resolution period, the asset is to be declared as a 'loss asset' by the SC/RC. CARE Ratings withdraws its recovery ratings on full redemption of the rated security receipts or after the expiry of the resolution period on receipt of the request of withdrawal from the SC/RC.

Rating Methodology

CARE Ratings considers various qualitative as well as quantitative parameters while assigning the RR. The expected recovery towards SRs would depend on many parameters related to the underlying non-performing account(s), including the resolution strategy adopted by the SC/ARC, valuation of the underlying securities, track record of recovery, order of payments, etc. These parameters are discussed below:

- **Reason for delinquency and resolution strategy**
  CARE Ratings attempts to delve into the reasons for which the account has turned non-performing and accordingly assesses the suitability of the resolution strategy adopted by the SC/ARC. The resolution strategy adopted by the SC/ARC, i.e., sale of assets, one-time settlement, settlement through scouting buyers for the assets, restructuring of business/management, etc., is considered while arriving at the RR.

  Resolution strategy - Sale of assets
  - **Nature and composition of security assets**
    The composition of assets in terms of movability, location, age, etc., are considered while assessing the recovery prospects. Immovable assets like land, property, factory building, etc., have better recovery prospects while assets like stock, machinery, etc. depreciate over time and hence have relatively weaker recovery prospects and are viewed negatively.

  - **Valuation of securities**
    CARE Ratings relies on independent valuation reports for arriving at the valuation of securities. The valuation reports mention the Distressed Market Value (DMV) and the Fair Market Value (FMV) of the underlying securities. CARE Ratings generally considers the DMV for the purpose of its valuation as the assets in consideration may involve various legal issues and are sold on an 'as is where is' basis which would deter the investors to buy the assets at FMV. The values and other security aspects mentioned in the valuation reports like the location of security, marketability, possession status, occupancy status, etc., are also considered while arriving at a RR.

  - **Status of possession of assets**
    CARE Ratings considers physical possession or symbolic possession of the underlying security as a positive while if the securities are not in possession of the SC/ARCs it may lead to a delay in recovery and hence will be considered negatively.

- **Resolution strategy – One-time settlement**
  - **Terms of the settlement and track record of payments as per agreed terms**
    Terms of the settlement agreed upon are considered and a track record of payments made is seen to assess whether they are in accordance with the agreed terms. Cash flows are accordingly drawn up to arrive at the expected recovery.

- **Probability of meeting the payments as per agreed terms**
  The strategy of 'one-time settlement' is generally adopted when the business of the underlying entity is generating adequate cash flows as a going concern. As such, the past operational track record of the entity is factored in to gauge the probability of the entity being able to meet the agreed-upon terms.

- **Resolution strategy – Sale of business or management/business restructuring**
  - **Probability of the sale/restructuring materialising**
    This resolution strategy is adopted when the business can potentially be sold in its entirety to a strategic investor willing to revive the business or when the business can be restructured to make it financially viable. CARE Ratings considers a higher probability of recovery if the sale deal/restructuring is in its final stages.

  - **Financial position of the strategic investor/experience of new management**
    If the prospective buyer is financially a strong entity or the new management is experienced in the given line of business, the probability of turnaround of the business and thus of higher recovery is greater.

- **Seniority of payments to SR holders**
  The order of payments is factored in while arriving at the expected recovery proceeds available for redemption of SRs.

- **Debt aggregation**
  CARE Ratings considers the level of debt aggregation by the concerned ARC. Higher the debt aggregated by the ARC, better are the recovery prospects as procedural delays with respect to acquiring approval of the other secured creditors in various matters are reduced if the concerned ARC holds over 60% or 75% of the total debt of the distressed asset, as the case may be.

- **Time elapsed from the assignment of loan**
  A track record of recovery during the recovery process gives an idea about the prospects of recovery. Cases where significant time has elapsed from the start of the recovery process and where the recovery pace has been slow will be viewed negatively, as it hints at weak recovery prospects.

- **Legal hurdles**
  CARE Ratings relies on discussion with the SC/ARC or details mentioned in the valuation reports to assess the possibility of legal hurdles in recovery and appropriately considers the same in the assessment of the pace of recovery.

On the basis of the above factors, CARE Ratings assumes the recovery prospects and works out the projected cash flows based on the adopted resolution strategy. The cash flows are worked out for the recovery period after drawing assumptions on the recovery expenses, statutory dues, legal fees, management fees, etc. CARE Ratings assigns a probability to the assumed recovery, based on the nature of security, probable legal hurdles, the status of possession of assets, etc. CARE Ratings then arrives at Net Present Value (NPV) of these probable cash flows till their maturity. CARE Ratings uses an indicative yield as the discounting rate for the valuation of SRs. The discounting rate is based on the prevailing interest rate scenario and appropriate risk premium. The recovery rating assigned to an SR is based on the NPV of the cash flows expected, stated as a percentage of the outstanding face value of the SR. The recovery rating scale and definitions are attached as Annexure for reference.

Methodology for rating pooled assets

At times, the SC/ARC bundles more than one loan from different accounts into a portfolio and issues SRs common to the whole portfolio. For arriving at the recovery rating for SRs issued under such portfolios, an assessment of all individual assets or at least top assets forming 75%-80% of the expected recovery by value in the portfolio is carried out in the same manner as the assessment for individual assets elaborated in the above section.

[For the previous version please refer to 'Rating Methodology – Recovery Ratings' issued in [March 2020](#)]

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About:

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