Rating Criteria for Security Receipts

Security Receipts (SRs) are issued by Asset Reconstruction Companies (ARCs)/Securitisation Companies (SCs) when the Non-Performing Assets (NPAs) of Commercial Banks (CBs) and/or Financial Institutions (FI) are acquired by ARCs for the purpose of recovery. The preferred way of conducting the transaction is to float a trust for the acquisition of distressed assets, and the ARC would act as a trustee. As per the latest RBI guidelines and Securitisation & Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), the trust holds the assets and administers the NPAs and issues SRs only to Qualified Institutional Buyers (QIBs). In the majority of the cases, the selling bank or FI is itself the investor in the SRs. The receipts are presently not tradable through public platforms; however, SEBI allows listing of SRs and restricted transfer among QIBs through private placement. This happens mainly when the ARCs are aggregating debt for better management and as a result, faster recovery. These SRs are predominantly backed by impaired assets and the security obtained by the lenders and cannot be characterised as debt instruments. At the time of issuance by the trust, and at the end of June and December every year, the SRs are required to be valued at their Net Asset Values (NAVs), for which the SRs are rated by CRAs. Recovery Ratings (RR) are based on expected recovery/realisation from the underlying impaired assets as compared to the outstanding SRs and are expressed in a range of recovery in percentage terms. As per guidelines, the SRs must be rated within six months of the formation date of the trust and reviewed twice a year.

The SARFAESI Act was enacted with the intent of providing banks or FIs to recover on NPAs without intervention by the court. This act provides two alternative methods to recover NPAs. It includes either taking possession of the borrower's secured assets (with the right to lease, assign or sell the secured assets) or taking over the borrower's management or business until the NPA is recovered. The SARFAESI Act also provides for the sale of financial assets by banks and financial institutions to ARCs. These assets can be sold to ARCs by adhering to the guidelines and directions stipulated by the RBI.

The rating of SRs is based on the information provided by the ARCs on the clients, which are vetted for reasonableness. Brickwork Ratings' (BWR's) assessment includes, among others, the probability of the ARC meeting the various liabilities out of recoveries effected by adopting a strategy suitable for a particular stressed asset. It also includes the distribution of payments available with SR holders, post trust expenses being reviewed, while analysing the recovery rating.

Scope of the criteria:

RRs are based on recovery from impaired assets rather than default risk. The main importance of the RR is to identify the probability of recovery from the value of the underlying impaired asset and the security offered to lenders by the said impaired asset while availing the facilities and is based on the strategies adopted by the ARC. The RR is based on the Net Present Value (NPV) of future cash flows expected from the recovery efforts. As per the Act, the SC or ARC shall formulate the policy for realisation of financial assets under which the period for realisation shall not exceed five years from the date of acquisition of the financial asset concerned or formation of trust. The board of directors of the SC or reconstruction company may increase the period for the realisation of financial assets so that the total period for realisation shall not exceed eight years from the date of acquisition of financial assets concerned. In exceptional cases, where the recovery is expected to happen in a time frame beyond eight years, the life of the relative trust can be extended beyond eight years with an approval from the RBI. Asset/Security Receipts (SRs), which remain unresolved/not redeemed as at the end of five years or eight years will be treated as loss assets.

Rating Methodology:

BWR assesses the RR on the basis of a qualitative and quantitative approach. The parameters considered in the rating process are as follows:

The Resolution Strategy:

The resolution strategy of the ARC is the starting point of the assessment. The three available strategies include the sale of assets, which is also called ‘Enforcement’, restructuring of debt for continuing business/operations and a One-Time Settlement (OTS) with existing promoters. Another available, but rarely used, strategy is a change of management. The strategy adopted by the ARC depends on various factors, including the operational status of the stressed asset, nature of the enterprise (usually, restructuring is limited to manufacturing enterprises) and the considered ability of promoters to settle dues and get on with the activity. The ARC also considers the reasons for delinquency by the borrowing entity and expected recovery from assets while formulating its strategy.

NPAs are generally distressed assets and have defaulted for various lengths of time. The financial situation of such companies is highly variable, which may compel them to turn into defaulters. As mentioned earlier, based on the assessment, ARCs evaluate various possible resolution strategies such as the sale of assets, restructuring of the business/operations, change of management, infusion of funds and monetisation of assets. The following are analysed to assess recovery from the impaired assets.

Sale of Assets (Enforcement):

During the sale of assets, the quality of assets, security provided against the loan, demand and marketability of assets, location, age and movability are some factors assessed by BWR. Immovable assets such as land, building and property have better possible recovery outlooks than depreciating assets such as machinery and stock. BWR assesses the reasonableness of the valuation report of the impaired assets and adds a discounting factor to come up with the Net Present Value (NPV) of the future expected cash flows from the sale of assets.

Due to the SARFAESI Act, the recovery process is quicker during a forced sales realisation. It would take approximately 6 months to 3 years. The recovery time under the legal route reduces as the extent of debt aggregation goes up. Recovery may be time consuming in cases where the borrower has fragmented across multiple banks, and lenders are unwilling to cooperate in speeding-up the recovery process.

One-Time Settlement:

The strategy of an OTS is generally employed when the business of the underlying assets is generating cash flows as a going concern or promoters are showing willingness to settle the dues from other sources. An OTS offer can be made for paying the full amount of the settlement money upfront or over a period of time with a defined payment schedule.

Sale of Business or Restructuring:

An entity could be sold entirely to a specific potential buyer/investor, there could be a change of management, there could be an infusion of additional funds, or the same business can be restructured including operational-cum-financial restructuring, in a way that it could become financially viable for a longer period. If the potential buyer is well-experienced and financially strong a business turnaround and recovery are easily achievable. Generally, the recovery percentage is much higher in the case of business restructuring than in the sale of assets. On the other hand, restructuring of facilities with the same management may take a little longer. However, this is preferred in cases where the ARC does not consider change of management as an option.

Brickwork Ratings - Rating Scale:

BWR RR1+	The Recovery Value (RV) of the Underlying Assets is greater than 150% of the Face Value (FV) outstanding of the SRs.
BWR RR1	The RV of the Underlying Assets is in the range of 100% -150% of the face value FV outstanding of the SRs.
BWR RR2	The RV of the Underlying Assets is in the range of 75% -100% of the FV outstanding of the SRs.
BWR RR3	The RV of the Underlying Assets is in the range of 50%-75% of the FV outstanding of the SRs.
BWR RR4	The RV of the Underlying Assets is in the range of 25%-50% of the FV outstanding of the SRs.
BWR RR5	The RV of the Underlying Assets is less than 25% of the FV outstanding of the SRs.

As evident from the Rating Scale, BWR RR1+ represents the highest recovery, while BWR RR5 represents the lowest recovery value. As mentioned earlier, the NPV of the expected recovery is used for assessing the recovery percentage.

Pooled assets:

Often, it so happens that the ARCs bundle more than one small loan into a portfolio and issue SRs for the pooled asset as a whole. While valuing such SRs, the valuation of each individual loan is examined. It is also possible that different strategies are applied for different units of the pool by the ARC. Therefore, the rating of such SRs will be based on the recoveries effected/expected overall cash flow from individual assets in the pool.

The previous version of this document can be found in
www.brickworkratings.com/download/Criteria-SecurityReceipts.pdf

About Brickwork Ratings: Brickwork Ratings (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by Reserve Bank of India [RBI], offers credit ratings of Bank Loan, Non-convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage-backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. BWR has rated over 11,400 medium and large corporates and financial institutions' instruments. BWR has also rated NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations. BWR has Canara Bank, a leading public sector bank, as one of the promoters and strategic partner. BWR has its corporate office in Bengaluru and a country-wide presence with its offices in Ahmedabad, Chandigarh, Chennai, Hyderabad, Kolkata, Mumbai and New Delhi along with representatives in 150+ locations.

Disclaimer: It must be clearly understood that a Rating opinion is based on various factors/aspects which includes application of certain Rating criteria. The particular criteria applied depends on a number of factors, inter alia, sector/Industry, historical performance, cyclical trends, prevailing economic condition, group support etc. Rating opinions factor many assumptions and the application of any particular criteria or a set of criteria may be full or partial depending upon peculiarity of each case. Application of any Rating criteria should not therefore be considered as rendering finality or completeness to a Rating assessment. A reference to criteria needs to be perceived in broad terms, only as an aid to a rating decision.

Brickwork Ratings India Pvt. Ltd. (BWR), a Securities and Exchange Board of India [SEBI] registered Credit Rating Agency and accredited by the Reserve Bank of India [RBI], offers credit ratings of Bank Loan facilities, Non-convertible / convertible / partially convertible debentures and other capital market instruments and bonds, Commercial Paper, perpetual bonds, asset-backed and mortgage-backed securities, partial guarantees and other structured / credit enhanced debt instruments, Security Receipts, Securitisation Products, Municipal Bonds, etc. [hereafter referred to as "Instruments"]. BWR also rates NGOs, Educational Institutions, Hospitals, Real Estate Developers, Urban Local Bodies and Municipal Corporations.

BWR wishes to inform all persons who may come across Rating Rationales and Rating Reports provided by BWR that the ratings assigned by BWR are based on information obtained from the issuer of the instrument and other reliable sources, which in BWR's best judgement are considered reliable. The Rating Rationale / Rating Report & other rating communications are intended for the jurisdiction of India only. The reports should not be the sole or primary basis for any investment decision within the meaning of any law or regulation (including the laws and regulations applicable in Europe and also the USA).

BWR also wishes to inform that access or use of the said documents does not create a client relationship between the user and BWR.

The ratings assigned by BWR are only an expression of BWR's opinion on the entity / instrument and should not in any manner be construed as being a recommendation to either, purchase, hold or sell the instrument.

BWR also wishes to abundantly clarify that these ratings are not to be considered as an investment advice in any jurisdiction nor are they to be used as a basis for or as an alternative to independent financial advice and judgement obtained from the user's financial advisors. BWR shall not be liable to any losses incurred by the users of these Rating Rationales, Rating Reports or its contents. BWR reserves the right to vary, modify, suspend or withdraw the ratings at any time without assigning reasons for the same.

BWR's ratings reflect BWR's opinion on the day the ratings are published and are not reflective of factual circumstances that may have arisen on a later date. BWR is not obliged to update its opinion based on any public notification, in any form or format although BWR may disseminate its opinion and analysis when deemed fit.

Neither BWR nor its affiliates, third party providers, as well as the directors, officers, shareholders, employees or agents (collectively, "**BWR Party**") guarantee the accuracy, completeness or adequacy of the Ratings, and no BWR Party shall have any liability for any errors, omissions, or interruptions therein, regardless of the cause, or for the results obtained from the use of any part of the Rating Rationales or Rating Reports. Each BWR Party disclaims all express or implied warranties, including, but not limited to, any warranties of merchantability, suitability or fitness for a particular purpose or use. In no event shall any BWR Party be liable to any one for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of any part of the Rating Rationales and/or Rating Reports even if advised of the possibility of such damages. However, BWR or its associates may have other commercial transactions with the company/entity. BWR and its affiliates do not act as a fiduciary.

BWR keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of the respective activity. As a result, certain business units of BWR may have information that is not available to other BWR business units. BWR has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

BWR clarifies that it may have been paid a fee by the issuers or underwriters of the instruments, facilities, securities etc., or from obligors. BWR's public ratings and analysis are made available on its web site, www.brickworkratings.com. More detailed information may be provided for a fee. BWR's rating criteria are also generally made available without charge on BWR's website.

This disclaimer forms an integral part of the Ratings Rationales / Rating Reports or other press releases, advisories, communications issued by BWR and circulation of the ratings without this disclaimer is prohibited.

BWR is bound by the Code of Conduct for Credit Rating Agencies issued by the Securities and Exchange Board of India and is governed by the applicable regulations issued by the Securities and Exchange Board of India as amended from time to time.