



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:

Recovery Rating	Implied Recovery	Rating Definition
BWR RR1+	More than 150%	Present Value of expected recoveries is more than 150% of the face value of outstanding SRs
BWR RR1	More than 100% and upto 150%	Range of the present value of expected recoveries is more than 100% and upto 150% of the face value of outstanding SRs
BWR RR2	More than 75% and upto 100%	Range of the present value of expected recoveries is more than 75% and upto 100% of the face value of outstanding SRs
BWR RR3	More than 50% and upto 75%	Range of the present value of expected recoveries is more than 50% and upto 75% of the face value of outstanding SRs
BWR RR4	More than 25% and upto 50%	Range of the present value of expected recoveries is more than 25% and upto 50% of the face value of outstanding SRs
BWR RR5	Upto 25%	Range of the present value of expected recoveries is upto 25% of the face value of outstanding 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-SecurityReceiptsUpdated.pdf

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