Infomerics Ratings

**Infomerics' Independent Credit evaluation of the residual debt as per the proposed Resolution Plan**

The Reserve Bank of India (RBI) has issued various circulars aimed at resolution of stressed assets in the economy, including introduction of certain specific schemes at different points of time. In view of the enactment of the Insolvency and Bankruptcy Code, 2016 (IBC), the existing guidelines have been substituted with a harmonised and simplified generic framework for resolution of stressed assets. Thus, RBI has issued the guidelines on 'Resolution of Stressed Assets – Revised Framework' on February 12, 2018.

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 – Joint Lenders' Forum (JLF) and Corrective Action Plan (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 the resolution of stressed assets.

In June 2019, RBI had introduced 'Prudential framework for resolution of stressed assets' as per the circular dated June 7, 2019. The framework applies to a larger universe of lenders, including NBFCs and small finance banks. The decision has been made 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, and penal provisions have been introduced for the 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.

Post outbreak of COVID-19 pandemic towards the end of the financial year 2020, RBI has released regulatory measures from time to time to help businesses tide through the COVID-19 pandemic and the related liquidity stress. The most recent measure by RBI to this effect is the 'Resolution Framework for COVID-19 related stress' announced on August 6, 2020.

As per the RBI circular, eligible borrowers are companies which are presently under stress on account of COVID-19 and which were classified as Standard, but not in default for more than 30 days with any lending institution as on March 1, 2020. The eligible borrowers have to apply for restructuring to lending institutions by submitting a resolution plan. The lending institutions are required to frame board-approved policies within the contours of the RBI circular to approve or reject such plans. The plan is said to be approved, or the resolution is said to be invoked when 75% by value and 60% by number of lenders agree to the resolution plan. Post approval, there is a process of signing of Inter creditor agreement within 30 days. The date of implementation of the plan has to be within 180 days of the date of invocation. RBI has constituted Expert Committee to make recommendations on the required financial parameters to be factored in the 'resolution plans for Covid 19 related stress' along with sector-specific benchmark ranges for such parameters. Similar to Resolution plans for stressed assets, ICE is required for the Resolution plans for Covid-19 related stress in respect of accounts where the aggregate exposure of the lending institutions at the time of invocation of the resolution process is Rs.100 crore and above by any one CRA authorized by RBI under the Prudential Framework.

Infomerics has been approved by RBI for the rating of ICE proposals vide letter dated October 22, 2024, as per which Infomerics is eligible to give RP ratings for residual debt under RP upto Rs.2000 crore.

In this context we are presenting the methodology for evaluating ICE proposals below.

**Independent credit evaluation requirement under the RBI guidelines**

- Infomerics shall assign an opinion on timely servicing of residual debt under the proposed resolution plan (RP).
- The residual debt means the aggregate debt (fund based as well as non-fund based) envisaged to be held by all the lenders as per the proposed RP.
- RPs involving restructuring / change in ownership in respect of 'large' accounts (i.e., accounts where the aggregate exposure of lenders is Rs 1 billion (100 crore) and above), shall require independent credit evaluation (ICE) of the residual debt.
- While accounts with aggregate exposure of Rs. 5 billion (500 crore) and above shall require two such ICEs, others shall require one ICE.
- Only such RPs which receive a credit opinion of RP4 or better for the residual debt from one or two CRAs, as the case may be, shall be considered for implementation

## Methodology

Infomerics shall examine the peculiar features of the resolution plan and the details provided by the lenders with respect to the same. Further, Infomerics would evaluate the impact that the proposed revised scenario will have on the business operations and the management of the entity and the degree of improvement that is possible due to it. The rating methodology for RP entails evaluating the ability of the entity to generate cash flows from the operations, the uncertainties pertaining to these cash flows and the adequacy of the same to meet the timely servicing of financial obligations as per the resolution plan. Infomerics would also take into account any implicit or explicit third party support and liquidity cushions kept in the form of liquid investments or cash and bank balances.

Apart from the above, Infomerics would follow the similar principles and processes as enumerated in its standard rating methodology for rating various types of entities.

However, the main difference between traditional credit rating and ICE is that ICE is based on the plan(s) of turning around the unit which will generate sufficient cash flow for timely servicing of the restructured debt. Typically, the resolution plan is drafted by lenders / committee of creditors based on techno-economic viability, quantum of sustainable debt which the operational cash flow of the business (recovery of debtors / claims, etc. as well as one-time cash inflows like sale of non-core assets) can comfortably sustain.

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 for which assessment is done | Over life of instrument being rated | Over resolution period on implementation of resolution plan. |
| Review frequency | Under surveillance till full repayment of rated debt | One-time exercise@ |
| Rating Scale | IVR AAA to IVR D | RP 1 to RP 7 |
| What does it indicate | An estimate of probability of default given current circumstances with a given repayment schedule of debt. | Viability of the unit and adequacy of cash flow to timely service residual debt during resolution period as per the resolution plan. Lenders may provide different plans (scenarios) which might for which different RP ratings may be assigned |
| Rating Agreement executed by | IVR with the entity to be rated | IVR with the lender |
| Information sourcing | Entity to be rated | Information sourcing is generally from the lenders with |

| | | |
|---|---|---|
| | | need-based access to the entity to be rated |

@ subject to review of failure rate by RBI

**Approach:**

Keeping in view of the nuances of ICE explained above, INFOMERICS Ratings considers the following aspects:

**1) Reasons for default and how addressed in resolution plan:-**

It is important to probe into the reasons for default which could be due to industry (down turn in industry cycle), business factors (availability of raw material, utilities, competition, piling up of debtors/inventories causing liquidity crunch etc), or financial issues (capital shortage, skewed capital structure) or management related issues. INFOMERICS examines how those factors are addressed in the proposed Resolution Plan.

**2) Management capability to turnaround:-**

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

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

The turnaround strategy may also be based on change in management. In that case, the relevant experience of the new management in the industry / sector and possible synergies with other companies of the group is examined. The strategic importance of the business to the overall business philosophy of the new management, their commitment and readiness to bring in required resources, etc., are also factored in.

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

The assumptions underlying the financial projections and cash flows are sensitized keeping in view the current scenario and possible realistic stress scenarios. The critical point analysed is whether the projected cash flow reasonably (with adequate cushion) covers future debt servicing as per the resolution plan(s).

**5) Liquidity backup:-**

Debt Service Reserve Account (DSRA) and provision to top it up in case of its utilization, provides liquidity cushion to withstand unforeseen cash flow volatilities. The DSRA may be provided upfront or built up in funded manner or provided as non-funded bank guarantee.

**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. INFOMERICS 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 the resolution plan of the stressed asset.

## Rating symbols

Infomerics would assign the RP ratings, in line with the RBI guidelines, based on the credit risk assessment carried out by it. The same is provided below-

**ICE Symbols and definitions**

| 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. |

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