

Criteria for independent credit evaluation of residual debt in the resolution plans for stressed assets

May 2024

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Executive summary

To address the problem of gross non-performing assets, the Reserve Bank of India (RBI) had introduced several resolution mechanisms such as Corporate Debt Restructuring (CDR), Joint Lender's Forum (JLF), 5:25, Strategic Debt Restructuring (SDR), and Scheme for Sustainable Structuring of Stressed Assets (S4A), etc.

Through its June 2019 circular, 'Prudential Framework for Resolution of Stressed Assets'¹ the RBI has come up with revised guidelines on stressed asset resolution and discontinued the extant resolution mechanisms. These guidelines require banks to get independent credit evaluation (ICE) of the residual debt by credit rating agencies for resolution plans involving restructuring / change in ownership of 'large'² accounts.

It has also prescribed a new scale for such ICEs – ranging from RP1 to RP7 (refer to the 'Scope' section for the scale and definitions). For a resolution plan to be considered for implementation without reference to the NCLT, the RBI guidelines require a credit evaluation of RP4 or better on the residual debt from credit rating agencies (CRAs) specifically authorised to do so by it.

CRISIL Ratings' standard criteria for manufacturing and services sector entities³, as well as relevant sector-specific criteria⁴, (used to assign credit rating on the existing scale of AAA to D⁵⁴) are also applicable in the case of the ICE of resolution plans on the new scale proposed by the RBI.

However, there are specific nuances due to which the approach for credit evaluation under the new scale differs slightly from that adopted when assigning ratings on the traditional scale. While ratings on the existing scale (AAA to D) are assigned to going concerns under a business-as-usual scenario, assessments on the new scale are undertaken on resolution plans for stressed assets i.e., entities that are already in default. This approach factors in the likely impact of the proposed resolution plan and is based on the assumption of materialisation of the resolution plan. Further, each stressed asset could have multiple resolution plans and each individual resolution plan would have its own credit evaluation.

Given the nature of this exercise, the evaluations under this new scale for stressed assets shall be a one-time exercise. This is in contrast to the ratings on the traditional scale that are kept under continuous surveillance.

Apart from the factors assessed for all manufacturing and services sector entities, ICE factors in the feasibility of the resolution plan, adequacy of cash flows vis-à-vis repayment obligations on residual debt, and management capability to effectively implement.

Given that the asset might have become stressed due to a variety of reasons – some extraneous to business, and some internal – the success and timely of implementation of any resolution plan will depend on how these factors are addressed. If a plan doesn't address these factors, there is high risk of the asset slipping back into stressed territory.

While analysing the financial risk profile of the stressed assets, CRISIL Ratings looks at the adequacy of cash flows and timeliness in meeting debt repayments envisaged as a part of the resolution plan.

¹ The June 2019 circular can be accessed at: <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580#ANN3>. RBI had earlier notified a circular in February 2018 on "Resolution of Stressed Assets - Revised Framework" (https://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=11218)

The February 2018 circular was later replaced with the June circular. ICE evaluations are also required for restructuring of accounts of over Rs 100 crore under RBI's "Resolution Framework for COVID-19 related stress", notified in August, 2020 (<https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11941&Mode=0>)

² Accounts where the aggregate exposure of lenders is Rs. 1 billion and above

³ Criteria for finance companies to be applied for ICE of resolution plans proposed by finance companies

⁴ These criteria can be accessed here: <https://www.crisil.com/en/home/our-businesses/ratings/understanding-rating.html>

⁵ CRISIL's ratings and rating scales are described in detail here: https://www.crisil.com/content/dam/crisil/criteria_methodology/basics-of-ratings/CRISILs_rating_and_rating_scales.pdf

Finally, CRISIL Ratings assesses the competence of management in effecting a turnaround, its resourcefulness and risk appetite. Further, if the resolution plan envisages the stressed asset being acquired by a different group engaged in the same line of business, the impact on the overall credit risk profile and benefits arising from change in management under the proposed resolution plan are considered.

Scope

This criteria⁶ is applicable for the ICE of resolution plans of stressed assets. The scale that will be used for evaluation is given below and is in line with the scale outlined in the RBI circular⁷. The circular defines default as the 'first instance of missed payment' (either principal or interest) and 30 days for revolving facilities such as cash credit. This is consistent with the definition of default on traditional scale.

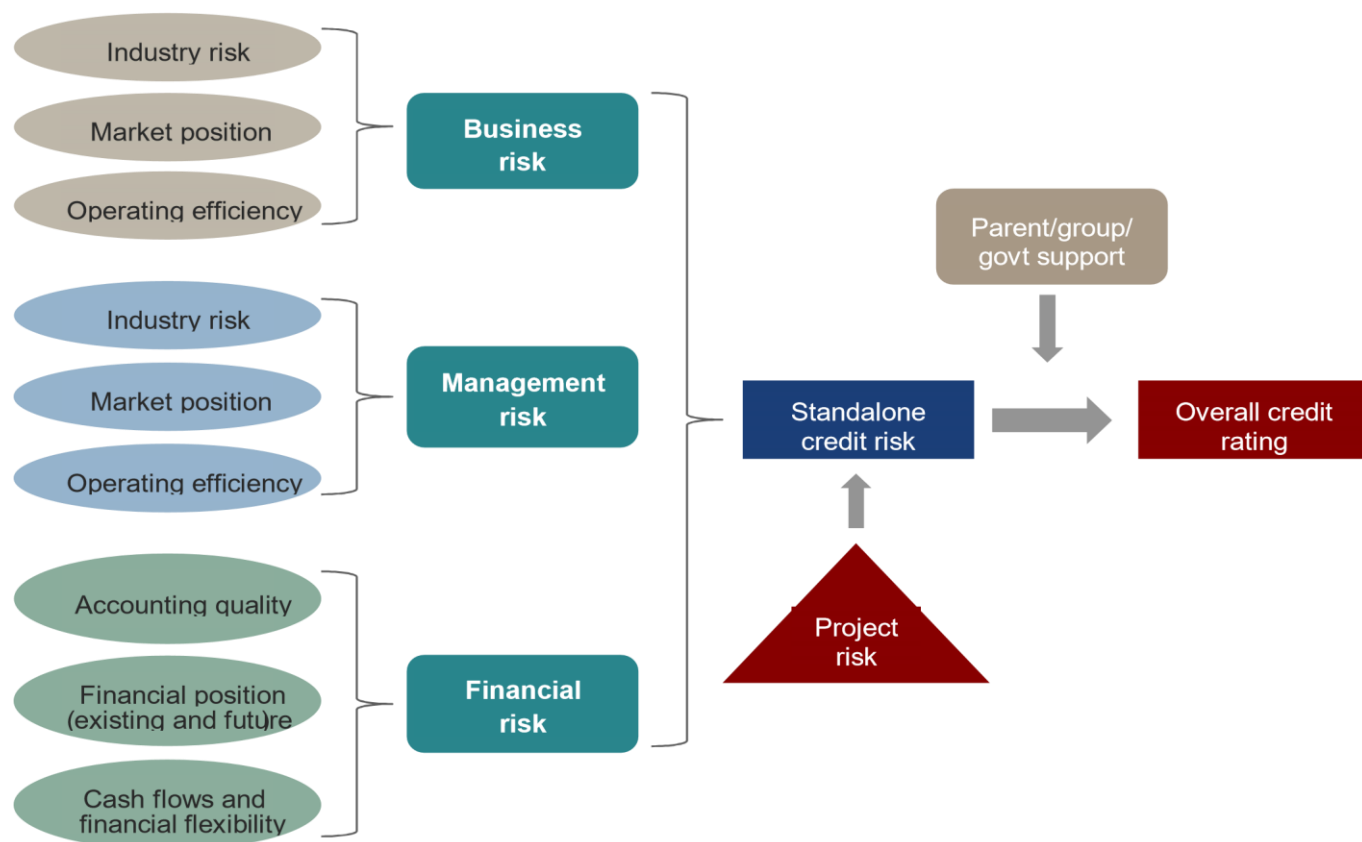
ICE Symbols	Definition
RP1	Debt facilities/instruments with this symbol are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such debt facilities/instruments carry the lowest credit risk
RP2	Debt facilities/instruments with this symbol are considered 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.

⁶ For the previous version of the article, please refer to: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/real-estate/archive/criteria-for-independent-credit-evaluation-of-residual-debt-in-the-resolution-plans-for-stressed-assets-may2021.pdf

⁷ The circular can be accessed at: <https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580#ANN3>

Methodology

CRISIL Ratings' criteria for manufacturing and service sector companies⁸ is applicable for the ICE of resolution plans as well. The framework is presented below, and can be accessed in greater detail on CRISIL Ratings' website.



However, the ICE of a resolution plan differs in certain aspects from the credit evaluation on traditional scale. These differences are highlighted in the table below:

Credit evaluation → Parameter ↓	Resolution plan	Traditional scale
Purpose	To assess the resolution plan and decide whether it would be resolved outside NCLT or needs to be referred to NCLT for resolution under IBC	<ul style="list-style-type: none"> • Pricing debt accurately • Capital provisioning for banks
Applicable for	Stressed assets (as per the RBI guidelines stressed exposure exceeding Rs 100 crore needs to have independent credit evaluation of resolution plan)	Typically going concerns in a business-as usual scenario
Scale	RP1 to RP7 in increasing order of credit risk	AAA to D in increasing order of credit risk
Surveillance	One-time exercise	Ongoing through the tenure of instrument

⁸ CRISIL Ratings' criteria for finance companies/Infrastructure sector to be used for ICE of resolution plans proposed by finance/infrastructure companies.

Contingent on	Materialisation of assumptions pertaining to funds infusion, liquidity support, etc.	Not contingent on any specific scenario
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On account of the differences highlighted above, there are certain nuances that will be factored in the evaluations on the resolution plan scale. These nuances include feasibility of the resolution plan, adequacy of cash flows in relation to residual debt, and management capability to effectively implement. These factors are expanded upon in the sections that follow.

Feasibility of the resolution plan put in place

The assessment involves understanding the reasons for default and whether the resolution plan addresses this. For instance, the delay may be on account of a variety of factors such as liquidity mismatch, high level of indebtedness in relation to the cash flow generation capacity, inadequate working capital, absence of raw material tie up, high debt funded acquisition/ capex, adverse regulations, adverse currency movement, etc., with some factors being internal to business and others extraneous. Successful implementation of any resolution plan will depend upon how these factors are addressed. These steps should ultimately lead to the resolution plan being viable and sustainable. Otherwise, there is high risk of the asset slipping back into default. CRISIL Ratings primarily analyses the efficacy of these resolution plans in tackling the core issues that led to the asset being in stress.

Analysis of sustainable debt and adequacy of cash flows

A key feature of any resolution plan is to determine the amount of debt that can be adequately serviced using the cash flows of the companies. As lenders usually agree to take a haircut on the existing debt and also restructure debt over a longer tenure when undertaking ICE of stressed assets, CRISIL Ratings places significant emphasis on the sustainable debt envisaged in the resolution plan, structure of debt repayment, and future cash flow generation capacity in relation to the debt service obligations.

While back-ended debt repayments allow businesses more time to stabilise, such structures also expose the residual debt to higher risk as cash flow predictability tends to be lower over the longer term. Since ICE assesses the credit profile over the tenure of debt, the cash flows generated by the company are estimated over the long run through different economic cycles.

Further, rigorous sensitivity analyses are carried out given the longer tenure of debt. CRISIL Ratings carries out an evaluation of the company's profit potential to evaluate the credit protection on the residual portion of debt and the sustainability of the same, by benchmarking the expected performance across industry peers.

In addition to business performance, CRISIL Ratings also evaluates the feasibility of sale of non-core assets, which are critical components of certain resolution plans. CRISIL Ratings assesses the potential valuation of the assets, the ability to find suitable buyers, and adequately sensitises the sale for potential delays, lower realizations.

Presence of liquidity buffers

The ICE evaluates the ability to service obligations in a timely manner. Typically, it is observed that stressed assets in their initial recovery phase may face some teething problems primarily on the liquidity front. These may be on account of stabilisation of newly commenced plant or limited credit period from the supplier. In such a situation, CRISIL Ratings evaluates if the resolution plan includes adequate liquidity buffers to address these issues.

Management risk analysis

Resolution plans could involve either the same management continuing at the helm of the company or a new management replacing it. In a few cases, a strategic investor may buy stake in the company while retaining the existing management. Resolution plans could also involve bringing in new management through sale of exposure to other entities such as asset reconstruction companies (ARCs), stressed asset funds, competitors in the industry targeting inorganic growth.

Continuation of existing management has the benefit of avoiding disruptions in operations, but is likely to run into trouble if management lacks competence, integrity or has high risk appetite. On the other hand, lenders may view a new management favourably, but such management may encounter integration issues in the initial phase even when significant synergies exist.

CRISIL Ratings analyses the competence of management (either existing or new) in effecting a turnaround. Past experience in turning around similar business/es or ability to operate similar asset through business cycles are viewed positively. For acquisitions, support from a larger business group and history of integrating new businesses are viewed favourably.

Integrity of management is assessed through factors such as retaining (or infusing) funds in the business through stressed times and following good governance practices. Since an aggressive risk appetite can push the asset back into stressed category, CRISIL Ratings assesses the management philosophy regarding expansion under the resolution plans.

Conclusion

CRISIL Ratings' methodology for ICE of resolution plans, therefore, involves extensive analysis of the business, financial, and management risk profiles of the company. In particular, a lot of emphasis is placed on the efficacy of the business plan in addressing issues concerning the business, stability and adequacy of the company's cash flows in relation to debt, and the management's competence, integrity and risk appetite in the context of its ability to turnaround the business.

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