

BANK LOAN RATING AND RECOVERY RATING

CONCEPT PAPER

PACRA is proud of the association it has with the hundreds of companies and other institutions who use its services, either through a direct relationship or otherwise. Credit rating from PACRA is obtained for different reasons and is used in a variety of contexts. Currently, there are two distinct but related aspects to a credit rating relationship with PACRA – the basic rating relationship and the assignment of ratings to specific instruments like TFCs.

Entity Credit Rating: the basic relationship

The entity credit rating is an opinion on an entity's overall credit quality: its capacity to pay its financial obligations on a timely basis and the level of expected credit risk. It generally indicates the likelihood of default regarding all financial obligations of an entity, because the entities that default on one debt type usually stop payment on all debt types. Entity rating is not specific to any particular financial obligation, as it does not take into account the specific nature or provisions of any particular obligation. As the entity credit rating provides an overall assessment of an entity's credit quality, it is used for a variety of financial and commercial purposes.

Instrument Rating: ratings of capital market transactions

PACRA rates individual debt instruments issued by different entities, under various structures, in the capital markets. The ratings on these issues may vary from the issuer's underlying entity credit rating, reflecting the relative standing of the holders of the instruments vis-à-vis other creditors in the event of default or bankruptcy. This opinion may reflect the creditworthiness of guarantors or other forms of credit enhancement on the obligation. A well-secured term finance certificate (TFC) issue of an entity is usually assigned a higher rating than the underlying entity rating, whereas a subordinated instrument is 'notched' down to a lower rating, reflecting its relatively junior status. A securitized TFC, on the other hand, could carry a rating higher than the entity rating of the originator.

Listed debt instruments constitute a small portion of Pakistan's total debt market. The dominant portion of debt rests with commercial banks in the form of either a direct loan to the borrower or a syndicate loan. The country's total listed debt instruments amount to less than PKR 50bln as against financial institutions total loan book of above PKR 1,500bln. Bank loans are often more complex debt instruments than public debt issues. They frequently include collateral security, restrictive covenants, and other structured features that provide additional protection to the lender. Although, while making a loan decision, bankers are increasingly relying on cash flow generation capacity of an entity, collateralization continues to be an important element in the structure of a bank loan. Collateral provides an additional source of repayment (what bankers sometimes call the 'second way out') in case the borrower's primary source – cash flow from its business operations – proves insufficient resulting in defaults.

Banks require sophisticated and detailed information and analysis on its loans. While making a loan decision the degree of investment risk – likely recovery in the event of default – is as important as the default likelihood. Moreover, with adoption of Basel II capital accord, the credit quality of a particular loan would have direct bearing on the bank’s capital requirement – the higher the quality of loan, the lower would be the quantum of required capital (AAA to AA- 20% risk weight, A+ to A- 50% risk weight). To answer these diverse needs of debt market, PACRA introduces: Bank Loan Rating and Recovery Rating.

Bank Loan Rating (BLR) focuses on both the risk of default and likelihood of ultimate recovery in the event of default. It is on the same familiar ‘AAA’ through ‘C’ standard rating scale, but, additionally, factors in the likely recovery in a post-default situation. The analysis takes into account covenants, collateral and other protective features impacting post-default recovery. In evaluating the collaterals and other credit enhancement features, PACRA would, inter-alia, look at the nature of collateral, ease of realisability and realisable values to estimate the ultimate recovery in the event of default. A primary purpose of BLR is to assist bankers, through a single rating measure, in assessing both probability of default and expected recovery prospects of the defaulted loan. BLR would facilitate differentiating between the more effectively secured loans from those that may be secured in name only. Bank loan ratings will have a prefix of ‘BLR’ attached to the rating symbol.

Recovery Rating focuses exclusively on expected loss and recovery in the event of default, with no relationship to underlying default likelihood of a given loan. Each recovery rating is defined in terms of an expected recovery range. These ratings are assigned on a numerical scale – with ‘1’ representing exceptionally strong recovery prospects and ‘5’ representing weak prospects.

Recovery Rating Scale – Symbols and Definitions		
Recovery Rating	Description	Recovery Expectation
R1	Exceptionally strong recovery prospects	100% of principal
R2	Very strong recovery prospects	100% of principal
R3	Strong recovery prospects	80-100% of principal
R4	Moderate recovery prospects	50%-80% of principal
R5	Weak recovery prospects	Below 50% of principal

* Full recovery of principal means 100% of the par amount of principal outstanding at the time of default to be recovered within a period of 24 months from the date the default is established and recovery proceedings initiated. PACRA uses the concept of ‘nominal recovery’, which means that repayments are not discounted to determine a present value.

Recovery ratings are primarily on an ordinal scale and given the numerous factors influencing recoveries over time, the scale does not attempt to predict a precise percentage recovery. The scale reflects relative recovery expectations and above-mentioned percentages are indicative of likely recovery rather than precise estimates.

PACRA evaluates several distinct factors while determining the bank loan and recovery ratings for a particular loan. These include:

Nature of charge on collateral

The most critical to ascertain recovery probability is the type of charge – exclusive, shared, unsecured, subordinated, etc. – created on the collateral by the lender. The nature of charge determines the priority the lender gets in proceeds realized through disposal of underlying asset in the event of default. The exclusive secured collateral arrangement is considered the superior structure compared to *pari passu* charge or second lien. In establishing the priority of the charge, PACRA would rely on the opinion of the legal division/counsel of the bank.

The type and the quality of the collateral security

The type and quality of the collateral – i.e., receivables, current assets, fixed assets, all assets, property, plant and equipment, equity securities, etc. – are critical because that determine how much stress the secured assets can absorb and still hold their value. This is of critical importance because in certain cases the ultimate value of a particular security is completely independent of fortunes of the underlying entity – for example a pool of general-purpose vehicles.

Loan-to-value

Loan-to-value refers to the amount of the loan being secured in relation to the amount of the collateral security. The amount of the collateral, as opposed to its type and quality, is equally critical. It has been observed that all types of collateral security, even of lower quality and less liquid, can be effective in protecting creditors if there is enough of it in relation to the loan to provide substantial cushion to absorb shrinkage in value.

The degree of access to and control over the collateral

The access to and control over the collateral by the lender, during both pre- and post-default periods, is important. The tighter the monitoring and control of the collateral, the greater likelihood that in the event of default the lenders will actually benefit from the protection against loss that they were counting on when the loan was first made.

A comprehensive evaluation of all these factors helps PACRA to determine the recovery likelihood. Based on PACRA's assessment of ultimate expected recovery of principal in the event of default, the loan rating will be 'notched up or down' by one or more notches from the underlying borrower entity's credit rating. The greater the likelihood of recovery, the more PACRA may notch up the loan rating. In case PACRA is not doing the entity credit rating of the borrower, it would undertake shadow entity rating for this purpose. Relationship between an entity's credit rating and rating of its loan after factoring in recovery analysis is explained in the following table:

Relationship between Bank Loan Rating and Entity Credit Rating		
Recovery Rating	Bank Loan Rating <i>Notching up / down to Entity Credit Rating (ECR)</i>	Description
R1	ECR <i>plus</i> 3 or 4 notches	Exceptionally strong likelihood of full recovery of principal and interest in the event of default
R2	ECR <i>plus</i> 1 or 2 notches	Very strong likelihood of full recovery of principal and interest in the event of default
R3	Un notched	Strong likelihood of substantial recovery of principal in the event of default; minimal loss expected
R4	ECR <i>minus</i> 1 notch	Likelihood of moderate recovery of principal in the event of default, despite potentially significant loss exposure
R5	ECR <i>minus</i> 2 notches	Weak likelihood of recovery attributable to collateral or structure in event of default

While PACRA does not attempt to predict the ultimate outcome of recovery proceedings, the exercise establishes the recovery risk profile by assessing the characteristics of various asset types used as collateral and subjecting the collateral to stress analysis. The probability of default increases as credit quality weakens – lower the entity rating higher the probability of default. On the contrast, the effect of collateral diminishes as the underlying credit profile improves. Intuitively, the higher the credit quality, lower the requirement of collateral as an alternative source of repayment. From a ratings perspective, the weightage assigned to recovery rating for notching will be lower as credit rating of an entity moves towards the higher end. Hence, relatively low rated entities (for example entities having credit rating in ‘BBB’ or ‘A’ categories) would benefit more in terms of notching up compared to high-rated entities.

Fee Structure – Bank Loan and Recovery Ratings

Scenario	Initial Ratings	Surveillance (once every 12 months)
Entity Credit Rating being done by PACRA	5 bps of the loan amount, with a minimum of PKR 150,000 and a maximum of PKR 750,000	5 bps of the outstanding loan amount, with a minimum of PKR 100,000 and a maximum of PKR 500,000
Entity Credit Rating not being done by PACRA	10 bps of the loan amount, with a minimum of PKR 300,000 and a maximum of PKR 1,000,000	7.5 bps of the actual loan amount, with a minimum of PKR 200,000 and a maximum of PKR 750,000

PACRA believes that bank loan and recovery ratings, alongwith our traditional entity ratings, will fill the needs of bankers for separate, distinct and fully transparent measures of both the likelihood of default, and the likely loss/recovery in the event of default. These ratings provide a borrower and a borrower’s banker with an independent opinion of the degree of protection that a particular loan is offering. This in turn would also facilitate the pricing of loan. Bank loan rating would also facilitate implementation of standardized approach of capital adequacy calculation – Basel II accord.