New Credit Rating System for

INFRASTRUCTURE SECTOR

BACKGROUND & RATIONALE

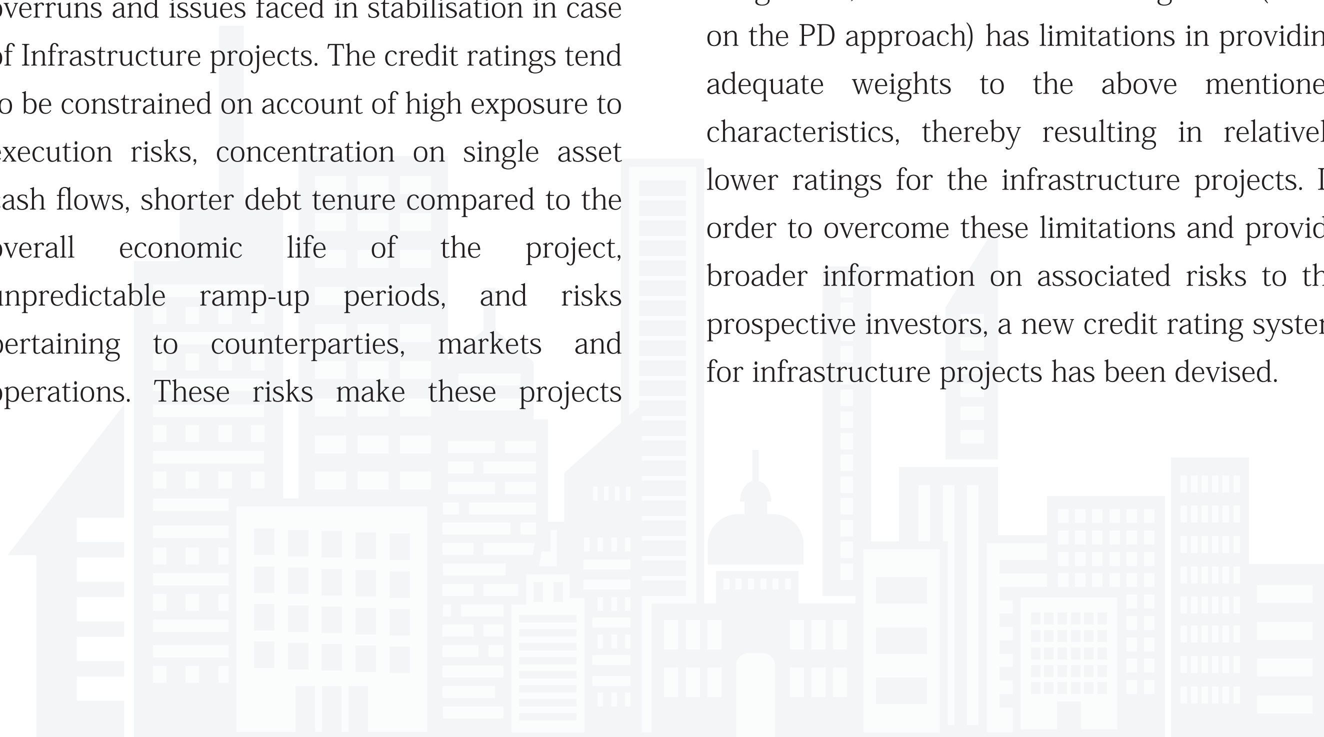
Infrastructure projects in India are mainly financed by debt from commercial banks in India, and there is limited participation of bond markets in financing infrastructure in India. Besides the low depth of the overall bond market, the reasons for limited participation in the infrastructure sector include:

- Higher risk perception, especially during the project implementation stage
- Low credit ratings for infrastructure projects (with almost 75% of projects rated in BBB or lower categories), and
- Prudential norms for pension and insurance funds restricting investments in lower rating categories

The high risk perception stems from the experience of implementation delays, cost overruns and issues faced in stabilisation in case of Infrastructure projects. The credit ratings tend to be constrained on account of high exposure to execution risks, concentration on single asset cash flows, shorter debt tenure compared to the overall economic life of the project, unpredictable ramp-up periods, and risks pertaining to counterparties, markets and operations. These risks make these projects highly vulnerable to volatile cash flows, resulting in lower credit ratings on a conventional rating scale, based on the Probability of Default (PD).

Infrastructure projects post completion and stabilisation tend to generate a steady stream of long-term cash flows. They often have a nearly monopolistic market position, relatively high pricing power and low technological obsolescence risk. Further, Public Private Partnership (PPP) infrastructure projects have additional features like availability of termination payments, contractual protection through some form of non-compete clause, strong counterparty, etc. Moreover, structural features such as ring-fencing of cash flows, well-defined cash flow waterfall mechanism, low incremental capex risk, and better governance, also act as risk mitigation tools.

Given the focus on timely servicing of financial obligations, the conventional rating scale (based on the PD approach) has limitations in providing adequate weights to the above mentioned characteristics, thereby resulting in relatively lower ratings for the infrastructure projects. In order to overcome these limitations and provide broader information on associated risks to the prospective investors, a new credit rating system for infrastructure projects has been devised.



INTRODUCING THE NEW CREDIT RATING SYSTEM FOR INFRASTRUCTURE SECTOR

A new credit rating system has been developed that would retain the valuable aspect of PD adopted by the conventional rating scale and integrates the same with Recovery Prospects, thereby taking into account the unique features of infrastructure project SPVs. Such a composite framework will effectively be a comment on the Expected Loss (EL)[1] of a project SPV over the life of the project, which would factor in the PD and the Recovery prospects. The inclusion of the recovery perspective, in ICRA's view, allows a distinction to be made between entities with favourable fundamentals and recovery prospects and those without.

While the PD aspect of the scale will focus on the timeliness of repayment in a conventional manner, the assessment of Recovery prospects will take into account the overall project viability over its life cycle or over the concession period, the expected level of indebtedness of project SPVs, structure of debt, and various protective aspects of infrastructure projects such as strength of concession, etc. Hence, the new framework will focus on the overall recovery of dues by the investor/lender over the lifecycle of the project.

THE RATING PROCESS

The Rating Process on the new scale will be similar to the existing Credit Rating process for issuers. The process is initiated on receipt of a formal request (or mandate) from the issuer. A rating team, which usually consists of two analysts with the expertise and skills required to evaluate the business of the issuer, is involved with the rating assignment.

An issuer is provided a list of information requirements and the broad framework for discussions. ICRA also draws on secondary sources of information, including its own research.

The rating involves assessment of a number of qualitative factors with a view to estimating the future debt servicing capacity of the issuer. This requires extensive interaction with issuer's management. Plant/site visits are made to gain a better understanding of the project.

After completing the analysis, a Rating Report is prepared, which is presented to ICRA's Rating Committee, which is the final authority for assigning ratings. The assigned rating, along with the key issues, is communicated to the issuer's top management.

If the issuer does not find the rating acceptable, it has a right to appeal for a review. Such reviews are usually taken up only if the issuer provides fresh material inputs. During a review, the issuer's response is presented to the Rating Committee. If the inputs and/or fresh clarifications so warrant, the Rating Committee is likely revise the initial rating decision. Non-accepted ratings are not disclosed and complete confidentiality is maintained on them. ICRA-assigned ratings are subject to regular periodic reviews. The assigned rating may be retained or revised (that is, upgraded or downgraded) following the review.

Expected Loss is calculated as the product of Probability of Default (PD) and Loss Given Default (LGD), where LGD = (1 - Recovery Rate)

RATING CRITERIA

The Infra-Ratings assigned by ICRA will involve assessment of the following aspects of infrastructure projects:

- Adequacy of termination payments (PPP projects) in conjunction with the credit quality of the concessioning authority or loan-to-value (LTV) in case of non-PPP projects
- Sponsor's undertaking to fund shortfalls Step-in/substitution rights available with lenders
- Adequacy of insurance cover
- Project life coverage ratio (PLCR)
- Project and equity IRRs to determine project viability over its life cycle under various scenarios

The new rating system for the infrastructure sector can be applied to assess projects throughout their life cycle. During the implementation phase, the execution risks will result in higher Expected Loss (EL) on account of both higher PD and LGD; whereas post COD, market and operational risks will determine EL which, in an ideal situation, should reduce post project commissioning. Thus the prospective investor could get useful information on factors constraining the rating, and the likely rating migration once the various risks are mitigated.

WHY USE ICRA'S INFRA-RATINGS – THE BENEFITS

ICRA's Infra-Ratings will benefit both the lenders and the rated entities in several ways, including the following:

Lender

- Serves as an independent and objective input in the assessment of the recovery prospects of issuers with volatile cashflows
- Enables differentiation among issuers on the basis of project's overall viability
- Allows risk-based pricing on the basis of expected loss, or loss given default
- Allows risk-based pricing and facilitates capital allocation on the basis of expected loss, or loss given default
- Serves as an input in decision on account exit, retention, or additional collateral requirement

Rated Entities

- Enables differentiation
- Facilitates benchmarking
- Facilitates access to institutional funding
- Facilitates risk-based pricing
- Ability to access to a broader investor base

THE NEW RATING SCALE FOR INFRASTRUCTURE SECTOR (INFRA-RATING SCALE)

The ratings on an EL basis will be assigned on the scale from [Infra] EL 1 to [Infra] EL 7.

Rating	Description
[INFRA] EL 1	Lowest expected loss – Instruments rated 'EL 1' are considered to have the lowest expected loss
[INFRA] EL 2	Very Low expected loss – Instruments rated 'EL 2' are considered to have very low expected loss
[INFRA] EL 3	Low expected loss – Instruments rated 'EL 3' are considered to have low expected loss
[INFRA] EL 4	Moderate expected loss – Instruments rated 'EL 4' are considered to have moderate expected loss
[INFRA] EL 5	High expected loss – Instruments rated 'EL 5' are considered to have high expected loss
[INFRA] EL 6	Very High expected loss- Instruments rated 'EL 6' are considered to have very high expected loss
[INFRA] EL 7	Highest expected loss - Instruments rated 'EL 7' are considered to have highest expected loss

ICRA

About ICRA Limited

About ICRA Limited ICRA Limited was set up in 1991 as a full-service Credit Rating Agency by leading Indian financial/investment institutions, commercial banks and financial services companies as an independent and professional investment information and credit rating agency. Through its subsidiaries, ICRA offers consulting and outsourcing services. ICRA shares are listed on the BSE and the National Stock Exchange. ICRA is majority-held by Moody's Group, which has 50.06% equity ownership stake in the Company.

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