CRISIL's Criteria For Rating Bank Loans

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CRISIL has been assigning bank loan ratings (BLRs) since June 2007, following Reserve Bank of India (RBI)'s announcement of the prudential guidelines for implementation of the new capital adequacy framework for banks, in April 2007. These guidelines require banks to link the capital they maintain on credit exposures to the external credit ratings on these exposures. RBI has recognised CRISIL as an eligible external credit assessment institution. Banks can, therefore, use CRISIL's ratings to compute the capital levels they need to maintain on rated credit exposures.

CRISIL rates fund-based and non-fund-based facilities extended by banks. This criteria document articulates CRISIL's approach to rating bank loans—the process followed, the rating scale used for, and the recognition of default on, each type of bank loan facility, and the policy for withdrawal of ratings.

Significance of rating bank loans

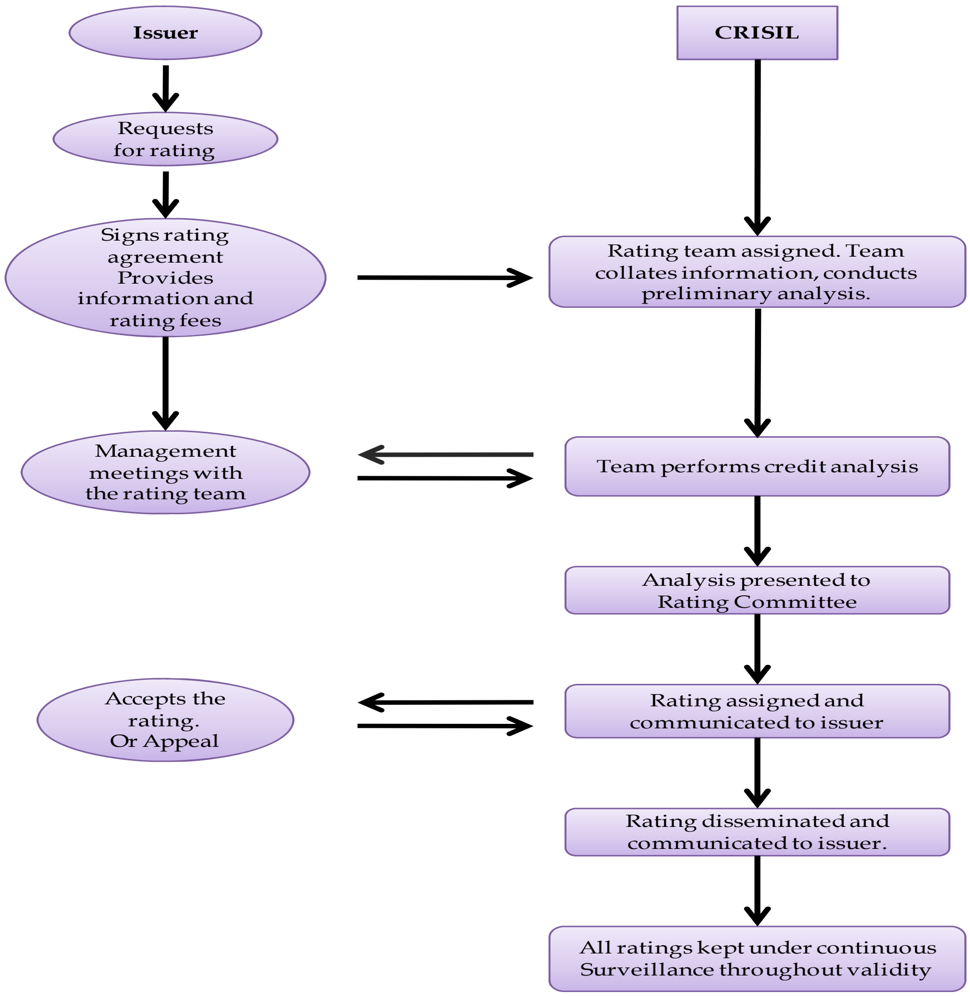
RBI, in its Guidelines for Implementation of the New Capital Adequacy Framework issued in April 2007, had asked foreign banks, and Indian banks with operations outside India, to adopt the standardised approach for credit risk, and the basic indicator approach for operations risk by March 31, 2008. All other scheduled commercial banks in India were required to do the same by March 31, 2009. As per the Basel II approach, which is an improvement over the Basel I approach, the credit risk of an exposure is governed by four parameters: the probability of default (PD), the loss given default (LGD), the exposure at default (EAD), and maturity. Of the four components of credit risk, CRISIL BLRs address the first—the PD component.

A CRISIL BLR reflects CRISIL's opinion on the likelihood of the financial obligations (arising out of a rated facility) being serviced on time and in full, as specified in the terms of the facility.

CRISIL's process for BLRs

The process that CRISIL follows (*refer to Chart 1*) in rating bank loans is similar to the process it follows in rating capital market debt instruments such as bonds, debentures and commercial paper. Chart 1 illustrates CRISIL's rating process for BLRs.

Chart 1: Process flow for a rating assignment



The impact of security on CRISIL BLRs

CRISIL's ratings address PD, one of the four components of credit risk, as identified under the Basel II approach. Since lenders normally enforce their security interests only after default has occurred, realisations from assets do not influence probability of default. For instance, for availing letter of credit (LC) facility, companies may offer 10-20 per cent of the facility limit as cash margins to the bank. However, this cash margin does not help the bank in preventing a company from default. Hence, CRISIL will not provide any uplift to the facility rating on account of these cash margins. Nevertheless, asset security does have a significant impact on the LGD component of credit risk under the Basel II approach.

The presence of liquid assets on a company's balance sheet does, however, add to its financial flexibility. CRISIL factors this additional financial flexibility into all its BLRs.

CRISIL's rating scales for BLRs

CRISIL assigns BLRs on the same scales as those it uses in assigning ratings to capital market debt instruments, including bonds, debentures, and commercial paper (*refer Annexure 1*).

Long-term vs short-term rating scale

The scale used in assigning a rating to a term loan depends on the loan's original maturity as specified in the terms of the facility. This is in line with CRISIL's approach for assigning ratings to debentures. Also, RBI guidelines specify that a bank facility's maturity is the original contracted maturity, and not residual maturity. Therefore, a term loan with an original contracted maturity of 7 years, for instance, will be rated on the long-term scale, even if the residual maturity is only 8 months.

Some fund-based facilities such as cash credit and working capital demand loans (WCDLs) are sanctioned for a period of one year; however, these facilities are often rolled over, and, hence, are akin to long-term exposures from the bank's perspective. CRISIL, therefore, usually assigns ratings to these facilities on the long-term scale. In fact, RBI's guidelines specify that banks use the long-term ratings to compute capital requirement on such exposures. Other fund-based facilities such as packing credit, post-shipment credit, and bill discounting have maturity of less than a year, and are, therefore, rated on the short-term scale.

CRISIL assigns ratings to non-fund based facilities such as letters of credit or bank guarantees usually on the short-term scale. When a bank guarantee is invoked, or a letter of credit devolves on the borrower, the bank makes a payment to the third party on behalf of the borrower. The borrower is required to make good this payment to the bank as per the terms of the bank guarantee facility within a short timeframe. Since the period available for the borrower for repayment is short, these facilities are rated on a short-term scale.

Table 1 lists the rating scales that CRISIL follows in rating bank loan facilities.

Table 1: Types of Credit Facilities and Rating Scale Applicable

Fund-based facilities	**Rating scale**
Packing credit	Short–term
Cash credit	Long–term
Working capital demand loan (WCDL)	Long–term
Purchase bill discounting	Short–term
Bill purchase/discounting	Short–term
Factoring/Forfeiting	Short–term
Post-shipment credit	Short–term
Short-term loan	Short–term
Foreign-currency non-resident loan	Long–term /Short–term *
Term loans	Long–term
External commercial borrowings (ECBs)	Long-term
Mortgage loan facility	Long-term
Vendor financing	Short-term
Non-fund-based facilities	**Rating scale**
Bank guarantee	Short–term
Letter of credit	Short–term

** Based on tenure of loan*

Banks often sanction credit limits to borrowers, and allow them the flexibility to draw down the limits as one of several pre-determined facilities—in other words, these facilities are fungible between those usually rated on the long-term scale (referred to as a long-term facility) and those rated on the short-term scale (referred to as a short-term facility). In such instances, the portion of the facility that can be drawn down as a long-term facility is assigned a rating on the long-term scale, while the remaining portion is assigned a rating on the short-term scale. CRISIL's approach is in line with RBI's clarification on this issue.

Recognition of default on bank loan facilities

CRISIL assigns ratings to bank loans as per the terms of the facility, with respect to both repayment amount and repayment date. Consequently, any failure to honour debt obligations as per the terms of the facility are construed as default on the rated facility; this is distinct from the banking norms, where an account is recognised as a non-performing asset (NPA) only when it remains unpaid for more than 90 days after the due date. All facilities in default will carry a rating of 'D' on the long-term scale, or 'P5' on the short-term scale. The rating will remain in the default category until the arrears are cleared, and a track record of timely repayment is established subsequently.

For term loans, failure to repay the amounts in full on due date is construed as default on the rated facility. Some bank facilities such as cash credit, which do not have specific due dates for repayment, allow borrowers to overdraw on the facility for a specified period with permission from the bank. Though such overdrawing may not necessarily indicate weakening in the borrower's credit quality, banks believe that facilities overdrawn for more than 30 days indicate deteriorating credit quality, and may classify such exposures as potential NPAs. As a result, CRISIL deems cash credit facilities to be in default if they continue to remain overdrawn for more than 30 consecutive days. Similar terms apply for some non-fund based facilities such as bank guarantees. Typically, banks classify non-fund based facilities which remain overdue beyond 30 days as potential NPAs. CRISIL deems these facilities to be in default if the devolved amount remains unpaid for more than 30 days. CRISIL also follows a similar approach to recognition of default for other working capital facilities like packing credit, bill discounting etc.

Treatment of restructuring and rescheduling

CRISIL expects entities that have requested restructuring or rescheduling of their debt obligations will continue to meet interest payment and principal repayment obligations on time and in full as per the existing debt repayment schedule, until the lenders formally approve such requests. If borrowers fail to meet debt service obligations on time and in full pending approval of the request, CRISIL will treat such failure as default on the rated facilities.

Upon receiving formal lender consent to the restructured terms, CRISIL will use the revised repayment schedule in its future analysis and recognition of default.

Withdrawal of ratings

CRISIL's BLRs are not one-time exercises and are under continuous surveillance over the life of the rated facility. CRISIL's policy for withdrawal of ratings stipulates that ratings on facilities (such as term loans), which have scheduled repayment dates, may be withdrawn only on redemption/maturity of the rated facilities. The ratings may also be withdrawn if the rated facilities are pre-paid by the borrower, with the lender's consent, before maturity. For facilities such as cash credit, which do not have a scheduled repayment date, the rating is placed on notice for withdrawal for one year, and subsequently withdrawn. CRISIL does not withdraw ratings immediately on request by borrowers; this is because the end users of the ratings (banks) may face sudden changes in prudential capital requirements when rated facilities suddenly go to an unrated state.

Annexure 1: CRISIL rating scales

Long-term rating scale
AAA
AA
A
BBB
BB
B
C
D
NM

Short-term rating scale
P1
P2
P3
P4
P5
NM

- CRISIL may apply '+' (plus) or '-' (minus) signs to ratings from 'AA' to 'C' to reflect comparative standing within the category; CRISIL may apply '+' (plus) sign to ratings from 'P1' to 'P4' to reflect a comparatively higher standing within the category.
- CRISIL may assign rating outlooks to ratings from 'AAA' to 'B'. Ratings on Rating Watch will not carry outlooks. A rating outlook indicates the direction in which a rating may move over a medium-term horizon of one or two years. A rating outlook may be 'Positive', 'Stable', or 'Negative'. A 'Positive' or 'Negative' rating outlook is not necessarily a precursor of a rating change.
- The suffix '(so)' indicates instruments with structured obligation. CRISIL's rating on structured obligations reflects CRISIL's opinion on the degree of credit protection provided by the credit enhancement structure. The assessment takes into consideration arrangements for payment on the instrument by an entity other than the issuer to fulfil the financial obligations on the instrument. It also takes into account other means of enhancing the credit quality of the rated obligation.
- The suffix 'r' indicates investments carrying non-credit risk. The 'r' suffix indicates that payments on the rated instrument have significant risks other than credit risk. The terms of the instrument specify that payments to investors will not be fixed, and may be linked to one or more external variables such as commodity prices, equity indices, or foreign exchange rates. This may result in variability in payments—including possible material loss of principal—because of adverse movement in the values of external variables. The risk of such adverse movement in price/value is not addressed by the rating.

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