CRISIL Ratings

Approach to recognising default

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Executive summary

CRISIL Ratings believes a rating agency should articulate its definition of default clearly to ensure transparency in its operations, and should strictly adhere to its stated policy on default to ensure credibility of its default statistics.

The performance of a credit rating agency (CRA) is best judged through its default and transition statistics, which hinge on the 'event of default' on the rated debt and the manner of default recognition.

It must be noted that investor tolerance varies between the bond market and the loan market. While bond investors prefer to have default recognised instantly, investors in the loan markets exhibit more forbearance due to their relationship-oriented nature.

The CRISIL Ratings norms for default recognition are in line with the best practices in the international bond/loan market as well as the expectations of domestic bond/loan investors. **CRISIL Ratings recognises default on the first instance of a missed payment on a rated instrument.**

Scope of the criteria

This article[1] outlines the default recognition principles of CRISIL Ratings for ratings assigned to all financial instruments, long-term and short-term debt, bank loan ratings, fixed deposits and structured finance instruments, as well as corporate credit ratings (CCR).

Rating systems and their place in assessing credit risk

The utility of rating systems in assessing credit risk associated with debt or bank loan instruments is recognised universally. This is evident from the critical role that rating agencies have played in the debt security and bank loan markets over decades, and the fact that the Bank of International Settlements, which serves as a bank for central banks, encourages banks to use rating systems to assess credit risk. The Reserve Bank of India (RBI) recognises CRISIL Ratings as an external credit assessment institution for bank loan ratings, and banks use ratings assigned by CRISIL Ratings to assign risk weights to their loan exposures. Given the growing importance of rating systems, how default is defined has a serious import on the reliability of ratings.

Default definition and its place in rating systems

Default definition in a rating system impacts all aspects of its interpretation, including:

- **What each scale point in the system means:** The interpretation of a rating of 5 on 10 in a system that defines default as a single day's delay on a payment obligation will vary significantly from a rating of 5 on 10 in a system that factors a grace period into its definition, or a system where default is not clearly defined. All other things remaining equal, an early recognition of default is critical from an investor's perspective.
- **The magnitude of post-default recovery:** Early recognition of default will support higher levels of post-default recovery as the sooner the creditors are able to move against a defaulting borrower, the better will be their chances of realising their dues. Therefore, unless all creditors to a defaulting borrower exercise identical forbearance, the longer a creditor delays the proceedings, the lesser are the chances of recovery. Even the Insolvency and Bankruptcy Code, 2016, which aims to resolve insolvencies in a time-bound manner,

[1] Previous criteria for the CRISIL Ratings approach to recognising default may be found at https://www.crisilratings.com/content/dam/crisil/criteria_methodology/basics-of-ratings/archive/CRISILs_approach_to_recognising_default-apr2023.pdf

recognises default as non-payment of debt, in part or whole, once it is due. As per the provisions, creditors (whether financial or operational, secured or unsecured) can initiate insolvency proceedings on default.

- **The default statistics:** Clarity on definition of default and consistency in its application have a direct bearing on the reliability of default statistics generated by the system. To generate credible default statistics, a rating agency must have a transparent and objective definition of default, and apply it consistently. A credible, high-quality rating system tends to generate stable default statistics over time.

Default definition in bank loan and bond markets

Across the world, the loan market has traditionally included a period of forbearance after the scheduled payment date in its understanding of default. This is perhaps considering the larger role that client relationships (extending beyond the outstanding loan) play, and the confidence of the lender in realising value from the available collateral.

The lenders' perspective on default is reflected in by the RBI definition of non-performing assets (NPAs), where banks recognise an account as an NPA when it remains unpaid for over 90 days past the due date.

On the other hand, the definition of default by S&P Global Ratings (a leading global rating agency) reflects the view of the bond market. It refers to default as a missed/delayed payment, filing for bankruptcy, or a coerced note exchange, causing an economic loss to investors, whichever occurs earliest. Thus, the bond markets favour instantaneous recognition of default, in contrast with the forbearance that is the norm in the loan market.

Incidentally, Indian regulators have also stressed the need for timely recognition of default.

The RBI, in its circular 'Guidelines on new capital adequacy framework', states that ratings on bank facilities should reflect 'timely payment of principal and interest'.
(Master circular: DBOD.No.BP.BC.4./21.06.001/2015-16/section 6.2.3 dated July 1, 2015).

The Securities and Exchange Board of India (SEBI) also emphasises that default be recognised at the first instance of a delayed payment. It has provided instrument-wise default recognition to be adopted by all CRAs. CRISIL Ratings believes these regulations emphasise the need for timely recognition of default, which is the cornerstone of any rating system.

Please see Annexure I for the instrument/facility-wise default definition followed by CRISIL Ratings.

The CRISIL Ratings policy on recognising default

The CRISIL Ratings policy on recognising default in various instances, outlined below, is in line with the SEBI and RBI guidelines.

- **When an instrument rated by CRISIL Ratings is in default:** The outstanding rating is revised to 'CRISIL D' at the first instance of the first rupee of default, regardless of the extent of default (what portion of the debt service obligation is not met) or the period of default (for how many days has the debt service obligation not been met). This approach applies to all capital market debt instruments, CCR, fixed deposit and term loans availed from the banks.
- **Default recognition for bank loan ratings[2]:**
  - For term loans, failure to repay in full on the due date is construed as a default on the rated facility.
  - For working capital facilities such as cash credit and overdraft, which do not have scheduled maturity/ repayment dates, CRISIL Ratings recognises default if the facilities remain continuously overdrawn for

[2] CRISIL Ratings formulates its policies for default recognition in line with regulatory directives.

more than 30 straight days, without the express written consent of bankers. Though over-utilisation of a facility by a few days may not necessarily indicate stress on the credit quality of the borrower, facilities overdrawn for more than 30 days indicate weakness. Incidentally, banks need to classify such exposures under the Special Mention Account category SMA-1.

  - Similar terms apply for some non-fund- based facilities such as bank guarantees and letters of credit. Typically, banks classify non-fund-based facilities that remain overdue beyond 30 days as SMA-1. CRISIL Ratings deems non-fund-based facilities to be in default if the devolved amount remains unpaid for more than 30 days.
  - CRISIL Ratings also follows a similar approach for recognition of default on working capital facilities such as packing credit and bill discounting. This is in line with the RBI guidelines for recognising default on bank loan facilities.

As part of the rating process, CRISIL Ratings may seek feedback from the banker to ascertain whether the delay was on account of operational lapses on part of the lending bank or on account of liquidity issues of the borrower.

- **When the rated instrument is rescheduled:** If investors in a rated instrument grant a formal consent for revision in the terms of repayment sufficiently before the repayment date, CRISIL Ratings will factor in the revised schedule in its analysis, along with the (presumably adverse) factors that necessitated the rescheduling.
  - CRISIL Ratings follows the same principle for bank loan facilities that have been rescheduled. Until lenders formally approve the request for restructuring, default would be considered from the original repayment dates.
- **When issuers default on unrated instruments:** When issuers with outstanding ratings on instruments default on external debt/loan facilities not rated by CRISIL Ratings (such as vehicle loans availed from financial institutions), it is very likely that the outstanding rating will be lowered to near-default status. This is because factors that cause an interruption in servicing debt on one instrument have a very strong likelihood of interrupting debt servicing on other instruments.
  - This holds for a majority of defaults that have occurred in the rating history of CRISIL Ratings. Therefore, it takes very strong mitigating factors, such as the presence of external credit enhancements, for CRISIL Ratings to conclude that default on one instrument will not be followed by default on other instruments.
- **When the instruments backed by guarantee are in default:** Instruments backed by guarantee from a third party should have a document describing the payment mechanism. The document should state that if the issuer is unable to make the payment as per the terms outlined in the payment mechanism, the guarantor will clear all the dues on the guaranteed instrument within the stipulated time when the trustee/banker invokes the guarantee.
  - If the instrument is not serviced within the timeline mentioned in the payment mechanism, CRISIL Ratings will downgrade its rating on the guaranteed instrument to the default category.
- **Default recognition principle for hybrid instruments:** CRISIL Ratings rates both hybrid instruments and conventional debt instruments on the same scale. Ratings on hybrid instruments reflect the likelihood of timely servicing on the instrument. Hence, if the issuer skips or defers payment on the instrument, the rating on the hybrid instrument will be downgraded to 'CRISIL D', even though it may be permitted to do so as per the terms of the instrument.
  - The key point to note for hybrid instruments is that transition from one rating to another can be significantly sharper vis-à-vis other debt instruments. This is because a hybrid instrument usually offers the issuer flexibility to defer payments.
- **Bankruptcy filing or coerced exchange:** The insolvency resolution process may be initiated against a company by its financial creditors, operational creditors, or by the company itself.

- If the corporate insolvency resolution process is initiated by financial creditors or the company itself, the latter would have already defaulted on its debt obligation. Hence, CRISIL Ratings would shift its rating to the default category.
- However, there may be instances where a company has not defaulted on its debt obligation, but its operational creditor has initiated the insolvency resolution process as payments are pending. In such cases, even if the insolvency resolution application is admitted by the adjudicating authority, CRISIL Ratings may not shift the rating to default category. This is considering the evolving nature of judicial proceedings in such cases, as there have been instances where the appellate authority or the Supreme Court has rendered invalid the insolvency resolution application initiated by an operational creditor and admitted by the adjudicating authority. Hence, CRISIL Ratings may place the rating on 'Rating Watch' in such cases, and closely monitor the judicial proceedings and debt servicing by the company. The rating will be taken to the default category only if a default on the company's debt obligation has been ascertained.
- In case of coerced exchange, where the investors need to take a haircut, CRISIL Ratings will take the ratings on instruments of such entities to the default category.

- **Default recognition for past defaults:** CRISIL Ratings periodically monitors the credit quality of all its outstanding ratings. However, there may be a rare instance where there has been a delayed payment on a rated instrument in the past without the knowledge of CRISIL Ratings, but the account has since been regularised and demonstrates a sufficiently long track record of timely repayment. In such cases, CRISIL Ratings shall downgrade the rating of the entity to the default category while simultaneously upgrading the rating to a level that considers the track record of timely repayment.

Curing period post default

Once a default is cured and the loan is regularised, CRISIL Ratings monitors whether the entity has cleared overdue amounts, regularised payments, and is meeting debt and interest obligations in a timely manner for at least 90 days (from the date of regularisation) before upgrading the rating. Generally, the rating would move to the non-investment grade category after the default is cured.

The rating may be upgraded to investment grade, generally after 365 days from the date of regularisation.

The rating upgrade could be driven by –

- Sustainable improvement in the business risk profile
- Sufficient liquidity to manage working capital requirement and debt obligation
- Improvement in the financial risk profile, indicating comfortable debt coverage indicators and balance sheet strength to support business requirements over the medium term

However, CRISIL Ratings may deviate from the curing period timelines on a case-to-case basis, if it believes the situation that led to the default may not recur in the near term. Some of the instances that could lead to this conclusion are:

- Change in the management
- Acquisition by a stronger firm
- Sizeable inflow of long-term funds
- Benefits arising from a regulatory action

- Force majeure event leading to default
- Restructuring of loans, as long as the business risk profile of the company remains strong
- Delay in debt servicing on account of operational or non-credit reasons

The reasons mentioned above are indicative and not an exhaustive list.

Box 1: How NPA recognition by banks is different from recognition of default by CRISIL Ratings

CRISIL Ratings assigns ratings to bank loans as per the terms of the facility, with respect to both, the repayment amount and date. Consequently, any failure to honour debt obligations as per the terms of the facility is construed as default on the rated facility. This is distinct from banking norms, where an account is recognised as an NPA when it remains unpaid for over 90 days after the due date. All facilities in default will carry a rating in the default category, which will continue until the arrears are cleared and a track record of at least three months of timely repayment is established.

Implications of the CRISIL Ratings policy on default recognition

The policy that governs analytical treatment of default by CRISIL Ratings has far-reaching implications for the interpretation of all its ratings by users, especially investors. Key points to note are:

- **Ratings are an opinion on the likelihood of the first-rupee default:** CRISIL Ratings benchmarks all instruments on its ratings scale, based on their likelihood of full and timely payment of interest and principal as per the pre-decided repayment reschedule. Therefore, rated instruments that are in default will always carry a rating in the default category, regardless of recovery prospects. Moreover, rated instruments that are likely to default in the near term (within 2-3 months) based on the current information, will also carry a 'near default' rating ('CRISIL C' or 'CRISIL D').
- **Ratings by CRISIL Ratings on a particular rating scale mean the same for all instruments:** CRISIL Ratings rates all bond instruments and bank loan facilities on its rating scale, representing the likelihood of full and timely payment of interest and principal. This policy does not, however, prevent CRISIL Ratings from factoring in post-default recoveries, if any, into its ratings on structured finance instruments such as collateralised debt obligations and partially guaranteed instruments. Such recoveries are considered for sizing credit enhancement levels, but only if CRISIL Ratings believes such recoveries are possible within the maturity of the rated instruments. Investors, therefore, need not interpret the ratings of CRISIL Ratings on structured finance instruments or guarantee-backed instruments any differently from its ratings on corporate bonds/bank loans.
- **The CRISIL Ratings default statistics are free from the effects of subjective interpretation:** The CRISIL Ratings definition of default does not include any acceptable grace period for the rated bonds. The resulting default statistics are, therefore, devoid of subjective factors that are open to varying interpretation. This allows the CRISIL Ratings default statistics to be used as a purely objective, and therefore, useful input for credit pricing.

Annexure I: Default definition followed by CRISIL Ratings

Facilities	Ratings scale	Definition of default
Fund-based facilities with pre-defined repayment schedule		
Term loan	Long term	Delay of one day even of Re 1 (of principal or interest) from the scheduled repayment date
Working capital term loan	Long term	Delay of one day even of Re 1 (of principal or interest) from the scheduled repayment date
Working capital demand loan	Long term	Delay of one day even of Re 1 (of principal or interest) from the scheduled repayment date
Debentures/bonds	Long term	Delay of one day even of Re 1 (of principal or interest) from the scheduled repayment date
Certificate of deposits/fixed deposits	Short/long term	Delay of one day even of Re 1 (of principal or interest) from the scheduled repayment date
Commercial paper	Short term	Delay of one day even of Re 1 (of principal or interest) from the scheduled repayment date
Packing credit (pre-shipment credit)	Short term	Overdue/unpaid for more than 30 days
Buyer's credit	Short term	Continuously overdrawn for more than 30 days
Bill purchase/bill discounting/foreign bill discounting/negotiation	Short term	Overdue/unpaid for more than 30 days
Fund-based facilities and no pre-defined repayment schedule		
Cash credit	Long term	Continuously overdrawn for more than 30 days
Overdraft	Short term	Continuously overdrawn for more than 30 days
Non-fund-based facilities		
Letter of credit	Short term	Overdue for more than 30 days from the day of devolvement
Bank guarantee (performance/financial)	Short term	Amount remaining unpaid for 30 days from invocation of the facility
Other scenarios		
When the rated instrument is rescheduled		Non-servicing of the debt (principal as well as interest) as per the existing terms in anticipation of a favourable response from the creditor for restructuring application/proposal shall be considered as a default. Rescheduling of the debt instrument by the lenders prior to the date of payment will not be treated as default, unless the same is done to avoid default or bankruptcy
Curing period		90 days for upgrade to speculative grade and generally 365 days for upgrade to investment grade

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CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 35,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs). CRISIL Ratings Limited ("CRISIL Ratings") is a wholly-owned subsidiary of CRISIL Limited ("CRISIL"). CRISIL

Ratings Limited is registered in India as a credit rating agency with the Securities and Exchange Board ofIndia ("SEBI").

For more information, visit www.crisilratings.com.

About CRISIL Limited

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It is India's foremost provider of ratings, data, research, analytics and solutions with a strong track record of growth, culture of innovation, and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers through businesses that operate from India, the US, the UK, Argentina, Poland, China, Hong Kong and Singapore.

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