CRISIL Ratings

Bank loan ratings: Process, scale and default recognition

November 2024

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Executive summary

A bank loan rating (BLR) by CRISIL Ratings reflects its opinion on the likelihood of the financial obligation (arising from the rated facility) being serviced on time and in full, as specified in the terms of the facility.

The CRISIL Ratings process for assigning ratings to bank loans is similar to that followed for rating bonds and debentures. Ratings are assigned on the long- and short-term scales, depending on the original maturity of the facility. Default on term loans is recognised on the first instance of a missed payment. For working capital and non-fund-based facilities, default is recognised if the facility remains overdrawn or irregular for more than 30 days continuously.

CRISIL Ratings has been assigning BLRs since June 2007, following the announcement of prudential guidelines by the Reserve Bank of India (RBI) 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 external credit ratings on these exposures.

The RBI has recognised CRISIL Ratings as an eligible external credit assessment institution. Banks can, therefore, use ratings assigned by CRISIL Ratings to compute the capital levels they need to maintain on rated credit exposures.

Scope and methodology of the criteria

CRISIL Ratings assigns ratings to fund and non-fund-based facilities extended by banks.

This article[1] describes the approach of CRISIL Ratings to rating bank loans—the process followed; the ratings scale used for, and the recognition of default on, each type of bank loan facility; the policy for withdrawal of ratings; and the treatment of security. It also provides an overview of the processes used for assigning ratings. It does not address detailed criteria and industry-specific parameters used in the assessment of credit risk, which are provided in the section, Criteria and Methodology, on the CRISIL Ratings website.

Significance of rating bank loans

As per the RBI guidelines for implementation of the new capital adequacy framework, banks operating in India have adopted the standardised approach for credit risk.

In the Basel-II and Basel-III approaches, which are 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. The BLRs assigned by CRISIL Ratings address the first, that is, the PD component.

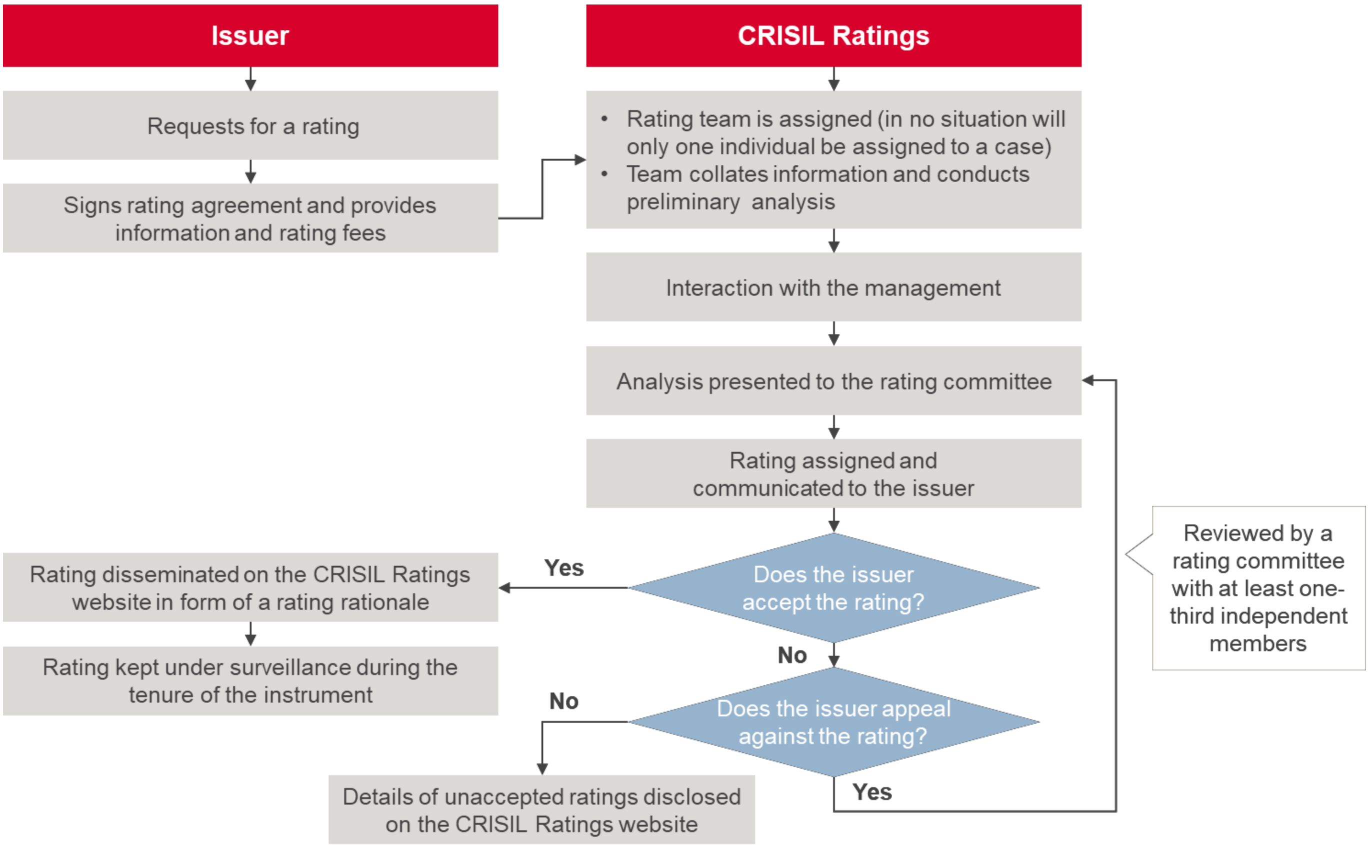
The BLR reflects the opinion of CRISIL Ratings on the likelihood of the financial obligations (arising from a rated facility) being serviced on time and in full, as specified in the terms of the facility.

The CRISIL Ratings process for BLRs

The process is similar to that followed for rating capital market debt instruments such as bonds, debentures and commercial paper. Chart 1 illustrates the rating process for BLRs.

[1] For accessing the previous published document on CRISIL's bank loan ratings – process, scale and default recognition, kindly refer to the following link: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/basics-of-ratings/archive/CRISILs_bank_loan_ratings_process_scales_and_default_recognition-apr2023.pdf

Chart 1: The CRISIL Ratings process for BLRs



The surveillance process for a rated client differs from the above process in the following aspects:

- Once rated, the performance of the issuer is regularly monitored and the rating is kept under surveillance. Therefore, the surveillance process starts from step 3.
- After a rating is reviewed, it is published on the CRISIL Ratings website. Therefore, step 6 is generally followed by step 9, unless the client appeals, in which case, step 8 follows step 6. Steps 7 and 11 are not applicable in this case.

Dissemination of ratings by CRISIL Ratings

Ratings assigned by CRISIL Ratings are disseminated through its publications and various other media. The RBI guidelines require ratings on bank loan facilities to be available in the public domain to be eligible for risk-weighting.

Additionally, the Securities and Exchange Board of India (SEBI) guidelines require rating agencies to adhere to the International Organisation for Securities Commissions (IOSCO) Code of Conduct, which stipulates that rating agencies publish the ratings along with a report that explains the rationale for the rating opinion. SEBI also requires CRAs to publish unaccepted ratings on their website.

CRISIL Ratings publishes ratings for bank facilities on its website and updates the rating list in real-time, in addition to providing the detailed rating report on the website.

The impact of security on BLRs

The BLRs address PD, one of the four components of credit risk, as identified under the Basel-III approach.

Lenders usually enforce their security interests only after default has occurred. Therefore, realisations from enforcement of the underlying security does not influence PD. For instance, for availing a letter of credit (LC) facility, a company may offer 10-20% of the facility limit as a cash margin to the bank. However, the cash margin does not help the bank prevent default by the company.

CRISIL Ratings, therefore, does not provide any uplift to the rating on the facility on account of the cash margin, though asset security does have a significant impact on the LGD component of credit risk.

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

Rating scale for BLR

Bank loans are rated on the same scale that CRISIL Ratings uses to assign ratings to capital market debt instruments, including bonds, debentures and commercial paper. The rating symbols employed by CRISIL Ratings to represent its different scales are covered in the article titled 'CRISIL Ratings: Ratings and ratings scale', which can be accessed at www.crisilratings.com.

Long versus short-term ratings 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. It is in line with the CRISIL Ratings approach for assigning ratings to debentures. Also, the 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 seven years, for instance, will be rated on the long-term scale, even if the residual maturity is only eight months.

Some fund-based facilities such as cash credit and working capital demand loans are sanctioned for one year. However, these facilities are often rolled over and are thus akin to long-term exposures from the bank's perspective. CRISIL Ratings, therefore, usually assigns ratings to these facilities on the long-term scale. In fact, the RBI guidelines specify that banks use 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 Ratings usually assigns ratings to non-fund-based facilities such as LCs or bank guarantees on the short-term scale.

When a bank guarantee is invoked or an LC 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 facility within a short timeframe. As the period available for the borrower for repayment is short, these facilities are rated on a short-term scale.

Table 1: Types of credit facilities and ratings scale applicable

Fund-based facilities	Rating scale
Packing credit	Short term
Cash credit	Long term
Working capital demand loan	Long term
Purchase bill discounting	Short term

Fund-based facilities	Rating scale
Bill purchase/discounting	Short term
Factoring/**forfaiting**	Short term
Post-shipment credit	Short term
Short-term loan	Short term
Foreign-currency non-resident loan	Long/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	**Ratings scale**
Bank guarantee	Short term
LC	Short term
Foreign exchange forward contract limit	Short term^

** Based on tenure of loan*

^ CRISIL Ratings rates the credit exposure limits sanctioned to companies for covering the mark-to-market fluctuations of the foreign exchange forward contracts that the company has entered into. Default is recognised on the facility if crystallised losses are not repaid within 30 days.

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 long-term facilities) and those rated on the short-term scale (short-term facilities). In such instances, in line with the RBI guidance, 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.

Recognition of default on bank loan facilities

The CRISIL Ratings approach to default recognition is in line with regulatory guidance.

CRISIL Ratings recognises default at the first instance of delayed payment for instruments/facilities with scheduled payment. 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, default is recognised when the facility remains continuously overdrawn for more than 30 days without the express consent of the bankers.

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.

Recognition of default on bank loan facility backed by guarantee: Bank loan facility backed by guarantee from a third party should have a document describing the payment mechanism. The document should state that if the borrower 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 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.

Curing period post default

After a default is cured and the loan regularised, CRISIL Ratings monitors whether the entity has cleared overdue amounts, regularised payments and is meeting debt and interest obligations in time for at least 90 days (from the date of regularising the default), 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 regularising the default.

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 position with comfortable debt coverage indicators and balance sheet strength to support medium-term business requirement

However, CRISIL Ratings may deviate from these curing period timelines if it believes that the situation that led to the default is unlikely to recur in the near term. Some of the instances that could lead to this conclusion are:

- Change in 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 loans so that 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.

Treatment of restructured and rescheduled debt

CRISIL Ratings expects entities that have requested restructuring or rescheduling of their debt to continue to meet interest payment and principal repayment obligations on time and in full, until the lenders formally approve such requests. If borrowers fail to meet debt obligation on time and in full pending approval of the request, CRISIL Ratings will treat such failure as default on the rated facilities. CRISIL Ratings will use the revised repayment schedule in its analysis and recognition of default only upon receiving formal lender consent to the restructured terms.

The guidelines regarding default recognition are covered in greater detail in the article titled 'CRISIL Ratings: Approach to default recognition', which can be accessed at www.crisilratings.com.

Withdrawal of ratings

A CRISIL Ratings BLR is not a one-time exercise, but is under continuous surveillance over the life of the rated facility. The CRISIL Ratings policy for withdrawal of ratings stipulates that ratings on securities/facilities that have scheduled repayment dates (such as bonds or term loans) may be withdrawn only on redemption/maturity of the rated facilities. The ratings may also be withdrawn if the debt is pre-paid by the borrower, with the lender's consent, before maturity. In such instances, CRISIL Ratings relies on confirmation from the banks or auditors or any other independent sources on whether the obligations have been met in full.

BLRs can also be withdrawn by CRISIL Ratings after receiving a request for withdrawal from the borrower along with a no-objection certificate from all the lending banks and on clearance of fees due (if any) to CRISIL Ratings.

For further details on the CRISIL Ratings withdrawal policy, please refer to the article titled 'CRISIL Ratings: Policy for withdrawal of ratings', which can be accessed at www.crisilratings.com.

About CRISIL Ratings Limited (A subsidiary of CRISIL Limited, an S&P Global Company)

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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