

insight



Clear Default Definition Critical For Reliable Credit Rating

Analytical Contact :

Kedar Deshpande

kdeshpande@crisil.com

The importance of reliable credit risk assessment in financial markets has increased over the years. Credit rating agencies are the foremost providers of third-party credit risk assessment; the efficacy of their performance can therefore have a profound impact on credit markets. For many years, default and transition statistics have been widely accepted as the most objective measure of the performance of credit rating agencies. This measure, in turn, depends on the definition of 'default'. However, a study of practices shows considerable divergence in the definitions of default that are used across financial markets and indeed across rating agencies. This opinion piece takes a closer look at the definitions of default in use by credit rating agencies across the world and in India.

The role of default definition in credit rating

The role of credit markets in modern economic systems has grown steadily, particularly over the past two decades. Today, credit markets are a crucial component of any modern economy, as the availability and cost of credit plays a key role in the trade of goods and services. Correspondingly, the importance of reliable credit risk assessment in financial markets has increased over the years. This has caused the role and performance of credit rating agencies, as the foremost providers of credit risk assessment, to come under closer scrutiny than ever before.

The performance of credit rating agencies is best judged through their default and transition statistics. An effective rating agency's default and transition rates ought to be ordinal at any point in time, and stable across points in time. However, a key point to note here is that the 'event of default' with respect to the rated debt, and the manner of default recognition by the rating agency, is the fulcrum upon which default statistics and, therefore, the performance assessment of the credit agency, would hinge. Curiously, there is no universally accepted description or definition for this 'event of default'. Therefore, defining-or even serially redefining-the 'event of default' is left to the discretion of individual credit rating agencies.

This opinion piece takes a closer look at the definitions of default in use by credit rating agencies across the world and in India.

Default, in plain terms, is a failure to fulfil an obligation. All credit rating agencies agree that a missed payment amounts to a default. However, the point in time at which the payment will be deemed by the rating agency to have been 'missed' can differ. Obviously, the sooner a rating agency chooses to recognise a missed payment, the more stringent its default recognition policy is. And, the more stringent the default recognition policy, the higher will be the number of defaults captured in the default statistics. Of course, other factors like the consistency of the default recognition policy will also affect the default statistics. Consequently, **any comparison of default statistics of two rating agencies must necessarily be preceded by a 'normalisation' for potentially different default recognition policies.**

With bank loan ratings gaining ground in India, the role of credit ratings in the financial system has expanded rapidly. So has the importance of using clear and consistent parameters for default recognition by credit rating agencies.

A comparative look at default definitions

Rating agencies, both Indian and global, have adopted varying approaches to the definition of default, based on their policies, interpretation of events, and analysis of issuers.

As seen in Table 1, global credit rating agencies (GCRAs) treat distressed exchange as default. Also, there is a degree of forbearance for delays, and default is recognised only if the promised payment is not made within the grace period.

Table 1: Default definitions of global credit rating agencies

Key Characteristics of Default Definition	Standard and Poor's	Moody's	Fitch	DBRS
1. Main event of recognition of default	First occurrence of a payment default on any financial obligation - rated or unrated	Upon a missed or delayed disbursement of interest and/or principal	Failure of an obligor to make timely payment of principal and/or interest under the contractual terms of any financial obligation	Failure to pay interest and/or principal by the required payment date
2. Other events for recognising default	<ul style="list-style-type: none"> Debtor files for bankruptcy (voluntary or forced) Distressed exchange of debt securities S & P would take the rating to 'R', if the debtor company is placed under regulatory supervision 	<ul style="list-style-type: none"> Bankruptcy, administration, legal receivership, or other legal blocks A distressed exchange of securities 	<ul style="list-style-type: none"> Bankruptcy filings, administration, receivership, liquidation, or other winding-up or cessation of business of an obligor Distressed or other coercive exchange of an obligation 	<ul style="list-style-type: none"> Company enters into bankruptcy or receivership A restructuring of the company's obligations as a result of distressed circumstances, including where the swapping of debt for other securities (equity, convertibles or preferred instruments) resulted in a material write-down of the company's obligations
3. Payments made within grace period	<ul style="list-style-type: none"> Not considered a default 	<ul style="list-style-type: none"> Not considered a default 	<ul style="list-style-type: none"> Not considered a default 	<ul style="list-style-type: none"> Not considered a default

Source: official websites of the rating agencies.

It is interesting to note that Moody's changed its default definition in May 2007. Previously, defaults were recognised when the borrower failed to pay interest as per the original schedule, even if the rated debt was serviced within the grace period. Presently, however, all the major GCRA's recognise defaults if payment is not made by the end of the grace period.

In the case of Asian rating agencies, the main event for recognising default is similar for all agencies. As can be seen from Table 2, in Korea, Malaysia, and Indonesia, payment missed on the due date, but made within the grace period, is not considered a default. This is similar to the approach adopted by global credit rating agencies.

Table 2: Key characteristics of default definitions of Asian credit rating agencies

Key characteristics of default definition	Japan Credit Rating Agency Ltd (JCR)	Rating & Investment Information (Japan)	Korea Rating Corporation [#]	Rating Agency Malaysia Berhad	Pefindo (Indonesia)
1. Main event of recognition of default	Inability to fulfil principal and interest payments for the rated debt as agreed originally	Situation in which the pledge of the obligor to creditors concerning the issuer's financial obligations is not fulfilled	When principal and interest of financial obligations are not paid in a timely manner	A missed interest and/or principal payment	A failure of a company to pay any of its financial obligations in the form of either interest or principle on timely basis
2. Other events for recognising default	If the company files for bankruptcy, or is under Japanese corporate or civil rehabilitation law, or if the company is under liquidation	Legal bankruptcy, abandonment of claims, debt-equity swaps, and restructuring of financial obligations	Reorganisation proceedings, filing for composition or obtained approval for composition, under Korean laws	<ul style="list-style-type: none"> Failure to honour the corporate-guarantee obligations provided to subsidiaries Legal insolvency or bankruptcy of the issuer A distressed exchange 	A 'selective default' [^] on debt instrument from a consolidated subsidiary company that belongs to the parent company will also be classified as a 'default' of the parent company
3. Payments made within grace period	<ul style="list-style-type: none"> Default definition is silent on this aspect 	<ul style="list-style-type: none"> Default definition is silent on this aspect 	<ul style="list-style-type: none"> Not considered a default 	<ul style="list-style-type: none"> Not considered a default 	<ul style="list-style-type: none"> Not considered a default

Source: official websites of the rating agencies.

Source: As per information collated for Asian Development Bank (ADB) report.

^ A selective default is defined as a default on a specific debt or class of obligation.

As seen in Table 3, rating agencies in India have well-established policies to recognise default; all default definitions converge on the breach of the promise to pay. However, some agencies recognise default in the event of non-payment on the due date, while others allow a grace period.

CRISIL, India's largest rating agency, adheres to a clear and unambiguous definition of default. CRISIL defines default as any missed payment on a rated instrument. In other words, it recognises even 'a single rupee of missed payment, or delay by a single day' as default¹.

¹ For more information on how CRISIL recognises default, please refer to the article [CRISIL's approach to recognising default, on www.crisil.com](http://www.crisil.com)

Table 3: Key characteristics of default definitions of Indian credit rating agencies

Key characteristics of default definition	CRISIL	ICRA	CARE	Fitch (India)
1. Main event of recognition of default	A single rupee missed payment or delay by a single day	A missed or delayed payment by an issuer in breach of the agreed terms of the issue	Any missed payment on its rated instrument	Failure of an obligor to make timely payment of principal and/or interest under the contractual terms of any financial obligation
2. Other events for recognising default	-	Issuers with technical or temporary delay and presence of transitional stress factors, or high recovery prospects, are classified under higher end of NI rating category (LBB); any converse conditions will entail an LD rating	Certain exceptions exist to recognise Default##	<ul style="list-style-type: none"> • Bankruptcy filings, administration, receivership, liquidation or other winding-up or cessation of business of an obligor; • Distressed or other coercive exchange of an obligation
3. Payments made within grace period	<ul style="list-style-type: none"> • No grace period is allowed for repayments 	<ul style="list-style-type: none"> • Provision for forbearance on account of temporary delay 	<ul style="list-style-type: none"> • Provision for forbearance on account of temporary delay 	<ul style="list-style-type: none"> • Not specifically considered in Fitch (India) default definition; however, Fitch internationally does not treat payments made within grace period as default

* Source: websites of the rating agencies

##As an exception, however, CARE looks at cases of missed payments attributable to technical reasons e.g. procedural delays caused by government machinery etc. which are likely to be rectified within a short time, as NOT in default. If, however, such delays are not rectified within a short time, CARE places them in the default grade.

In conclusion, the robustness of ratings assigned by different rating agencies rests upon their default definitions and the default recognition practices. Accordingly, only ratings assigned by rating

agencies that have similar default definitions and recognition practices are truly comparable.