CRISIL’s approach to recognising default

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Previous criteria for Crisil’s Approach to recognizing default may be found at  
https://www.crisil.com/content/dam/crisil/criteria_methodology/basics-of-ratings/archive/CRISILs_approach_to_recognising_default.pdf
Executive summary

CRISIL believes a rating agency should articulate its definition of default clearly in order to ensure transparency in its operations. And it should adhere strongly to the stated policy on default to ensure credibility of its default statistics.

The performance of a credit rating agency is best judged through its default and transition statistics. The ‘event of default’ on the rated debt and the manner of default recognition are the fulcrum on which a rating agency’s default statistics – and thereby its performance – rest.

That being said, investor tolerance varies from the bond market to the loan market. In most financial markets, bond investors prefer to have default recognised instantly, whereas loan markets exhibit relative forbearance due to their relationship-oriented nature.

CRISIL’s norms for default recognition are in line with the best practices in the international bond/loan market, and expectations of the domestic bond/loan investors. CRISIL recognises default on the first instance of a missed payment on a rated instrument.

Scope of the criteria

This article outlines CRISIL’s default recognition principles for ratings assigned to all financial instruments, long-term and short-term debt, bank loan ratings, fixed deposits, structured finance instruments, and corporate credit ratings.

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 in 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 (BIS), which serves as a bank for central banks, has advocated the use of rating systems by banks to assess credit risk. The Reserve Bank of India (RBI) recognises CRISIL as an external credit assessment institution (ECAI) for bank loan ratings, and banks use CRISIL’s ratings to assign risk weights to their corporate loan exposures. Given the growing importance of rating systems, a default definition can have a serious impact on the reliability of ratings.

Default definition and its place in rating systems

A rating system’s definition of default impacts all aspects of its interpretation. This includes:

- **What each scale point in the system means:** For instance, 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:** An 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, 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 upon default.

- **The default statistics**: Clarity on definition of default, and consistency with which it is applied in any rating system, has a direct bearing on the reliability of default statistics generated by the system over time. To generate credible default statistics, a rating agency must have a transparent and objective definition of default, and apply it consistently over time. 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 lenders’ confidence in realising value from the available collateral.

The lenders’ perspective on default may be indicated by the RBI’s 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 bond market’s view. It refers to default as a missed/ delayed payment, filling for bankruptcy, or a coerced note exchange, causing an economic loss to investors, whichever occurs earliest. Thus, bond markets tend to favour an 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’**, also 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) in its **Guidelines for credit rating agencies’ (CRAs) computation of default statistics** has specified that default be recognised at the first instance of delayed payment (Circular: CIR/MIRSD/CRA/6/2010 dated May 3, 2010). In its circular titled ‘Enhanced Standards for CRAs’ (Circular: SEBI/HO/MIRSD/MIRSD4/CIR/P/2016/119 dated November 1, 2016), SEBI has standardised the instrument-wise default recognition to be adopted by all CRAs. This has been appended in the Annexure I of this document for the convenience of the reader.

CRISIL believes these regulations support the need for a timely recognition of default, which is the cornerstone of any rating system.

### CRISIL’s policy on recognising default

CRISIL’s policy on recognising default in various instances is outlined below. These policies are in line with SEBI’s guidelines on default recognition annexed in this document.

- **When the CRISIL-rated instrument is in default**: In all such cases, the outstanding rating is revised to ‘CRISIL
D’, 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).

In other words, the rating will be revised to ‘CRISIL D’ at the first instance of the first rupee of default. This approach applies to all capital market debt instruments, corporate credit rating (CCR)\(^1\), fixed deposit and term loans availed from the banks.

We observe that in some instances, there are delays or missed payments due to non-credit reasons, purely attributable to operational issues or administrative errors. Such instances may include, but are not limited to, operational lapses at the end of the lender(s), failure of accounting systems and processes, and human errors. In such instances, CRISIL applies reasonable judgment to assess whether the delays were on account of non-credit factors. In doing so, it evaluates whether there was willingness, ability (also including availability of funds), and intent of the issuer, to make the respective payment on the due date, and if the delay is solely attributable to operational issues. Additionally, CRISIL would ascertain if the delay is expected to correct in few business days and whether the issuer has taken corrective measures to avoid such instances in future.

Thus, in situations where CRISIL believes the delays are purely on account of non-credit reasons, the missed payment will not be regarded as a default, as the instance does not reflect a material weakening in credit quality.

- **Default recognition for bank loan ratings:** 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 recognises the event as a default only if the facilities remain continuously overdrawn for more than 30 days, without the express written consent of bankers. Though over-utilisation of a facility by a few days may not necessarily indicate stress in the borrower’s credit quality, facilities overdrawn for more than 30 days indicate weakness, and 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 deems non-fund-based 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 on working capital facilities such as packing credit and bill discounting. This is in line with the guidelines issued by the RBI and SEBI for recognising default on bank loan facilities.

- **When the CRISIL-rated instrument is rescheduled:** If investors in a rated instrument grant a formal consent for revision in the terms of repayment sufficiently prior to the repayment date, CRISIL will factor in the revised schedule in its analysis, along with the (presumably adverse) factors that necessitated the rescheduling.

CRISIL 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. However, in case the bank loan is restructured prior to the due date, revised payment dates will be considered for default recognition.

\(^1\) Corporate credit rating is not assigned to any specific issue but to the borrowing firm. Hence, for CCR, CRISIL also has a rating symbol of ‘SD’ or selective default which indicates defaulting on specific issue or class of obligation.
• **When issuers with CRISIL ratings default on unrated instruments:** When issuers with outstanding CRISIL-rated instruments default on external debt/loan facilities not rated by CRISIL (such as vehicle loans availed from financial institutions), it is very likely that the outstanding CRISIL 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 CRISIL’s rating history. Therefore, very strong mitigating factors, such as the presence of external credit enhancements, need to exist for CRISIL to conclude that an instance of default on one instrument will not occur with other instruments.

• **When the instruments backed by guarantee are in default:** In case of instruments backed by guarantee from a third party, there should exist a clear payment mechanism. The documents should state that in case 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 time stipulated in the payment mechanism when the trustee/banker invokes the guarantee.

In case the instrument is not serviced within the timelines mentioned in the payment mechanism, CRISIL will downgrade the rating on the guaranteed instrument to the default category.

• **Default recognition principle for hybrid instruments:** CRISIL rates hybrid instruments on the same scale as conventional debt instruments. CRISIL’s ratings on hybrid instruments reflect the likelihood of timely servicing on the instrument. Hence, if the issuer skips or defers the payment on the instrument, the rating on the hybrid instrument will be downgraded to ‘CRISIL D’, even though it may be permitted 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 primarily 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

  - In case 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, in such cases, CRISIL would shift the rating to 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 may not take 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 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 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 will take the ratings on instruments of such entities to default category.
• **Default recognition for retrospective defaults**: CRISIL monitors the credit quality of all its outstanding ratings on a periodic basis. However, there might be a rare instance where there has been a delayed payment on a CRISIL-rated instrument in the past, without CRISIL getting to know about it, but the account has since been regularised and demonstrates a sufficiently long track record of timely repayment. In such cases, CRISIL shall downgrade the rating of the entity to default category while simultaneously upgrading the rating to a level that takes into account the track record of timely repayments.

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**Curing period post default**

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

Further, the rating may be upgraded to investment grade, generally after 365 days from the date of regularisation. Upward revision in the rating could be driven by –

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

However, CRISIL may deviate from the above-mentioned curing period timelines, on a case-to-case basis, if it believes the situation that lead to default earlier, may not recur in the near term. Some of the instances that could lead to the aforementioned conclusion have been listed below –

- Change in management
- Acquisition by a stronger firm
- Sizeable inflow of long-term funds
- Technical nature of defaults
- Benefits arising out of a regulatory action
- Force majeure event leading to default
- Restructuring of loans, as long as business risk profile of the company continues to remain strong

The reasons mentioned above are indicative in nature and not an exhaustive list. CRISIL will continue to evaluate its policy in this regard.
### Box 1: How NPA recognition by banks is different from CRISIL’s recognition of default

CRISIL 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, are 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. The rating will remain in the default category until the arrears are cleared, and a track record of timely repayment of at least three months is established, subsequently.

### Implications of CRISIL’s policy on default recognition

The policy that governs CRISIL’s analytical treatment of default has far-reaching implications for the interpretation of all its ratings by users, especially investors. Key points to note in this regard include:

- **Ratings are an opinion on the likelihood of the first-rupee default:** CRISIL 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, all CRISIL-rated instruments in default will always carry a rating in the default category, regardless of recovery prospects. Moreover, all CRISIL-rated instruments that are in existence, but 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’).

- **CRISIL’s ratings on a particular ratings scale mean the same for all instruments:** CRISIL rates all bond instruments and bank loan facilities on its ratings scale, representing the likelihood of full and timely payment of interest and principal. This policy does not, however, prevent CRISIL 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 taken into account in sizing credit enhancement levels, but only if in CRISIL’s opinion, such recoveries are possible within the maturity of the rated instruments. Investors, therefore, need not interpret CRISIL’s ratings on structured finance instruments or government-backed instruments any differently from its ratings on corporate bonds/bank loans.

- **CRISIL’s default statistics are free from the effects of subjective interpretation:** CRISIL’s definition of default does not include any acceptable grace period for the rated bonds. The resulting default statistics are, therefore, also devoid of subjective factors that are open to varying interpretation. This allows CRISIL’s default statistics to be used as a purely objective, and therefore, useful input for credit pricing.
### Annexure I: Annexure A1 of SEBI circular titled ‘Enhanced standards for credit rating agencies (CRAs)’

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About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better. 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.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Ltd (“CRISIL”). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India (“SEBI”). With a tradition of independence, analytical rigour and innovation, CRISIL sets 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, other structured debt instruments and also the resolution plans for stressed assets. We have rated over 27,180 large and mid-scale corporates and financial institutions.

CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered the unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility of rating services to a wider market. Over 150,000 MSMEs have been graded by us.

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