

CRISIL's bank loan ratings: process, scale and default recognition

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Executive summary

A CRISIL bank loan rating (BLR) reflects CRISIL's opinion on the likelihood of the financial obligation (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 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, while in the case of working capital and non-fund-based facilities, default is recognised if the facility remains overdrawn or irregular for more than 30 days continuously.

CRISIL has been assigning BLRs since June 2007, following the Reserve Bank of India's (RBI) announcement of 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.

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

Scope and methodology of the criteria

CRISIL rates fund- and non-fund-based facilities extended by banks.

This article describes CRISIL's approach 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 CRISIL's treatment of security. It also provides an overview of the processes used for assigning CRISIL ratings. It does not address detailed criteria and industry-specific parameters used in the assessment of credit risk, which are provided in a separate section, Criteria and Methodology, on CRISIL's website.¹

Significance of rating bank loans

As per the RBI's 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. Of these, CRISIL BLRs address the first: the PD component.

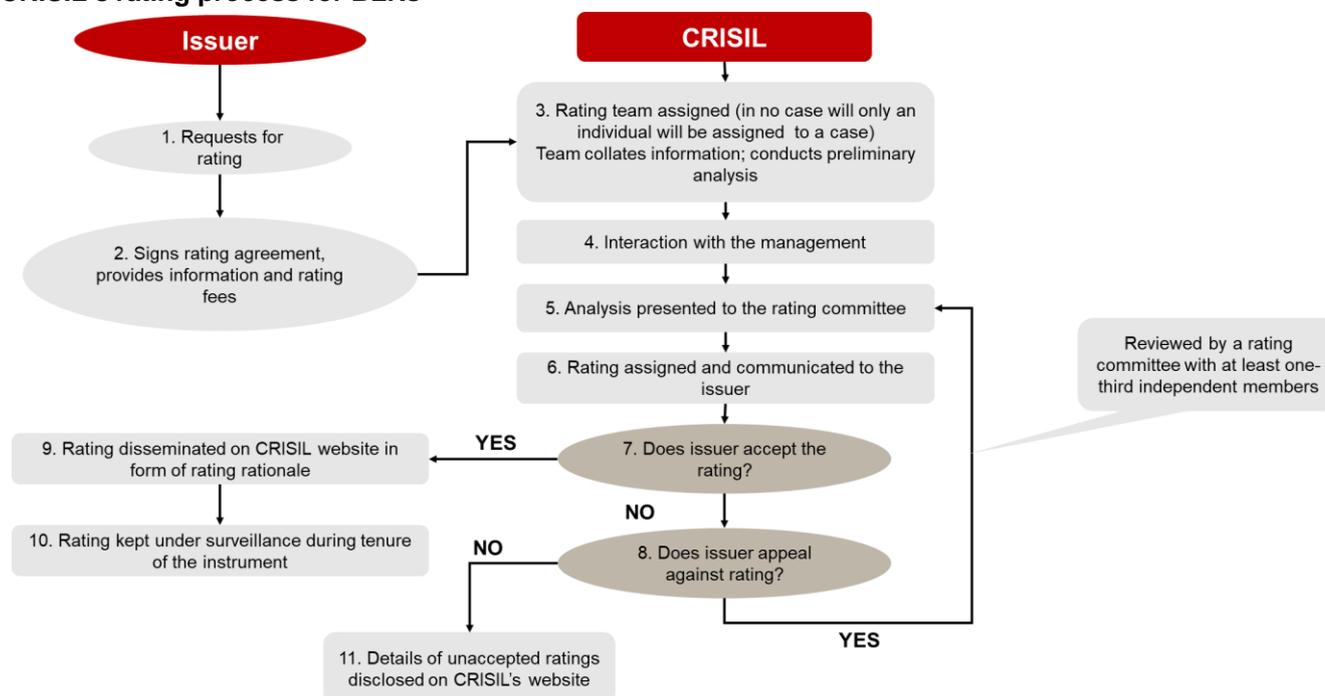
The BLR reflects CRISIL's opinion on the likelihood of the financial obligations (arising out of a rated facility) being serviced on time and in full, as specified in the terms of the facility.

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.crisil.com/content/dam/crisil/criteria_methodology/basics-of-ratings/archive/CRISILs_bank_loan_ratings_process_scales_and_default_recognition.pdf

CRISIL's 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 CRISIL's rating process for BLRs.

CRISIL's rating 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 CRISIL's 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 assigned by CRISIL are disseminated through CRISIL 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 released a circular titled 'Enhanced standards for credit rating agencies (CRAs)' on November 1, 2016 (refer circular SEBI/HO/MIRSD/MIRSD4/CIR/P/2016/119), mandating all CRAs to publish unaccepted ratings on their website.

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

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.

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

CRISIL, therefore, does not provide any uplift to the facility rating on account of these cash margin, though 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 ratings.

CRISIL's ratings scale for BLR

CRISIL rates bank loans on the same scale that it uses to assign ratings to capital market debt instruments, including bonds, debentures and commercial paper. The rating symbols employed by CRISIL to represent its different scales are covered in the article titled CRISIL's ratings and ratings scale, which can be accessed at www.crisil.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 CRISIL's approach for assigning ratings to debentures. Also, the RBI's 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, therefore, usually assigns ratings to these facilities on the long-term scale. In fact, 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 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: CRISIL's ratings scale for bank loan facilities

Table 1: Types of credit facilities and ratings scale applicable

Fund-based facilities	Ratings scale
Packing credit	Short term
Cash credit	Long term
Working capital demand loan	Long term

Fund-based facilities	Ratings scale
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/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 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, 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's approach to default recognition is in line with regulatory guidelines published by SEBI and the RBI.

SEBI, in its circular titled 'Enhanced standards for CRAs', standardised the instrument-wise default recognition to be adopted by all CRAs. These uniform guidelines indicate that default should be recognised at the first instance of delayed payments for instruments with scheduled payment. Working capital facilities such as cash credit and overdraft, which do not have scheduled maturity/repayment dates, require default recognition when such facilities remain continuously overdrawn for more than 30 days without the express consent of the bankers.

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 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 the availability of funds) as well

as intent of the issuer to make the payment on the due date, and whether the delay is solely attributable to operational issues.

Additionally, CRISIL would ascertain if the delay is expected to be corrected in a few business days and evaluate whether the issuer has taken necessary corrective measures to ensure that such delays are not repeated in future. Thus, in situations where CRISIL believes the delays are purely on account of non-credit reasons, it would not recognise the missed payment as a default as the instance does not reflect a material deterioration in credit quality.

Curing period post default

After a default is cured and the loan regularised, CRISIL 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, 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 regularising the default.

Upward revision in the rating 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 may deviate from these curing period timelines if it believes that the situation that lead to default earlier, 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
- Technical nature of defaults
- Benefits arising out of a regulatory action
- Force majeure event leading to default
- Restructuring of loans so that the business risk profile of the company remains strong

The reasons mentioned above are indicative in nature and not an exhaustive list. CRISIL will continue to evaluate its policy in this regard.

Treatment of restructured and rescheduled debt

CRISIL 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 service obligation on time and in full pending approval of the request, CRISIL will treat such

failure as default on the rated facilities. CRISIL will use the revised repayment schedule in its future 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's approach to default recognition', which can be accessed at www.crisil.com.

Withdrawal of ratings

A CRISIL BLR is not a one-time exercise, but is under continuous surveillance over the life of the rated facility. CRISIL's 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 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 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.

CRISIL's withdrawal policy is in line with the recent SEBI circular titled 'Enhanced standards for CRAs', applicable to all CRAs. For further details on CRISIL's withdrawal policy, please refer to the article titled 'CRISIL's policy for withdrawal of ratings', which can be accessed at www.crisil.com.

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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