



## ICRA Rating Feature

# Policy on Default Recognition

This document describes ICRA's policy on default recognition when an entity fails to meet its debt servicing obligations in a timely manner. This document also specifies ICRA's policy on upgrading the rating once the default is cured. The policy draws from the various guidelines issued by the Securities and Exchange Board of India (SEBI) on this subject in the past, including the most recent circular (SEBI/ HO/ MIRSD/ CRADT/ CIR/ P/ 2020/ 87) dated May 21, 2020. The policy also incorporates the past guidelines issued by the Reserve Bank of India (RBI) on this subject, prescribing a uniform default definition for bank loan facilities.

This policy updates and supersedes ICRA's earlier document on this subject, published in August 2019.

## ICRA's Definition of Default

### Default recognition in case of bank facilities or borrowing programmes that have a pre-defined repayment schedule

- » ICRA defines default as a missed or a delayed payment by an entity in breach of the agreed terms of the loan facility or the borrowing programme. Thus, even a 'single day single rupee' delay—in case of bank facilities or borrowing programmes having a pre-defined repayment schedule—is treated as a default. ICRA has been using this definition of default consistently for all its default-related studies, and the practise has remained unchanged over the years.

### Default recognition in case of bank facilities that do not have a pre-defined repayment schedule

- » In the case of bank facilities that do not have any pre-defined repayment schedules (such as cash credit and overdraft facility), ICRA recognises default only in case of continuous and sustained overdrawals.

Refer to the *Annexure* for the instrument-wise definition of default followed by ICRA.

### Default recognition when the lenders or investors allow a grace period for debt-servicing beyond the scheduled payment date

- » In case the lenders or investors allow for a grace period to the borrowing entity to service the debt obligations N days post the due date T, the deemed due date for debt servicing is construed as 'T+N' by ICRA, provided the borrowing entity will not be classified by the lenders as a defaulting entity during these N days post the due date. Such a grace period should be specifically mentioned as part of the loan agreement or the sanctioned letter or communicated by the lenders or investors in writing before the scheduled due date. A missed or a delayed payment by an entity beyond the allowable grace period is treated by ICRA as a default.

### Default recognition in case of rescheduling of debt

- » The rescheduling of a debt obligation is not treated as a default by ICRA, provided the debt servicing had been timely till the time the lenders provide the consent to the rescheduling and it was not a case of a

distressed exchange<sup>1</sup>. However, in such cases, the ratings may be suitably revised downwards in case debt rescheduling was intended to provide a relief to the borrower, owing to its extant or expected financial stress or if there is a fundamental impairment in the entity's credit quality.

### **Default recognition in case of commercial dispute**

ICRA takes into consideration, on a case-by-case basis, the reasons that led to delays in debt servicing by an entity and its potential implications on the entity's willingness and ability to service its other debt obligations in a timely manner.

- » In case the delay is primarily because of the weak liquidity position of the entity, the delay in debt servicing is treated as a default.
- » In case the liquidity position of the rated entity is comfortable such that it was in a position to service all its debt obligations in a timely manner and the delay in debt servicing is on a specific instrument<sup>2</sup> on account of a bona-fide commercial dispute, as assessed by ICRA, the delay is not treated as a default. However, if such a delay in debt servicing may impact the financial risk profile of the entity because of reasons such as invocation of certain covenants, the entity's rating may be suitably revised downwards.

### **Default recognition in case of hybrid instruments**

- » A missed or deferred payment on the hybrid instrument is treated as a default, even if the terms and conditions of the hybrid instrument allow for a payment deferral or skipping under certain conditions.

### **Default recognition post the withdrawal of rating**

- » As per ICRA's Withdrawal and Suspension Policy, the rating of securities (such as bonds, non-convertible debentures or NCDs etc.) can be withdrawn subject to ICRA having rated the security continuously for five years or 50% of the tenure of the security, whichever is higher. Also, when a security is rated by multiple credit rating agencies without a regulatory requirement for multiple ratings, the rating can be withdrawn subject to ICRA having rated the security continuously for three years or 50% of the tenure of the security, whichever is higher. In such cases, post the rating withdrawal but before the maturity of the security or the completion of three years from rating withdrawal (whichever is earlier), if it comes to the notice of ICRA that there is any delay or default in payment on the said security, ICRA would include such an instance in its default statistics, irrespective of the rating on that security having been withdrawn earlier. This is in line with the methodology prescribed by SEBI on computation of default rates by CRAs as per the circular SEBI/ HO/ MIRSD/ DOS3/ CIR/ P/ 2019/ 70 dated June 13, 2019. For tracking the timeliness (or lack thereof) of payment on such security, ICRA would rely on the information received by it from the Debenture Trustee for the said security and/ or the stock exchange filings (in case of a listed security) or information received by ICRA from any other source.

### **Dealing with technical delays**

- » In case ICRA can establish that the occurrence of a delay or a missed payment by an entity is solely because of technical reasons/ errors, beyond the control of that entity, and that such an occurrence is not a reflection of the lack of ability or willingness of the entity to pay its debt obligations, such occurrence is not treated as a default. However, in such cases, ICRA would publish a rating rationale citing the occurrence of such an event and ICRA's opinion on the same.

<sup>1</sup> A distressed exchange is one whereby the investors or lenders get a diminished value on a Net Present Value (NPV) basis relative to the debt obligation's original promise, and has the effect of allowing the entity to avoid a likely default.

<sup>2</sup> The rating of the instrument on which default has occurred is put on watch to inform the lenders/ investors that ICRA has taken cognizance of the default and the reason for taking no rating action is, as per ICRA's assessment, a bona-fide commercial dispute. The rating watch is removed upon resolution of the dispute.

## Impact of Default on Credit Ratings

Upon a default, ICRA downgrades the ratings for all the rated instruments to [ICRA]D, regardless of the magnitude or duration of the default. This policy is in accordance with the approach prescribed by both the RBI as well as the SEBI i.e. a delay of one day even of one rupee (of principal or interest) from the scheduled payment date is to be construed as a default.

However, if strong reasons exist for differentiating among the rating of the debt instrument that is in default and that of the other debt instruments that aren't, the reasons and protective factors for such instruments (that are not in default), as assessed by ICRA, would have a critical bearing on the rating of the other debt instruments. In such cases, the rating of the other instruments may not be revised to [ICRA]D, but suitably reviewed. The above described rating action could be taken in the following cases, among others:

- » The other debt instruments on which there is no default are senior to the debt in default and the default probability of the senior debt is distinctly lower than that of the debt in default - such as in the case of default on hybrid instruments
- » The cash flows meant for servicing the other debt instruments (that are not in default) are ring fenced and no cross-default clauses apply
- » The other debt instruments on which there is no default are supported by a third-party explicit support such as a corporate guarantee

## Rating upgrade after the passage of the curing period

For an entity rated in the default category, to qualify for an upgrade to within the non-investment grade, generally at least 90 days should have passed from the most recent date of default<sup>3</sup>. Also, for the rating to qualify for a further upgrade to the investment grade, generally 365 days should have passed from the most recent date of default. The period of 90/ 365 days mentioned above is henceforth referred to as the "curing period".

- » **Curing period when loan restructuring/ rescheduling happens:** Consider a situation where the rating of an entity's debt facilities/ instruments is downgraded to [ICRA]D post which the entity's debt is restructured/ rescheduled such that a revised payment schedule becomes applicable. In such cases, the curing period would be considered to have commenced from the date when the loan restructuring/ rescheduling is approved, and not from the retrospective date from which the restructuring/ rescheduling is effective.
- » **Exceptions to policy:** ICRA may make exceptions to adhering to the general curing period specified above and may consider upgrading the rating of an entity even prior to the passage of the curing period. This may happen in cases where the fundamental credit profile of the defaulting entity undergoes a significant change. Such change in credit profile may be because of change in ownership and/ or management, sizeable inflow of long-term funds, rescheduling of loans providing a material liquidity relief, benefits arising out of a favourable regulatory action, access to some form of explicit support from a stronger third-party or any other such discrete event that has a strong positive influence on the entity's/ instrument's credit quality. It is clarified that normal business-related developments like receipt of substantial new orders from customers are not construed as discrete events.

Also, there may be situations wherein the rating of an entity's debt facilities/ instruments is downgraded to the default category because of technical reasons. As an example, a rating may be downgraded to the default category because a formal approval from the lenders/ investors for a proposed rescheduling was not in place prior to the due date of payment because of some procedural reason (even though an in-principle approval was in place prior to the due date). In such instances, ICRA may consider upgrading the

<sup>3</sup> Passage of the minimum curing period is a necessary but not a sufficient condition for an upgrade from the default category. An entity's rating may continue to be designated as [ICRA]D, even after the passage of the minimum curing period, if ICRA assesses that the entity may again slip to the default status over the near term after a temporary period of regularity in debt servicing.

rating from the default category prior to the passage of the curing period once the formal approval from the lenders/ investors for rescheduling the payments is received.

In all cases where ICRA makes an exception to its policy, the same would be adequately disclosed in the rating rationale.

- » **Factoring in past defaults:** In rare circumstances, ICRA may become aware of delays in debt servicing by a rated entity with a considerable time lag. Accordingly, the rating of the debt facilities/ instruments of such an entity would not have been downgraded to the default category immediately at the time of the occurrence of the default. However, as soon as ICRA becomes aware of such delays, the rating would be downgraded to [ICRA]D. If by the time ICRA becomes aware of past delays, the debt servicing might have become regular over the course of the curing period, ICRA will recognize the past default by downgrading the rating to [ICRA]D. In such cases, the rating may also be simultaneously upgraded to a non-default category, in accordance with ICRA's policy outlined in this document.
- » **Other points:** The curing period principle for default category ratings would apply to both fresh rating assignments as well as surveillance assignments and usually at the entity level. This implies that if ICRA is rating an entity afresh, a non-default rating would not be assigned if the curing period post an earlier default on any instrument of similar seniority has not lapsed. However, for ratings on subordinated or hybrid bonds, since a default on such instruments may not necessarily imply a default by the entity on senior instruments, the curing period principle would apply at the instrument level. In case of default on subordinated or hybrid instruments, ratings on senior instruments may not be upgraded during the curing period for subordinated and hybrid instruments. Further, if a rated instrument is credit enhanced or there is a structure around the cash flows, the curing period will apply at the instrument level, as default by the entity on other instruments may not imply or lead to a default on a credit enhanced instrument.

## Annexure

Facilities	Definition of Default
<b>Fund-based facilities</b>	
Term Loan	A delay of 1 day even of 1 rupee (of principal or interest) from the scheduled payment date
Working Capital Term Loan	
Working Capital Demand Loan (WCDL)	
Debentures/Bonds	
Certificates of Deposit (CD)/ Fixed Deposits (FD)	
Commercial Paper	
Packing Credit (pre-shipment credit)	Overdue or unpaid for more than 30 days
Buyer's Credit	Continuously overdrawn for more than 30 days
Bill Purchase/Bill discounting/Foreign bill discounting /Negotiation (BP/BD/FBP/FBDN)	Overdue or unpaid for more than 30 days
Cash Credit	Continuously overdrawn for more than 30 days
Overdraft	Continuously overdrawn for more than 30 days
<b>Non-fund based facilities</b>	
Letter of Credit (LC)	Overdue for more than 30 days from the day of devolvement
Bank Guarantee (BG) (Performance/ Financial)	Amount remaining unpaid for 30 days from invocation of the facility
<b>Other scenarios</b>	
When the rated instrument is rescheduled	<p>Non-servicing of the debt (principal as well as interest) as per the existing repayment terms in anticipation of a favourable response from the banks of accepting the restructuring application/ proposal is considered as a default.</p> <p>Rescheduling of the debt instrument by the lenders prior to the due date of payment is not treated as a default, unless the same is done to avoid default or bankruptcy.</p>
Curing Period	<p>Generally 90 days for upgrade from the Default category to within the non-investment grade;</p> <p>Generally 365 days for upgrade from the Default category to the investment grade<sup>#</sup></p>

<sup>#</sup> ICRA may make exceptions to the above in cases where the fundamental credit profile of the defaulting entity undergoes a significant change, while being within the curing period window. Examples of these are outlined earlier in the document.

*Note:* The default definitions in the table above are principally based on the SEBI circular (SEBI/ HO/ MIRSD/ MIRSD4/ CIR/ P/ 2016/ 119) dated November 1, 2016 applicable to all credit rating agencies in India.



ICRA Limited

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