



Recognition of Default Criteria Methodology

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Summary

This document explains LRA's criteria for recognition of default. LRA believes that a clear definition of default and consistent adherence to the same is critical for a rating agency to ensure transparency in its default statistics and accurately reflects its performance.

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1. Definition of Default

Capitalized terms used herein are defined in Annexure I “Defined Terms”

1.1 Default, in plain terms, is a *failure to fulfill a contractual financial obligation* and all CRAs unanimously agree upon this basic definition. Thus, “*Default*” essentially means an obligor (*entity / issuer*) has not paid a financial obligation on its due date, which it is required to have paid. However, the *point in time* or the “*instance*” at which the default is deemed to have “*occurred*”, differs as per a CRA’s interpretation of the **Credit Event**.

1.2 In most cases, the *occurrence* of a Credit Event acts as a *pre-cursor* to an Event of Default, thus serving as a “*red flag*” for the rating agency to take appropriate rating action.

LRA defines **DEFAULT** as:

Failure of an obligor to make *timely payment of principal and/or interest* under contractual terms of any financial obligation

A distressed restructuring *whereby* the restructuring has the effect of *allowing* the obligor to avoid a payment default

This definition is *uniformly* applied both for capital market instruments and bank/financial institution’s facilities.

1.3 LRA’s Standard Rating Scale contains a *single* category indicating default with no *notching* - “**D**” (**Default**). The rating definition for this category is as follows:

“**D**” (**Default**): Obligations are *currently* in default

2. Events of Default

2.1 A *description and explanation* of each Event of Default *underlying* LRA’s definition of default is as follows:

2.2 Missed payment that remains “unremedied” after the grace period: This is an “**actual**” *missed interest or principal* payment on an issue/debt facility after the lapse of *originally contracted* grace period (also referred to as “*remedy*” or “*cure*” period) in accordance with documentation. The moment of *occurrence* of such an event is the “*First instance of the first Rupee default after the lapse of the grace period*”. However, payments made within the *originally contracted grace period* do not constitute default. This event of default is irrespective of the *extent of default* (what portion of debt obligation is not met, be it interest or principal)

2.3 Default-avoiding distressed restructuring: LRA includes pre-default distressed restructuring in its definition of default in order to *capture* events whereby an entity / issuer *effectively* fails to meet their debt service obligations, but do not *actually* miss a principal and / or interest or payment.

2.3.1 It is *noteworthy* that LRA does not consider restructuring, per se, as a credit event. In fact, it *clearly* distinguishes between restructuring as in *business as usual* and the one that constitutes an event of default:

- **Opportunistic restructuring:** This takes place during the normal course of business.
- **Distressed restructuring:** This takes place as an out-of-the-ordinary exercise to avoid default.

2.3.2 LRA's "establishing entity / issuer's intent to avoiding default" criteria rests on the following factors:

- 1. Entity / Issuer creditworthiness:** LRA measures *profitability, coverages, leverage, liquidity, cash flows* as defined in an applicable methodology and *covenant* levels to assess whether the entity / issuer has the ability to meet *upcoming* debt service payments. The analysis may point towards lasting *fundamental deterioration* in the financial profile of the underlying entity.
- 2. Characteristics of restructuring:** The characteristics of restructuring usually indicate the intent of the move, when viewed in combination with the entity / issuer's current creditworthiness. A restructuring exercise is deemed "*distressed*", if it:
 - i. Is undertaken at a time of *general economic / operating environment* distress rather than buoyancy;
 - ii. *Hints* at compulsion. Such compulsion may take the *form* of: (i) no *formal written* consent by the investors and/or furnishing oral / written consent of a few investors, "*forcing*" the other investors to agree to restructured terms, and / or, (ii) *Initiating / disclosing* restructuring too close to the repayment date to leave the investors *no choice* but to accept the new terms or else face loss in principal amount;
 - iii. Takes place at terms significantly *inferior* to those of the original (for instance, inclusion of any *subordination clause* in the restructured term sheet, pushing the *maturity* too far off from the original maturity, extending *grace period* on coupon / principal repayment, (*financial obligation materially diminished* relative to the original obligation, etc.)), or a default on financial obligations is sure to follow if the said restructuring *fails* to materialize.
 - iv. Involves a *larger portion* of the total debt

PLEASE REFER TO ANNEXURE: Recognizing Default – Course of Events

3. LRA's Policy for Recognizing Default

3.1 Recognizing default for a LRA rated issue: The term "**issue**" includes any form of contractual financial obligations such as: (i) Bonds / sukuk (*listed, privately placed with multiple institutions OR with a single institution*) and, (ii) Bank/Financial Institution loans / facilities.

- When LRA establishes that an event of default has occurred, it revises the issue rating to '**D**' (**Default**) irrespective of *ultimate recovery prospects*. Since there is *no notching*, hence, well secured, senior unsecured and subordinated issues are all rated "**D**".
- Corresponding entity / issuer rating is revised to "**D**" (**Default**).

3.2 When a LRA rated entity defaults on any one of their unrated OR non-LRA rated issues: When an entity with LRA ratings defaults on any of its *unrated borrowings or those that are rated, but not by LRA*, LRA considers the event putting *significant downward pressure* on respective LRA *outstanding instrument / bank loans / facilities* ratings and entity / issuer ratings as historical evidence shows that an entity / issuer defaulting on one contractual obligation is *highly likely* to default on others as well. Faced by such a scenario, LRA's policy for *recognizing default and Implications for ratings* are as follows:

- Outstanding Instrument / bank loan / facility ratings (*that are still performing*) are downgraded/revised, usually into **speculative grade** vs. **default** categories, if adequate mitigants are not seen found
- Outstanding entity / issuer ratings are immediately revised to **“D” (Default)**

3.3 Distressed Restructuring: Whenever a LRA rated entity / issuer and / or issue undergoes restructuring, the event warrants *revisiting* the rating opinion.

3.3.1 LRA employs judgment call to form an opinion as to the *type* of restructuring; whether opportunistic or distressed:

- If restructuring is deemed **opportunistic**, ratings are likely to be **“maintained”** or even **“adjusted higher”** as post-restructuring, the entity / issuer is considered to have a stronger base to service its financial obligations.
- If restructuring is deemed **distressed**, the *recognition of default* and *implications for ratings* materialize in a *three-phase* manner:
 - i. As soon as LRA establishes the entity / issuer’s plans / intent to **undertake** a distressed restructuring, all its issue and entity / issuer ratings are downgraded/revised, usually into the **speculative grade** categories.
 - ii. At the *first instance* of a distressed restructuring exercise being formally **implemented / completed**:
 - a. The issue ratings of the issue(s) being thus restructured and the corresponding entity / issuer ratings are revised to **“D” (Default)**
 - b. The issue ratings of issue(s), not part of the *distressed restructuring exercise*, may be affirmed at their recent downgraded status
 - iii. Hence, at the *culmination* of the entire distressed restructuring exercise, both the entity / issuer ratings and the issue ratings (*corresponding to issues that have been part of the distressed restructuring exercise*) would be standing in *default* category. *Post-restructuring*, these ratings are revised back to reflect *probability of default* as per the *restructured terms* and their likely impact upon the financial standing of the entity.

4. Other Judgement Considerations

4.1 “Intent / Willingness” to Default: *CLEAR* and *APPARENT* exhibition of the *“Intent to default”* by the entity / issuer overrides all indentures, credit enhancements, provisions for default protection and grace periods as a consideration for recognizing default. However, when the *“intent to default”* is **clear** and **apparent**, a **“D” (Default)** rating is not assigned *prospectively*. In such an eventuality, ratings are moved to **near-default** categories and revised into default categories *“at the first instance of the first Rupee”* default.

4.2 Bankruptcy filing or legal receivership by the entity / issuer: LRA defines bankruptcy as a *filing of insolvency in a court of law*. As such, it is expected to result in a legal finding that imposes *court supervision* over the financial affairs of those who are insolvent. Both *voluntary* and *forced* bankruptcy is considered a credit event. It would be an event of default only if it leads to actual default on any financial obligation.

4.3 Parent / subsidiary / associate default: When a rated / unrated entity / issue in a group defaults, the event exerts *significant pressure* upon the ratings of other entities / issues in the group and warrants *heightened vigilance* and an immediate review of the group’s creditworthiness and the nature of parent/subsidiary/associate relationships along with the stand-alone creditworthiness of each entity. Event of default would be *recognized* only when *cross default* and *obligation acceleration* provisions are present within the group companies. Otherwise, outstanding ratings are revised as per *respective implications*.

4.4 Securitization: The formation of a “*special purpose vehicle (SPV)*” as a funding vehicle by an entity does not necessarily “fireproof” the SPV and the real borrower against the spillover risk of default. The extent of credit risk despite the *theoretical* “bankruptcy remote” status of the SPV would be considered carefully to infer the implications upon ratings.

4.5 Corporate Guarantee: LRA considers a *failure to honor a corporate financial guarantee* a credit event. This credit event is relevant for: (i) an upstream guarantee, and (ii) a downstream guarantee. The credit event triggers an event of default for both the issuer / entity and the entity issuing the corporate guarantee, that is, the guarantor, *IF* the guarantee is “*invoked*” and not made good within the pre-agreed framework.

4.6 What Happens to Ratings Post-Default: Default is an “*all consuming*” event. Once the default is cured, the underlying entity / issuer is assigned a new rating as an initial rating based on the post-default fundamentals.

4.7 Putting Commercial Forbearance in Perspective: Commercial forbearance is a special agreement (*through a tacit / informal understanding*) between the entity and the trade creditor to alter the terms of payments, hence delaying a foreclosure. Commercial forbearance is generally:

- Manifested in the form of *revised payment terms and conditions* in response to an existing or anticipated payment default
- Offered industry-wide in response to an entity’s failure to honor its commitments as a direct result of *bottlenecks* in the *government machinery* or *temporary changes* in an *industry’s dynamics* and not weakness in its own credit profile.

4.8 Limitations posed by availability of information: LRA’s policy of recognizing default is subject to limitations posed by availability of information. Hence, the timing of the reporting of default by LRA may or may not coincide with the actual date of the missed payment.

4.8.1

In the Sri Lankan context, under IFRS 9 regulations, the Central Bank of Sri Lanka (CBSL) mandates that banks and financial institutions classify exposures as non-performing (default) if there is a missed payment for ninety (90) days. Additionally, for banking facilities, apart from the entity itself or its lenders/bankers (which are considered insider sources), there is limited availability of independent information sources for tracking and detecting timely loan payments in the local market.

In the wake of COVID-19, CBSL, subject to fulfillment of requisite conditions, offered certain relaxations in the criteria for the restructuring/rescheduling of loans. That was coupled with permission to defer principal payments on loan obligations, and the time period to classify an exposure as non-performing had been extended to 180 days.

4.8.2 Faced by such an information constraint, LRA commits to recognizing defaults on a best-efforts basis only. Particularly, it has to be through sources, which cover a significant portion of the rated universe.

4.9 Technical Default: A contravention in debt covenants ⁱⁱ is not necessarily considered an event of default, though it may be technical default ⁱⁱⁱ. Its impact, if any, on the creditworthiness of the entity / issuer, would be reflected in the rating.

5. Regulatory Requirements

LRA's Compliance for Methodology for Recognition of Default	
SEC Rules relating to Credit Rating Agencies SEC Act No 19 of 2021	
SEC Rules	Code Clause
Rule no 40 Every Credit Rating Agency shall publish on its website: (a) The rating Criteria and methodology that it follows in the rating analysis in order that ratings are consistent and transparent, using all information available to it, and considered relevant by the Credit Rating Agency (b) Rating symbols and scales that are to be used and their individual meanings (c) its definition of “default” taking into consideration the timeliness of payment or performance of debt obligations and recovery values expected after a default. (d) a list of issues downgraded due to a default. (e) a historical record of any default during the preceding period of five (5) years; and	The Methodology has been developed and disseminated on the website

ⁱ **Voluntary and forced bankruptcy:** Voluntary bankruptcy is filed by the debtor itself, whereas, forced bankruptcy is filed as a petition by the creditor(s) against the debtor to force the latter into bankruptcy

ⁱⁱ **Covenants:** Affirmative covenants are clauses in debt contracts that require firms to maintain certain levels of capital or financial ratios. The most commonly violated restrictions in affirmative covenants are tangible net worth, working capital/short term liquidity, and debt service coverage. Negative covenants are clauses in debt contracts that limit or prohibit corporate actions (e.g. sale of assets, payment of dividends) that could impair the position of creditors. Negative covenants may be continuous or incurrence based. Violations of negative covenants are rare compared to violations of affirmative covenants

ⁱⁱⁱ **Technical default:** Technical default happens when an affirmative or a negative covenant is violated

6. Annexure I

Credit Event	A tangible (negative) change in a borrower's or entity / issuer's credit standing, which brings into question its ability to repay its financial obligations.
Distressed Restructuring	Restructuring as a reactive attempt to avoid default amidst an existing pressure on entity / issuer's financial profile pointing towards imminent default if restructuring fails to take place.
Events of Default	Events / Instances signaling that “Default” has taken place. Events of Default always take place in retrospect and can never be prospective. Events of Default include both an actual default (that is, the failure to pay principal or interest when it falls due for payment), and imminent default (when payment is not yet due, but it is clear that it will not be paid when it does fall due – as in the case when the entity / issuer has already begun liquidation proceedings or when a formal plan to restructure has been announced).
Grace Period	The time period stipulated in the original loan contract / instrument indenture / term sheet during which a late payment will not result in any penal (interest) charges, cancellation of loan / instrument agreement and / or triggering of an Event of Default.

Opportunistic Restructuring

Restructuring as a proactive, pre-emptive attempt to take advantage of change in entity / issuer's profile, market liquidity and / or interest rate dynamics with no existing (pre-restructuring) pressure seen on financial profile and ability to repay upcoming debt obligations.

