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September 15, 2020

Loan Restructuring and Rating Implications

This document outlines the rating implications, particularly relating to default recognition, in the context of the circular issued by the Securities and Exchange Board of India on [August 31, 2020](#) and the circular issued by the Reserve Bank of India on [August 6, 2020](#). This document also expresses the broad approach that ICRA would be taking to assign and review the ratings of entities that apply/ intend to apply for loan restructuring as part of the resolution framework for Covid-19-related stress, specified by the RBI. Some Frequently Asked Questions (FAQs) on this subject are answered below.

Q1. What does the existing default recognition policy of ICRA specify?

As per ICRA's existing [policy on default recognition](#), which is based on the guidance provided by SEBI vide its circular dated [November 1, 2016](#):

- » *Non-servicing of debt as per the existing payment terms in anticipation of a favorable response from the lenders on accepting the restructuring application is considered a default*
- » *Rescheduling of debt, even if prior to the due date of payment, is treated as default if the rescheduling is done to avoid default*

Q2. What are the relaxations permitted by SEBI vide its circular of August 31, 2020 in respect of default recognition?

As per the latest SEBI circular, if a loan restructuring is affected by the lenders/ investors solely because of the COVID-19-related stress faced by a rated entity or under the aforementioned RBI framework, the same need not be considered a default by the Credit Rating Agencies (CRAs). Thus, even if such restructuring is done to avoid default, it need not be considered a default. This is going to be a departure from the existing default recognition policy outlined in Q1 above. However, such deviation from the existing policy is temporary and permitted by SEBI only until December 31, 2020. Accordingly, until the above period, if a rated entity's loan is restructured by the lenders/ investors because of COVID-19-related stress, ICRA would not consider such instances as default even if such restructuring would likely have the effect of avoiding default. However, ICRA would disclose the above aspect in its press releases, as guided by SEBI.

Q3. What is the RBI direction to the lenders in terms of asset classification norms to be followed for the accounts that are restructured?

The RBI, vide its circular of August 6, 2020, has specified to the lenders that the asset classification of the loan accounts that are restructured could remain as "Standard", even when the RP does not involve a change in ownership. However, the circular does not provide for any standstill on asset classification/ SMA status transition upon missed payments during the period that the RP is invoked or implemented¹. This implies that during the

¹ This is unlike what was allowed as per one of the earlier RBI circulars dated [March 27, 2020](#), whereby a standstill applied on asset classification during the moratorium period, if the relief was provided specifically to enable the borrowers to tide over the economic fallout from COVID-19.

period of invocation/ implementation of the RP, a missed payment by a borrower may not halt its transition from a non-SMA account to SMA-0; or from SMA-0 to SMA-1; or from SMA-1 to SMA-2.

Q4. What is going to be ICRA's broad approach to default recognition during the period of loan restructuring?

As per clarifications provided by the RBI, in the period of loan restructuring, the CRAs are guided to follow a different approach towards treating missed payments as default, as compared with the direction given to the lenders for asset classification. As an example, if a rated entity applies for loan restructuring prior to the due date but misses its payment obligations in the interim period between the application and the invocation of the RP, such instance may not be treated as default if an interaction with the lenders suggests that the RP would likely be invoked in due course. This approach is guided to be followed amid the exceptional circumstance created by COVID-19 and the possibility of procedural delays that the borrowers may have to contend with during the period that the resolution plans (RPs) are invoked/ implemented by the lenders.

Q5. What are the various scenarios that may play out and what is going to be ICRA's rating approach in such scenarios?

Given below are select scenarios and the broad rating approach that ICRA would adopt in these scenarios:

S.N.	Scenario	ICRA's Rating Approach
1	<p>A rated entity applies for loan restructuring prior to the due date but misses its payment obligations in the interim period between the application and the invocation (and/ or implementation) of the RP by the lenders. Further, ICRA's interaction with the lenders suggests that the RP would likely be invoked/ not rejected in due course.</p> <p><i>Note: For considering adopting the approach mentioned alongside, ICRA would need documentary evidence from the rated entity of having applied to the lender(s) for loan restructuring, prior to the due date.</i></p>	<p>Such missed payment may not be considered as default by ICRA. However, the ratings may be placed on "Watch" to reflect the uncertainty around whether the RP would be invoked, and if invoked what the terms of the resolution/ restructuring might be.</p> <p>Even upon invocation of the RP by the lenders, the "Watch" may be retained until the implementation of the RP. The "Watch" would reflect the uncertainty around the terms of the RP that may get finalized eventually, the uncertainty around whether the lenders would consider the RP rating assigned by CRAs favourably (applicable for exposures greater than Rs. 100 Crore), and whether the RP process would be vetted by the Expert Committee (applicable for exposures greater than Rs. 1500 Crore).</p> <p>The placement of ratings on "Watch" does not preclude the possibility of a rating downgrade. More on this later in the document.</p>
2	<p>A rated entity applies for loan restructuring prior to the due date but misses its payment obligations in the interim period between the application and the invocation (and/ or implementation) of the Resolution Plan (RP) by the lenders. Further, ICRA's interaction with the lenders suggests that the RP would likely be invoked in due course. Based on</p>	<p>The earlier missed payment would be recognized as default if the dues are not cleared within a reasonable timeframe or within the timeframe specified by the lender(s).</p>

S.N.	Scenario	ICRA's Rating Approach
	the above, ICRA does not immediately recognize the missed payment as Default (as per the approach mentioned in Scenario 1 above). However, later it becomes known to ICRA that the RP is not invoked/ implemented.	
3	A rated entity applies for loan restructuring prior to the due date but misses its payment obligations in the interim period between the application and the invocation of the RP by the lenders. However, ICRA's interaction with the lenders suggests that the RP is unlikely to be invoked.	Missed payment to be considered as default. However, if the RP is later invoked and implemented, the rating may be upgraded to a level commensurate with the post-restructuring credit profile, in accordance with the "curing period" policy/ exceptions specified in ICRA's policy on default recognition ² .
4	A rated entity applies for loan restructuring post the due date having missed its payment obligations.	Missed payment to be considered as default
5	A rated entity that has capital market instruments (securities) on its balance sheet approaches its investors for restructuring of the payment terms. The entity misses its payments even as neither a formal approval nor an in-principle approval is provided by the investors prior to the due date.	Missed payment to be considered as default.

While the above table outlines the broad approach, the overall credit assessment by ICRA would involve a case-by-case analysis and judgment. Further, the approach would be subject to change if there are further developments/ clarifications from the regulators.

Q6. What would be the broad approach that ICRA would follow for assigning/ reviewing the ratings of entities that apply for loan restructuring or once the loan restructuring is implemented?

As per ICRA's estimates, around 5-8% of the banking system's loans would come up for restructuring as part of the resolution framework specified by the RBI in its August 6, 2020 circular. Further, the Expert Committee constituted by the RBI has specified some specific [financial metrics](#), that define the contours within which the lenders are expected to formulate resolution plans. In the extant period of uncertainty around what the revised terms would be for the payment of restructured loans, ICRA would be adopting the approach mentioned in S.N. 1 below for assigning and reviewing the ratings. Further, once the RP is implemented, ICRA would review the rating based on the revised loan terms.

² Once the RP is implemented, the rating of a defaulting entity would be reviewed as per the revised loan terms specified in the RP. Given that the asset classification norms specified by the RBI for the lenders (as per the August 6, 2020 circular) allow an upgrade of the account to Standard (if it slipped into the NPA category) post the implementation of the RP, ICRA too may consider upgrading the rating immediately post the implementation of the RP. This would be in line with the 'Curing Period' principles outlined in ICRA's existing policy on default recognition

S.N.	Scenario	ICRA's Rating Approach
1	<p>The RP is yet to be implemented</p> <p>An entity's credit profile has weakened because of business disruption caused by COVID-19. Without any loan restructuring, the entity's rating was expected to be downgraded sharply. However, because of a possible loan restructuring, the adverse pressures on the credit profile are expected to be mitigated somewhat.</p>	<p>While a loan restructuring could be expected to partially mitigate the credit pressures, the same may not be affected in a manner or intention of restoring the entity's credit profile. This implies that in the period that the RP is in the process of being invoked and implemented, an entity may experience a rating downgrade based on ICRA's assessment of the degree of erosion of its business profile to the extent that it is unlikely to be offset by the loan restructuring.</p>
2	<p>The RP is implemented</p> <p>The revised loan terms have been finalized by the lender(s).</p>	<p>ICRA would review the rating on a case-by-case basis which would involve an assessment of the credit profile based on the revised loan terms.</p>

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