The Pakistan Credit Rating Agency Limited

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Recognition of Default Criteria

Methodology

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Summary

This document explains PACRA's criteria for recognition of default. PACRA 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

1.1 **Default** is the failure to fulfill a contractual financial obligation. An occurrence of a default means that an obligor (entity/issuer) has not paid a required financial obligation in full (the total due amount) and timely manner (on its due date). The point in time (or instance) at which the default is deemed to have occurred, differs as per a PACRA'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 PACRA to take appropriate rating action.

PACRA defines a default as:

i. Failure of an obligor to make a timely payment of principal and/or interest under contractual terms of any financial obligation
ii. A **distressed restructuring** whereby the restructuring has the effect of allowing the obligor to avoid payment default

This definition is uniformly applied for both capital market instruments and banking/financial institution's facilities

1.3 PACRA's Standard Rating Scale contains one category indicating default with no notching: "D" (Default). The rating definition for this category is: "Obligations are currently in default".

2. Events of Default

2.1 A description and explanation of each event of default underlying PACRA's definition of default is as follows:

2.1.1 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).

2.1.2 Default-avoiding distressed restructuring: PACRA 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.

It is noteworthy that PACRA does not specifically consider restructuring as a credit event. PACRA distinguishes between restructuring as in "business as usual" and restructuring as in an event of default:

i) Opportunistic restructuring: This takes place during the normal course of business to benefit from change in market conditions.
ii) Distressed restructuring: This takes place as an out-of-the-ordinary exercise to avoid default.

2.2 PACRA's criteria pertaining to establish an entity/issuer's intent to avoiding default rests on the following factors:

i) Entity/Issuer Creditworthiness: PACRA 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.

****Bold** *terms used herein are defined in Annexure I "Defined Terms"*

ii) 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:

- **a.** Is undertaken at a time of general economic/operating environment distress rather than buoyancy;
- **b.** 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;
- **c.** 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.
- **d.** Involves a larger portion of the total debt.

3. PACRA's Policy for Recognizing Default

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

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

3.2 When a PACRA rated entity defaults on any one of their unrated OR non-PACRA rated issues: When an entity with PACRA ratings defaults on any of its unrated borrowings or those that are rated, but not by PACRA, PACRA considers the event putting significant downward pressure on respective PACRA 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, PACRA's policy for recognizing default and Implications for ratings are as follows:

- Outstanding instrument/bank loan/facility ratings (that are still performing) and downgraded/revised usually into speculative grade or default categories if adequate mitigants are not found.
- Outstanding entity/issuer ratings are immediately revised to speculative grade or "D".

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

3.3.1 PACRA 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 PACRA establishes the entity/issuer's 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:
   - The issue ratings of the issue(s) being restructured and the corresponding entity/issuer ratings are revised to "D".
   - 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" 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: PACRA 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: PACRA 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 into 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. 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: PACRA's policy of recognizing default is subject to limitations posed by availability of information. Hence, the timing of the reporting of default by PACRA may or may not coincide with the actual date of the missed payment.

4.8.1 In the local context, the State Bank of Pakistan (SBP) – under IFRS 9 regulations – requires banks/DFIs to classify exposures as non-performing (default) after ninety (90) days have elapsed on a missed payment. Moreover, for bank facilities especially, apart from the entity itself or its lenders/bankers (both of which are insider sources of information), two Credit Bureaus report overdue payments on loans taken from financial institutions. However, Credit Ratings Agencies do not have access to credit bureaus reports under current regulations. Thus, PACRA currently does not have any independent source(s) of information to rely upon to track and detect timely loan payments. In case of debt instruments, where a mutual fund has invested, information availability is relatively better. In such cases, Mutual Funds Association of Pakistan (MUFAP), a reliable source of information, recognizes default on an instrument after offering a forbearance period of fifteen (15) calendar days.

4.8.2 In the wake of COVID-19, SBP and SECP, 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. SECP offered similar relaxations for debt instruments. Arrangements of this sort, even if temporary, further enhance information asymmetry in recognition of default or classification of restructuring.

4.8.3 Faced by such an information constraint, PACRA 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.

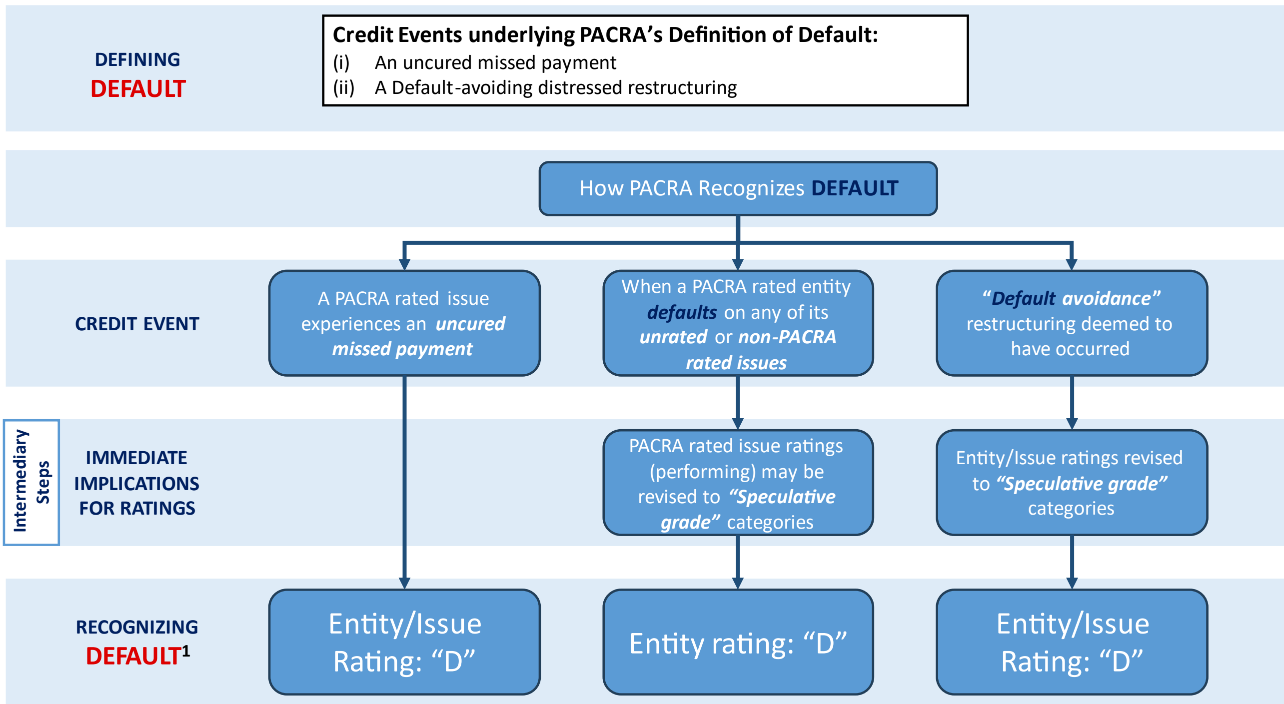
4.9 Technical Default: A contravention in debt covenants is not necessarily considered an event of default, though it may be technical default. Its impact, if any, on the creditworthiness of the entity/issuer, would be reflected in the rating.

5. Regulatory Requirements

PACRA's Compliance for Recognition of Default Methodology	
Forum	**Regulatory requirement/international best practice**
Securities Exchange Commission of Pakistan *[SECP Credit Rating Companies Regulations, 2016, September 19, 2022]*	**ANNEXURE G – Criteria and Methodologies to be Developed and Disclosed by a Credit Rating Company/Agency:** "The criteria, methodologies and procedures to be developed and disclosed by a credit rating company shall include at least the following: (ix) Definition of default and calculation of the default rates. Code Clause: The methodology has been developed and disseminated on the website.

6. Annexure I

Defined Terms	
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/Curing 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.



[1]After the occurrence of the credit even, PACRA retains the right to recognize default immediately, without observing any intermediary steps