Policy on Definition and Recognition of Defaults

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1. Introduction

- Currently, Vietnam has not had explicit regulations or definitions on the classification of credit rating when an issuer fails to repay its debt obligations (including interest and/or principal payment of specific or group debt instruments) when they are due, referred to as “Default”.
- Current regulations in Vietnam on credit rating services require credit rating agencies to disclose on the official website the following information: “Once every six (06) months, the credit rating agency must disclose on the official website the following basic statistics: Average rate of full and timely fulfillment of debt obligations of rating category” (Clause 2, Article 36, Decree 88/2014/ND-CP, referred to as “Decree 88”)”.
- According to international and regional practices, a credit rating agency should define and publish their policy on the definition of default as part of their rating operation for its communication to market.

2. The Purpose

The definition of default plays crucial roles in FiinRatings’ rating methodology:

- Ensure transparency in credit rating operation: clarifying the meaning of each rating scale and assigning for each issuer of ratings and surveillance thereafter.
- Assist investors in monitoring the changes in assigned ratings and detecting default events early.
- Create a premise to conduct research and statistics on the performances of rated issuers and debt instruments
- For regulatory reporting purposes in compliance with Decree 88/2014/ND-CP.

3. The Scope of Application

This policy on default recognition applies to companies under rating coverage by FiinRatings and the following debt instruments (“issues”):

- Corporate bonds;
- Bank credit;
- Financial debt instruments;
- Structured finance instruments;
- Other long-term and Short-term debts; and
- The Issuer/ Guarantor of the aforementioned instruments.

This policy does not apply to trade payables (including accounts payable, advance from customers, deferred revenue); tax and payables to the State; employee payables; and other payables.

4. Definition of Default and Related Rating Scales

For Issuer Credit Rating:

- “SD” (Selective Default): the rating applied when FiinRatings believes that:
    - an issuer selectively fails to pay principal and/or interest on a specific issue or a class of obligations and FiinRatings evaluates that it will continue to repay other financial obligations of other issues or classes of obligations in a timely manner.
    - “SD” can also be applied to an issuer being under special control or receiving support from the regulators owing to its financial distress, in which the regulator may have the power to support the Issuer to meet certain obligations and not others.
- “D” (Default): the rating applied when an issuer fails to timely pay principal and/or interest for a specific issue or a class of obligations and FiinRatings evaluates that it will hardly be able to fulfill its financial obligations on other issues or classes of obligations in a timely manner.

An issuer can be assigned “SD” or “D” rating when the issuer is undergoing debt restructuring due to financial distress.

For Issue Credit Rating:

- “D” (Default): An issue will be assigned “D” when the issuer fails to fully and timely fulfill financial obligations on an or several obligations arising from that specific issue.
- An issue can also be assigned “D” rating when the issue is undergoing a debt restructuring process due to financial distress.

5. Recognition of Defaults Policy

5.1. Recognition of defaults

❖ ***Default recognition for Bonds, Term Loans, and other financial instruments with pre-determined repayment schedules***

FiinRatings considers a default has occurred when:

- An Issuer fails to fulfill financial obligations arising from a financial instrument, FiinRatings recognizes default on the first instance of a missed payment related to that financial instrument; or
- An Issuer or one of its lenders (the creditor of loans and finance lease, bonds, or other interest-bearing debt instruments) files for the Issuer’s bankruptcy as a signal of the Issuer’s inability to fulfill financial obligations in a timely manner, or
- An Issuer conducts a distressed debt restructuring.

❖ ***Default recognition for financial instruments with no pre-determined repayment schedules***

- For financial instruments/ facilities that do not have scheduled maturity/ repayment dates such as line of credit, FiinRatings recognizes the event as a default only if the facilities remain continuously overdrawn for more than thirty (30) days, without the express written consent of creditors. Though over-utilization of a facility by a few days may not necessarily indicate stress in the borrower’s credit quality, facilities overdrawn for more than thirty (30) days indicate weakness and deterioration of borrower’s credit worthiness, and creditors need to classify such exposures under the Special Mention Loan account (SML).

❖ ***Default recognition for hybrid instruments***

- FiinRatings rates hybrid instruments on the same scale as conventional financial instruments. Ratings assign on hybrid instruments reflect the likelihood of timely servicing of the instrument. Hence, if the issuer skips or delays the payment on the instrument, FiinRatings considers a default has occurred on the first instance of a missed payment and the rating on the hybrid instrument will be lower to D.

❖ ***Default recognition for financial instruments backed by guarantee***

- In case of financial instruments backed by guarantee from a third party, there should exist a clear payment mechanism. The documents should state that in case the issuer is unable to make the payment as per the terms outlined in the payment mechanism, the guarantor will clear all the dues on the guaranteed financial instrument, within the time stipulated in the payment mechanism when the trustee/ banker invokes the guarantee. In case the instrument is not serviced within the timelines mentioned in the payment mechanism, FiinRatings considers a default has occurred and immediately will downgrade the rating on the guaranteed instrument to the default category.

5.2. Possible exceptions

In the following cases, FiinRatings will apply reasonable judgment to determine whether an event of default has occurred:

- Delays or missed payments due to non-credit administrative errors which are expected to be resolved within a few working days (e.g., delay in payment caused by connection errors of banks, human errors in doing paperwork, or errors from Third Parties);
- Delays or missed payments due to non-credit extraordinary events (e.g., wars, natural disasters, fires, epidemics);
- There is a stated grace period in the original agreements: the payment must be made within the stated grace period;
- Suppliers, employees, or other partners of the Issuer file for the Issuer's bankruptcy due to delays in payment for commercial or other liabilities that are not under the Scope of this document;
- An exchange offer or issue maturity extension/ reschedule conducted well in advance of the original maturity date and where creditors receive compensation in the form of amendment fees, a higher interest rate, a beneficial change in the instruments seniority, or an increase in, or the introduction of, security interest;
- The renegotiation of a bilateral bank loan is conducted in the normal course of a business unless there is clear evidence that the renegotiation is distressed;
- An Issuer conducts an opportunistic debt restructuring.

5.3. Rating actions implemented when default has occurred

When an entity defaults on an instrument rated by FiinRatings, the issue rating assigned to that instrument is lowered to "D".

An issuer rating is lowered to "SD" (selective default) when it fails to service one or more of its financial obligations (rated or unrated), but the default will be limited to that specific financial obligations and the entity will continue to honor other financial commitments in a timely manner. An issuer rating is assigned "D" when an entity defaults on a financial obligation or several financial obligations and is expected to default on all, or nearly all, of its other financial obligations.

5.4. Retrospective recognition of past defaults

FiinRatings conducts periodic surveillance of the credit profiles of Issues and Issuers that are rated by FiinRatings. However, in some cases where FiinRatings has not yet recognized defaults on rated Issuers and Issues, the related obligations have subsequently been fulfilled in full, FiinRatings will retrospectively revise the assigned ratings to "D" or "SD" at the date of the event of default, then immediately makes a rating upgrade to an appropriate level according to the current situation, taking into account the adequacy and timeliness of the debt instruments and the Issuer's payment history.

6. Monitoring Post Default

Once a default has occurred, FiinRatings monitors whether the issuer has cleared overdue amounts and monitors its repayment performance of other debt obligations. When the issuer services its financial obligations in a timely manner for at least ninety (90) days from the date of the original repayment schedule, FiinRatings can upgrade its credit rating. Generally, the rating would move to speculative rating categories (BB+ or lower) after the default is recovered. In order to upgrade the credit rating to investment grade categories (BBB- or higher), monitoring during curing period post-default typically extends to at least three hundred sixty five (365) days from the date of original repayment schedule. However, the assigned rating could be revised only if FiinRatings believes the creditworthiness of obligor is sustainably improved.

Upgrade revision in the rating could be driven by the following factors (including but not limited to):

- Sustainable improvement in business risk profile
- Sufficient liquidity to manage working capital requirements and debt obligation
- Improvement in financial risk profile, indicating comfortable debt coverage indicators and balance sheet strength to support business requirements in the medium term

However, FiinRatings may consider other cases and not limited to the above-mentioned curing period timeline, on a case-to-case basis, if FiinRatings believes the situation that led to default earlier, may not recur in the near term. Some of the instances that could lead to the aforementioned conclusion have been listed below (but not limited to):

- Change in management
- Acquisition by a stronger firm
- Sizeable inflow of long-term funds
- Benefits arising out of a regulatory action
- Force majeure event leading to default
- Restructuring of loans, as long as business risk profile of the company continues to remain strong

Appendix 1: Terminology

- ***Short-term debts:*** financial obligations that issuers have obligations to repay within twelve (12) months or less.
- ***Long-term debts:*** financial obligations that issuers have obligations to repay in more than twelve (12) months.
- ***Initial disbursement date***: is the date of the first disbursement of any Loan/Debt proceeds by the Lender to the Borrower as determined by the loan agreement.
- ***Repayment period***: refers to periods as agreed in the loan agreement and at the end of these periods, the Borrower must repay debt principal and/or interest amounts in part or in whole to the Lender.
- ***Debt tenor:*** the period of time starting on the day following the initial disbursement date and ending on the day when Borrower repays in full debt principal and interest amounts.
- **Credit Limit** – the maximum amount of Loan set up for the Borrower, up to which the Borrower can use the Loan flexibly.
- ***Grace Period:*** the period of time after the determined date of payment that is given to the Borrower to fulfill its debt obligations with little or no consequence resulting from failure to meet the initial deadline.
- ***Debt restructuring:*** the process that allows in which the Borrower and the Lender negotiate, agree upon, and modify initial terms and conditions related to specific debt obligations. The debt restructuring process typically involves, but is not limited to, the following approach:
    - Restructuring the payment term: the Lender agrees to extend the debt tenor to repay principal and/or interest amount in part or in whole including late payment penalties (if any). The period of time when the Borrower is allowed by the Lender to extend the repayment period is called the debt extension period.
    - Restructuring the principal or interest of the debt: the Lender agrees to waive or reduce the principal or interest amount in part or in whole, including late payment penalties (if any).
    - Debt to equity swap: the Borrower and the Lender agree to convert principal and/or interest amount in part or in whole into equity shares of the Borrower.
- ***Distressed debt restructuring***: the debt restructuring in which FiinRatings assesses that the investor will receive less value than promised when the original debt was issued, and there is a realistic possibility of a conventional default if the debt restructuring does not take place.
- ***Opportunistic debt restructuring***: the process that occurs when the Borrower takes advantage of favorable conditions in the market to bring financial benefits to the organization. Even without debt restructuring, the Borrower still has the ability to fully and timely fulfill debt obligations in the short to medium term.
- ***Bankruptcy:*** the situation when an enterprise or a cooperative becomes insolvent and is declared bankrupt by the People's Courts having jurisdiction.
- ***Hybrid financial instruments:*** instruments that have both the characteristics of a debt instrument and the characteristics of an equity instrument such as convertible bonds, loans with options to convert to equity, or other benefits to the creditors.

About FiinRatings

FiinRatings Joint Stock Company is an independent credit rating agency licensed by the Ministry of Finance on March 20, 2020. FiinRatings provides credit rating services for issuers and their debt instruments and other relevant services for investors. Furthermore, on March 10, 2022, FiinRatings was officially approved by the Climate Bonds Initiative (CBI) as the first authorized company in Vietnam to verify green bonds issued by Vietnamese businesses.

For further information, please visit: https://fiingroup.vn/FiinRatings.

For analytical inquiries

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