An Analysis of Defaults of Long-term Rated Debts

Suveera Gill

Lately, the credit rating agencies have been the subject of significant criticism for failing to warn the investors of the defaults well in advance. Investors in long-term debt instruments are usually risk averse, buy-and-hold types; and hence, for them, the variability of investment-grade default rates is particularly important since they employ simple investment-grade rating cut-offs in the design of their investment eligibility plan. According to ICRA (Investment Information and Credit Rating Agency of India) and the other credit rating agencies, default means that the company has either already failed in the payment of interest and/or principal as per terms or is expected to fail. The debt rating at no time informs as to how much bond face value holders would recover in the event of a default. The present regulations pertaining to the credit rating agencies preclude the investors and issuers from suing agencies for awarding a particular rating. Hence, credit ratings are of value only as long as they are credible.

This paper tests the reliability of ratings assigned by ICRA on the basis of the actual default rate experience on long-term debt across five sectors over a period of seven years, i.e., 1995-2002. The reason for including only long-term debt instruments for the purpose of analysis is that the assigned rating and its movement can be observed only over a long period. Since the credit rating agencies do not publish ratings that are not accepted by the issuers, this study is limited to only those issues that have been accepted and used by the issuers. The default statistics were examined sector-wise, period-wise, and company/institution-wise. Analyses of the background and business, operating performance, management and systems, financial performance, prospects, key issues, and the reasons cited for defaults were undertaken with respect to all the companies. Simple metrics like default rates by rating grades and rating prior to default were used to analyse whether low ratings (i.e., speculative-grade ratings) were assigned by ICRA to defaulting credits well in advance of default rate. Further, an attempt was made to identify whether companies in default had issued other debt instruments that were rated by other credit rating agencies.

The findings highlight the following:

- The performance of the manufacturing sector vis-à-vis other sectors has been dismal.
- The period of high defaults (1997-1999) coincides with a high interest regime and poor economic conditions in India.
- ICRA’s performance in terms of proper surveillance and provision of timely and complete information about the companies rated by them has not been up to the mark.

The findings certainly draw attention towards the fact that excessive reliance on credit rating needs to be reduced. Since the governance of the credit rating agencies is questionable, adequate steps have to be taken to make them more accountable.
The spate of financial crises and scandals have invited vehement public criticism of the credit rating agencies for failing to give timely warning of the impending crisis. The credit rating system is supposed to alert investors against the issuers who are prone to default (Gupta, Gupta and Jain, 2001). Default is the risk that a firm will fail to make obligated debt payments such as the interest expenses or principal payments. The reliability of ratings can be established on the basis of the actual default rates over a reasonably long period. In the absence of a systematic study of default rates on credit rated instruments in India, it is not known whether the credit rating truly reflects the average default rate for each rating class. This study tries to plug this research gap.

This paper measures ICRA’s (Investment Information and Credit Rating Agency of India) rating performance based on the rating history and the default experience of long-term debt instruments between April 1995 through March 2002. Credit rating in India is a concept with not too long a history. Four credit rating agencies are operating in India: The Credit Rating and Information Services of India Ltd. (CRISIL), ICRA Ltd., Credit Analysis and Research Ltd. (CARE), and Fitch Ratings India. Regulations promulgated by the Securities and Exchange Board of India (SEBI) govern the holdings of debt with reference to its rating by the credit rating agencies.

The credit rating agencies describe their ratings as a symbolic indicator of the current opinion on the relative capability of the issuer to service its debt obligation in a timely fashion, with specific reference to the instrument being rated. At the same time, they categorically specify that ratings are at best well informed opinion and provide no guarantee/assurance against default risk.

This paper presents three facts about credit ratings. First, that the defaults on ICRA-rated long-term debt instruments are the highest in the manufacturing sector followed by the financial services sector. The other three sectors, i.e., financial institutions/banks, state level institutions, and sub-sovereign sectors have neither defaulted in the payment of interest and/or principal as per terms nor are expected to default. There are two possible interpretations of the tendency for high defaults in the manufacturing sector. One is that the maximum number of debt instruments have been rated in this sector. ICRA has rated debt instruments since August 31, 1991. During 1995-02, there were 316 debt issues for which rating was assigned by ICRA and accepted by the issuers out of which 203 were for the manufacturing sector alone. Two, the other sectors are also governed by stringent regulations imposed by the central and/or state governments. For example, the banks and financial institutions are governed as per the guidelines of the Reserve Bank of India (RBI).

The second fact arises from a comparison of the number of defaults during the period under study, i.e., 1995-02. The highest number of defaults was for the period 1997-99 while there were no defaults for the period 1995-96. The period of high defaults coincides with the poor economic conditions and a high interest rate regime in India.

The third relates to the fact that ICRA has not been fully successful in performing its function of proper surveillance and providing timely and complete information about the companies rated by them. The level and variability of investment-grade default rates are particularly important for the investors who employ simple investment-grade rating cut-offs in the design of their investment eligibility plan (Sehgal and Arora, 1999). Further, the rating prior to default is reflective of the rating agencies’ success at assigning the lowest ratings to companies that subsequently default. ICRA has not only underperformed on account of these two reasons but also due to the fact that, in some cases, it has not disclosed the rationale for default in its Rating Profile.

CREDIT RATING IN INDIA

In India, the credit rating agencies are governed by the SEBI Regulations, 1999 and the SEBI (Amendment) Regulations, 2003. Accordingly, any body corporate that is engaged in or proposes to be engaged in the business of rating of securities has to obtain a certificate of registration from the SEBI and comply with the provisions of the Act.

Further, according to the SEBI (Disclosure and Investor Protection) Guidelines, 2000, a company offering convertible/non-convertible debt instruments through an offer document must comply with the requirements of credit rating. The provisions are as follows:

- No public or rights issue of debt instruments (including convertible instruments) in respect of their maturity or conversion period shall be made unless credit rating from a credit rating agency has been obtained and disclosed in the offer document.
- For a public/rights issue of debt security greater...
than or equal to Rs 1 billion, two ratings from two
different credit rating agencies shall be obtained.
• In cases where credit rating is obtained from more
than one credit rating agency, all the credit rat-
ing/s, including the unaccepted credit ratings, shall
be disclosed.
• All the credit ratings obtained during the three
years preceding the public or rights issue of debt
instrument (including convertible instruments) for
any listed security of the issuer company shall be
disclosed in the offer document.

According to Chapter X of the SEBI (Credit Rating
Agency) Regulations, 1999, a credit rating agency shall
not withdraw a rating so long as the obligations under
the security rated by it are outstanding, except where
the company whose security is rated is wound up or
merged or amalgamated with another company.

According to Chapter III on ‘General Obligations of
Credit Rating Agencies’ of the SEBI (Credit Rating
Agencies) Regulation, 1999, every credit rating agency
during the lifetime of securities rated by it shall
continuously monitor and disseminate information
regarding the newly assigned ratings and the changes
in earlier rating promptly through press releases and
websites, and in the case of securities issued by the listed
companies, shall also provide such information simultaneoulsy to the concerned regional stock exchange
and to all the stock exchanges where the said securities
are listed. Further, every credit rating agency shall make
available to the general public information relating to
the rationale of the ratings which shall cover an analysis
of the various factors justifying a favourable assessment
as well as the factors constituting a risk.

The credit rating agencies receive a revenue by
charging the rating fee and the annual surveillance fees
on the debt instruments rated by them. Further, all the
travel and out-of-pocket expenses incurred by the credit
rating agencies during the rating process, both initially
and during surveillance, have to be reimbursed by the
issuer. The independence of the ratings has been
questioned in recent years, especially when the credit
rating agencies are paid for their services.¹

According to ICRA and the other credit rating
agencies, default means that the company has either
already failed in the payment of interest and/or principal
as per terms or is expected to fail. The debt rating at no
time informs as to how much bond face value holders
would recover in the event of a default. Table 1 shows
comparative letter grades used by the Indian credit rating
agencies for the long-term debt instruments. Default is
represented by the rating symbol D.

The present regulations pertaining to the credit rating
agencies preclude investors and issuers from suing
agencies for awarding a particular rating. Credit ratings
are of value only as long as they are credible. If the
opinion of the credit rating agencies is independent,
objective, and timely, the investors’ investment is safe;
otherwise it would be risky.

**LITERATURE REVIEW**

In the international literature, increasing attention has
been given to the default rate experiences of corporate
debt because of the publicity given in the financial press
to the debt rated below investment grade. Hickman
(1958) analysed the large bond issues and a sample of
small bond issues from 1900 through 1943 and found
that, in general, the riskier the bond, the higher the
percentage of bonds that subsequently default. Altman
and Nammacher (1985) examined the default experience
of corporate bonds over the period of 1970 to 1984. Like
Hickman, they also found that bonds with a speculative
grade rating at the time of issue subsequently had a

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**Table 1: Comparative Letter Grades Used by Indian Credit Rating Agencies for Long-term Debt Investment**

<table>
<thead>
<tr>
<th>ICRA</th>
<th>CRISIL</th>
<th>CARE</th>
<th>Fitch India</th>
<th>Explanation of Rating (ICRA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>LAAA</td>
<td>AAA</td>
<td>CARE AAA</td>
<td>AAA (ind)</td>
<td>Highest safety</td>
</tr>
<tr>
<td>LAA</td>
<td>AA</td>
<td>CARE AA</td>
<td>AA (ind)</td>
<td>High safety</td>
</tr>
<tr>
<td>LA</td>
<td>A</td>
<td>CARE A</td>
<td>A (ind)</td>
<td>Adequate safety</td>
</tr>
<tr>
<td>LBBB</td>
<td>BBB</td>
<td>CARE BBB</td>
<td>BBB (ind)</td>
<td>Moderate safety</td>
</tr>
</tbody>
</table>

Speculative

<table>
<thead>
<tr>
<th>Speculative</th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>LBB</td>
<td>BB</td>
<td>CARE BB</td>
<td>BB (ind)</td>
<td>Inadequate safety</td>
</tr>
<tr>
<td>LB</td>
<td>B</td>
<td>CARE B</td>
<td>B (ind)</td>
<td>Risk prone (CRISIL: High risk)</td>
</tr>
<tr>
<td>LC</td>
<td>C</td>
<td>CARE C</td>
<td>C (ind)</td>
<td>Substantial risk</td>
</tr>
<tr>
<td>LD</td>
<td>D</td>
<td>CARE D</td>
<td>D (ind)</td>
<td>Default</td>
</tr>
</tbody>
</table>

*Note:* Credit rating agencies may apply ‘+’ (plus) or ‘−’ (minus) signs for ratings from AAA to C to reflect comparative standing within the
category.
much higher default rate than bonds that were initially of investment grade.

Studies have also looked into the history of credit rating agencies’ past rating actions and their variability over time. Atkinson and Simpson (1967) studied the trends in corporate bond quality from 1900 to 1965 and found that the default rate peaks coincide with the periods of economic distress. Cantor and Packer (1997) examined the evolution and economics of the ratings industry and showed that the meaning of specific ratings varied over time and across agencies. Blume, Lim and Mackinlay (1998) showed that the firms with given accounting ratios received significantly lower ratings in the early 1990s than the firms with similar accounting ratios would have done in the late 1970s and early 1980s. The implication being that, over time, the rating agencies have changed the way in which they evaluate credit standing. A study done by Sehgal and Arora (1999) indicated that bond ratings are becoming extremely variable over time and a majority of the rating changes are on the downside having price risk implications for investors.

A number of studies has looked into the role of credit rating agencies as providers of superior, low-cost, and timely information about debt securities. Sherwood (1966) showed that the letter grades assigned by the rating agencies served only as a general, somewhat coarse form of discrimination and they did not totally solve the investor’s problem of default-risk. He concluded that the ratings changed (up or down) slowly. Under constant review, they are altered only when the agencies deem that sufficient changes have occurred. Cantor and Packer (1995) analysed the differences of opinion in the credit rating industry for a broad sample of corporate bond ratings in the year ending 1993. Their findings raise a number of questions about the certification role of the rating agencies and about the strength of the rating agencies’ incentive to maintain a reputation for high quality (accurate) ratings. Using equity and liability data for the US firms, Delianedis and Geske (1998) constructed alternative credit risk indicators and compared their forecasting performance to that of ratings. They concluded that the default probabilities generated by their models increased well in advance of the downgradation of the ratings. They cited this as an evidence of ‘rating stickiness’ implying that the rating agencies do not immediately change ratings when news affecting an obligator’s credit quality is revealed.

Kealhofer (2003) showed that the Estimated Default Frequency (EDF™), developed by KMV Corporation, was superior to Moody’s or S&P’s ratings as a predictor of defaults by the US companies from 1990 to 1999. According to him, EDF™ measure produces fewer Type I errors than predictions based on Moody’s or S&P’s ratings. Covitz and Harrison (2003) empirically tested 2,000 credit rating migrations from Moody’s and S&P’s and concluded that the rating changes did not appear to be prominently influenced by the rating agency conflicts of interest, but rather by the reputation related incentives. In India, similar studies have been done by Raghunathan and Varma (1992) who have evaluated the rating given by India’s leading credit rating agency, CRISIL, and showed that the ratings are far too liberal by international standards and lack consistency. According to an independent report (unpublished) prepared by Price Waterhouse LLP (1996), the rating industry in India is driven more by the issuers’ requirements than by the investors’ demand for information. Further, issuers could play the rating agencies against one another in an attempt to receive higher rating and had the right to accept or reject the rating and that the rating could not be published unless the issuer accepted it. According to Gupta, Gupta and Jain (2001), the major reason for the lack of confidence among the retail investors in the bonds of private sector companies is the high default rate. Their 1997-survey indicated that 67.7 per cent of the respondents had no or low confidence in the ratings given by the credit rating agencies. The study concludes that the credit rating standards followed by the Indian credit rating agencies seem to be rather lax, showing greater consideration to the issuers’ needs than for the investors’ interests.

No previously published research in India, however, has examined the default rate experiences of the rated debt instruments. In this paper, an attempt has been made to examine the reliability of the rating on the basis of the actual defaults by limiting its scope to ICRA-rated long-term debt instruments.

**DATA AND METHODOLOGY**

To obtain data on companies/institutions rated by ICRA for long-term debt instruments during 1995-02 under the five sectors (Table 2), various issues of ICRA Rating Profile and ICRA Rating Update were scanned from 1995-03. However, it needs to be noted that these publications do not disclose the total ratings assigned by ICRA. The
ratings of only those issues that have been accepted and issued by the issuers are disclosed. This study is, therefore, limited to publicly available rating information. Besides these publications, information was also tapped from the websites of ICRA, CRISIL, CARE, Fitch India, RBI, SEBI, BSE, and NSE.

This study analyses only long-term debt instruments since the assigned rating and its movement can be observed only over a long period. The long-term debt instruments include all types of debentures and bonds. The list includes partially-convertible debentures (PCDs), non-convertible debentures (NCDs), optionally-convertible debentures, unsecured debentures, structured obligation bond programmes, subordinated bond programmes, tax-free bonds, taxable bonds, sub-sovereign rating, and other long-term debt obligation funds.

The default statistics were examined sector-wise, period-wise, and company/institution-wise. Analyses of the background and business, operating performance, management and systems, financial performance, prospects, and the key issues were done with respect to all the companies/institutions. Information was obtained for the year in which these issues were first rated and also the number of times they were upgraded/downgraded. To analyse whether low ratings (i.e., speculative-grade ratings) were assigned by ICRA to the defaulting credits well in advance of the default rate, the following metrics were used:

- Default rates by rating grades: It measures whether or not default rates are higher for lower rating grades than they are for higher rating grades. Generally, the default rates should be higher for the lower rating grades. This metric shows the ability of the credit rating agency to differentiate issues with regard to the credit risk.

- Rating prior to default: The rating prior to default is a tool which measures a rating agency’s success at assigning its lowest ratings to companies that subsequently default. The rating performance is improved whenever the average rating prior to default is lowered.

The reasons cited for default for a particular issue by ICRA were looked into. In case of the companies where the rationale for defaults was missing in ICRA’s Rating Profile, the same was found from other sources. Further, effort was made to identify if companies in default had issued other debt instruments that were rated by other credit rating agencies.

**DEFAULT STATISTICS**

While evaluating rating performance over time, it is important to keep in mind that the number of issues is generally growing over time and, thus, the number of defaults within each period can be quite erratic. Figure 1 depicts the change in the number of rated issues and defaults over time. Except for the period 1998-99 and 1999-00, there is a general increase in the trend of ratings assigned by ICRA with the highest number being 108 rated during 1997-98. The number of defaults, on the other hand, is quite erratic, for example, maximum defaults occur during one of the leanest periods with regard to the number of rated issues, i.e., 1999-00.

**Sector-wise Defaults**

A total number of 23 companies with 28 issues defaulted in the manufacturing and financial services sectors. The other three sectors, i.e., financial institutions/banks, state level institutions/bodies, and the sub-sovereign have neither defaulted in the payment of interest and/or principal as per terms nor are expected to default. The maximum number of 21 companies with 26 issues defaulted in the manufacturing sector as can be seen from Table 3.

A graphical depiction of the pattern of sector-wise defaults in Figure 2 shows that there has been no default

**Table 2: Number of Sectors Analysed during 1995-02**

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Number of Companies/Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing companies</td>
<td>209</td>
</tr>
<tr>
<td>Financial services companies</td>
<td>23</td>
</tr>
<tr>
<td>Financial institutions/Banks</td>
<td>27</td>
</tr>
<tr>
<td>State level institutions/Bodies</td>
<td>32</td>
</tr>
<tr>
<td>Sub-sovereign</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>292</strong></td>
</tr>
</tbody>
</table>
for any sector during 1995-96. The manufacturing sector has the highest equal number of defaults during 1997-98 and 1999-00. The financial services companies have equal number of defaults during 1999-00 and 2001-02.

**Period-wise Defaults**

No manufacturing company defaulted on its long-term debt instrument for the period 1995-96 (Table 4). In the case of financial services companies, there was no default for the period 1995-99 and 2000-01. The maximum number of seven companies (both manufacturing and financial services companies) defaulted in 1999-2000, followed by six in 1997-98, three each in 1996-97, 1998-99 and 2001-02, and only one in 2000-01.

**Company-wise Defaults**

Appendix 1 gives the details of the manufacturing companies in default and the ratings assigned to them as on March 2002. The industries to which they belong are building material, cables, food/food products, fertilizers/agro-chemicals, metals and mining, paper and packaging, pharmaceuticals, petroleum and derivatives, miscellaneous/diversified, real estate and construction, sugar, and textiles. The maximum number of four defaults is in the pharmaceuticals industry followed by three in the textile industry. The type of long-term debt instruments which defaulted included PCDs and NCDs. One of the NCD instruments was with the detachable warrants. Table 5 gives the details of the financial services companies in default. The type of debt instrument that defaulted was NCDs.

**RATING PROFILE**

**Default Rates by Rating Grades**

From Appendix 1 and Table 5, one can see that all the debt instruments fell in the investment grade when the ratings were originally assigned. None of the issues of manufacturing companies was assigned the top investment grades of LAAA and LAA+. The highest grade of LAA was given to Core Healthcare Ltd., followed by LAA+ given to KND Engineering Technologies Ltd. and Parasrampuria Synthetics Ltd., LA (+/-) given to DCM Ltd., JF Laboratories Ltd., Overseas Cables, Paam Pharmaceuticals (Delhi) Ltd., Pasupati Spinning and Weaving Mills Ltd., Pennar Aluminium Ltd., Rama Pulp and Paper Ltd., Simbhaoli Sugar Mills Ltd., and Torrent Gujarat Biotech Ltd. The lowest investment grade of LBBB (/-) was given to JK Dairy and Foods Ltd., Gujarat NRE Coke Ltd., Gujarat Optical Communication Ltd., Pennar Profiles Ltd., SB Petroleum (Port Terminals) Ltd., STI Granite Ltd., Unipon India Ltd., and Western Orissa Sugar Ltd. In the case of financial services companies, the highest grade of LAA+ was given to the issue of Gujarat Lease Financing Ltd., followed by LA+ to Nucent Finance Ltd. (Pressman Ltd.).

Figure 3 displays default by rating grades over different investment horizons. This chart demonstrates the power of credit ratings to distinguish between the relative credit risks. As expected, generally, the default rates increase as the rating level and the investment horizon decrease.
Table 5: Company-wise Default on Debt Instruments of Financial Services Companies during 1995-02

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Instrument</th>
<th>When Defaulted</th>
<th>Previous Rating</th>
<th>First Time Rated</th>
<th>Ratings Assigned as on March 2002</th>
<th>No. of Times Upgraded/Downgraded</th>
</tr>
</thead>
</table>

Rating Prior to Default

For the manufacturing companies, there were five issues (19.23%) that defaulted within three years, 15 issues (57.69%) that defaulted within six years, and only six issues (23.07%) that defaulted in nine years. The shortest time span is of one year and eleven months in the case of Paam Pharmaceuticals (Delhi) Ltd. The longest time span between the assigning of the original rating and the actual default is nine years in the case of Core Healthcare Ltd. For the financial services companies, the longest time span between the assigning of the original rating and the actual default is six years in the case of Nucent Finance Ltd. (Pressman Ltd.), followed by five years and two months for Gujarat Lease Financing Ltd. Thus, 78.57 per cent of the long-term bond issues defaulted in the span of first six years from the time they were issued.

On analysing Figure 4, one can observe that 78.57 per cent of the debt issues fell in the non-investment grade before default. In the case of Overseas Cables Ltd., at one time, the fall of rating was the steepest by 15 notches, i.e., from LA+ to LD. Gujarat NRE Coke Ltd., followed by falling from LBBB+ to LD, i.e., by 12 notches. Unipon India Ltd. and Gujarat Optical Communication Ltd. fell from LBBB to LD, i.e., by ten notches. The fall was the least from LC to LD, i.e., by two notches for DCM Ltd., Paam Pharmaceuticals (Delhi) Ltd., and JF Laboratories Ltd. In the case of both the financial services companies — Nucent Finance Ltd. (Pressman Ltd.) and Gujarat Lease Financing Ltd. — the fall was by eight notches, i.e., from LBB to LD.

The trend of ratings assigned by ICRA year after year before the default reflected either reaffirmation or downgradation. In the case of 17 companies, there was a minimum of at least one downgrade before the issue fell in the default grade. There were 11 companies whose issue/s were downgraded in the first three years of rating. There were four issues for which there was not even a single downgrade before they defaulted. Three issues, namely Overseas Cables Ltd., Gujarat Optical Communication, Ltd. and Unipon (India) Ltd., were continuously reaffirmed at the rating which was originally assigned to them and then, in one shot, were put downgraded to default.

Figure 3: Multi-Year Default Rates by Rating Grades during 1995-02

Figure 4: Rating Grades Prior to Default
under the default grade. There were two manufacturing companies, namely, Simbhaoli Sugar Mills Ltd. and Gujarat NRE Coke Ltd., which were upgraded once before default. All the six debt instruments that were put under the rating watch with negative implications were immediately downgraded.

Rating by other Credit Rating Agencies

There were two manufacturing companies which got their other long-term debt issues rated by credit rating agencies other than ICRA. As on 31st March 2002, the rating by CARE for Gujarat NRE Coke Ltd. on its PCD programme stood withdrawn while that for Rama Pulp and Papers Ltd. on its NCD programme was not in use. There was one financial services company, Gujarat Lease Financing Ltd., that got one of its other NCD programme rated by CRISIL, which stood suspended as on March 14, 2001.

REASONS FOR DEFAULT

Out of the total number of companies that have defaulted, the Rating Profile cited the rationale for defaults only for nine manufacturing companies. It is silent about the reasons for default with regard to the 12 manufacturing companies and two financial services companies.5

The reasons for default in the case of manufacturing companies, as can be seen from Appendix 2, were bleak industrial scenario, poor operational performance, bad investments, increased competition, high gearing, and poor interest coverage indicators leading to erosion of net worth, low capacity utilization, excess supply, cost over-run on projects, mounting raw material expenses, and non-availability of fresh finance that ultimately led to default on debt obligations. In the case of one of the companies, SB Petroleum (Port Terminals) Ltd., no reasons were found for default. The ICRA press release equipped that the company has been put in the default grade on the basis of some press reports that indicated that the Supreme Court had ordered the accounts of the company to be frozen and the assets to be attached. On further probe, it was discovered from the website of the Central Bureau of Investigation that an FIR was filed against the promoters of the company who were absconding after raising huge amounts of funds from the general public.

The reasons for default in the case of financial services companies as seen from Table 6 were scarce lending opportunities, increased competition, and deterioration in asset quality that led to default in debt obligations.

The default experience of the manufacturing and financial services companies bears the fact that the period of high default coincides with the poor economic condition and a high interest rate regime in India.

CONCLUSION

The results of this study present the following facts about the ratings assigned by ICRA to its long-term debt instruments:

- The performance of the manufacturing sector vis-à-vis other sectors has been dismal. Although the manufacturing sector accounts for 64.24 per cent of the total ratings assigned and accepted by the issuers during 1995-02, it alone accounts for 92.86 per cent of the defaults.
- The period of high defaults (1997-99) coincides with the poor economic conditions and a high interest rate regime in India. The reason for defaults further supports the view that when business is bad, most firms are affected.
- ICRA’s performance in terms of proper surveillance and provision of timely and complete information about the companies rated by them has not been up

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Source of Information</th>
<th>Reasons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gujarat Lease Financing Ltd.</td>
<td>Press release made by ICRA</td>
<td>1. Scarcity of lending opportunities: The scarcity of lending opportunities and increased competition resulted in a reduction in lending rates, thereby squeezing the interest spread. 2. Deterioration in asset quality: Lower collection efficiency and increased proportion of sub-standard assets led to higher income reversal and provisioning requirements which adversely affected profitability.</td>
</tr>
</tbody>
</table>
to the mark. The reasons are as follows:

- 21.43 per cent of the total debt issues (both for manufacturing and financial services companies) fell in the investment grade before being dropped to the default grade.
- The debt issues of three companies did not have even a single downgrade before they defaulted. These were continuously reaffirmed at the investment grade and then suddenly dumped to the default grade.
- No rating rationale has been provided in ICRA’s Rating Profile for around 60 per cent of companies which were put under the default grade.

The investors who made investment decisions solely on the basis of the ratings assigned by ICRA find themselves in trouble. Further, in the absence of adequate information, the hapless investors who rely on the safety certificate fail to wind down their investment in time. Many of the defaulting companies have ended up in the lap of BIFR (Board for Industrial and Financial Reconstruction). Even for the secured bondholders, there is no easy way of realizing their money or seeing a speedy liquidation of the defaulting company. The findings certainly draw attention towards the fact that excessive reliance on credit rating needs to be reduced. Since the governance of the credit rating agencies is in doubt, adequate steps have to be taken to make them more accountable.

Since this paper is limited to the assessment of default on long-term debt instruments rated by ICRA, it is not possible to judge if the same conclusions are applicable to all the other credit rating agencies. Future research could be carried out to test the findings for other credit rating agencies.

Appendix 1: Company-wise Defaults on Debt Instruments of Manufacturing Companies during 1995-02

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Name of the Industry</th>
<th>Instrument</th>
<th>When Defaulted</th>
<th>Previous Rating</th>
<th>First Time Rated</th>
<th>Ratings Assigned as on March 02</th>
<th>No. of Times Upgraded/Downgraded</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td></td>
<td></td>
<td></td>
<td>2. Downgraded to LA-@ (May 1997)</td>
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<td></td>
<td></td>
<td></td>
<td>3. Downgraded to LBB@ (Aug. 1997)</td>
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<td></td>
<td></td>
<td>Rs. 20m 19% NCD Programme</td>
<td>LD (Jan. 2001)</td>
<td>LBB@ (Aug. 1997)</td>
<td>LAA (Jan. 1992)</td>
<td>LD</td>
<td>(a) Downgraded to LA-@ (May 1997)</td>
</tr>
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<td></td>
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<td></td>
<td>(b) Downgraded to LBB@ (Aug. 1997)</td>
</tr>
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<td></td>
<td>neous/ Diversified</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td>2. Downgraded to LC@ (Feb. 1998)</td>
</tr>
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<td></td>
<td></td>
<td></td>
<td>(a) Downgraded to LBB+B (Aug. 2000)</td>
</tr>
<tr>
<td>JF Laboratories Ltd.</td>
<td>Pharmaceuticals</td>
<td>Rs. 127.5m 12.5% PCD Programme</td>
<td>LD (Nov. 1999)</td>
<td>LC(P) (May 1996)</td>
<td>LA(P) (Nov. 1992)</td>
<td>LD</td>
<td>1. Downgraded to LC (P) (May 1996)</td>
</tr>
</tbody>
</table>

Contd.
## Analysis of Defaults of Long-Term Rated Debts

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Name of the Industry</th>
<th>Instrument</th>
<th>When Defaulted</th>
<th>Previous Rating</th>
<th>First Time Rated</th>
<th>Ratings Assigned as on March 02</th>
<th>No. of Times Upgraded/Downgraded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parasrampuria Synthetics Ltd.</td>
<td>Textiles</td>
<td>Rs. 573m NCD Programme</td>
<td>LD (May 1997)</td>
<td>LBB@ (Aug. 1996)</td>
<td>LAA- (July 1992)</td>
<td>LD</td>
<td>1. Downgraded to LA (Feb. 1996)</td>
</tr>
</tbody>
</table>

Contd.
<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Name of the Industry</th>
<th>Instrument</th>
<th>When Defaulted</th>
<th>Previous Rating</th>
<th>First Time Rated</th>
<th>Ratings Assigned as on March 02</th>
<th>No. of Times Upgraded/Downgraded</th>
</tr>
</thead>
</table>
2. Downgraded to LBB- (Nov. 1998) |

Legend:  
@ indicates under-rating watch with negative implications.
(P) The letter P in parenthesis after the rating symbol indicates that the debt instrument is being issued to raise resources by a new company for financing a new project and the rating assumes successful completion of the project. The rating symbols for different instruments of the same company need not necessarily be the same.

Appendix 2: Reasons for Default on Debt Instruments of Manufacturing Companies

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Source of Information</th>
<th>Reasons</th>
</tr>
</thead>
</table>
| Core Healthcare Ltd. (Erstwhile Core Parentals Ltd.) | Asian CERC and ICRA press release | 1. Export obligations remain undischarged: The export obligations undertaken by the company under the Export Promotional Capital Goods Scheme (EPCG) did not get realized which were subsequently written off and the benefits obtained by the company under various schemes had to be surrendered / refunded to central government.  
2. Poor performance of companies: The performance of all the subsidiaries in which CHL has made investments performed poorly.  
3. Time and cost overrun: There was time and cost overruns incurred in the Rs. 8.91 billion expansion cum diversification project that adversely affected the company’s profitability.  
4. Low capacity utilization: Due to shortage of working capital, there was low capacity utilization in all its product lines. |
| DCM Ltd. | ICRA Rating Profile and NSE India | 1. Deterioration in operational performance of various divisions: DCM’s Engineering Division (DCM Engineering Products) registered a decline in the production volume and sale of iron castings over 12 months ended December 1997 because of lower exports. DCM’s Textile Division witnessed a decline in profitability, which led to a fall in its sales realizations. The performance of the third division, i.e., DCM Tools & Dyes also suffered on account of the recession in the automobile industry.  
2. Gearing remained high and interest coverage indicators poor: DCM’s gearing increased to 8.22 times as on December 31, 1997. This was because of the erosion of net worth and a rise in debt following the inclusion of interest accrued and due to debt. The interest coverage was below one time in 1996-98 indicating the inadequacy of cash from operations to even meet the interest payment obligations. |
<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Source of Information</th>
<th>Reasons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gujarat NRE Coke Ltd.</td>
<td>Asian CERC and ICRA press release</td>
<td>1. Large scale dumping affecting the demand adversely: In 1997, the operations of the company were affected adversely by large scale dumping of Chinese coke and other management problems.</td>
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<tr>
<td></td>
<td></td>
<td>2. High cost debt: High interest expense and write-offs resulted in a negative net profit margin of 1.33 in 1996-97. The debt/equity ratio of the company stood at 0.69 as on March 1997.</td>
</tr>
<tr>
<td>Gujarat Optical Communication Ltd.</td>
<td><a href="http://www.sharekhan.com">http://www.sharekhan.com</a> and ICRA press release</td>
<td>1. Cancellation of order for its optical fibre cables (OFC): Post commissioning, GOCL had only one trial order for manufacture of OFC from Department of Telecommunication (DOT) that was later cancelled. The cash generation was severely affected since it did not receive the payment against dispatches it had already made.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Increased competition and steep decline in prices for Polythene Insulated Jelly Filled Telephone Cables (PIJF): There were around 48 PIJF cable manufacturers in India which resulted in increased competition and pressure on the prices of the cables. Orders were accepted by the competitors at a rate much below the variable cost of GOCL.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Increase in debt: The company’s debt continuously increased since 1997. In March 1997, the debt was Rs. 640 million that increased to Rs. 830.6 million in June 1998 and further Rs. 922.4 million in June 1999.</td>
</tr>
<tr>
<td>JK Dairy &amp; Foods Ltd.</td>
<td>ICRA Rating Profile and <a href="http://www.indiainfoline.com">http://www.indiainfoline.com</a></td>
<td>1. Dumping of milk powder: In 1999-00, the company’s sales suffered following large scale dumping of milk powder by countries belonging to the European Union (EU).</td>
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<tr>
<td></td>
<td></td>
<td>2. Change of inventory valuation: In compliance with the guidelines of Institute of Chartered Accountants of India (ICAI), the company changed its inventory valuation method that resulted in an extra charge on the profit and loss account to the extent of Rs 17.1 million.</td>
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<tr>
<td></td>
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<td>3. Lower realizations, change in product mix and high price of raw materials: As for 2000-01, the key factor behind company’s poor performance was the steep decline in the prices of ghee (accounting for 39% of sales) by 12% over the previous years levels. JKDF’s operating margins declined from 6.4% 1999-2000 to –2.7% in 2000-01 on account for lower realizations, change in product mix, and higher raw material expenses.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4. High gearing: JKDF’s gearing was significantly high leading to the erosion of net worth.</td>
</tr>
<tr>
<td>JF Laboratories Ltd.</td>
<td><a href="http://www.indiainfoline.com">http://www.indiainfoline.com</a> and ICRA press release</td>
<td>1. Delay in commencement of its principal product: There were technical intricacies in initiating and stabilizing the process and commencement of commercial production of amino acids.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Excessive competition: Since JFLL was primarily engaged in the sale of generic drugs, it faced strong competition.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. High gearing: JFLL’s gearing was significantly high leading to erosion of net worth.</td>
</tr>
<tr>
<td>KND Engineering Technologies Ltd.</td>
<td><a href="http://www.indiainfoline.com">http://www.indiainfoline.com</a> and ICRA press release</td>
<td>1. Lack of new business: Due to lack of securing new contracts and timely completion of the same, the normal operations were adversely affected.</td>
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<td>2. Diminution in value of investments: There was a fall in the market value of its quoted and unquoted investments.</td>
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<tr>
<td></td>
<td></td>
<td>3. High interest burden: Deterioration of financial position mainly on account of high interest burden and its inability to secure mobilization advance against proposed commercial complex at Calcutta.</td>
</tr>
</tbody>
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Contd.
<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Source of Information</th>
<th>Reasons</th>
</tr>
</thead>
</table>
| Montari Industries Ltd.             | ICRA Rating Profile and http://www.indiainfoline.com | 1. Operational problems: Due to operational problems, its agro-chemical units ceased manufacturing. Its export business of bought-out leather garments and home furnishings in the quality conscious markets of USA, EEC, and Japan did not take off well.  
   2. High gearing: MIL's gearing was significantly high following the erosion of net worth. |
|                                     |                               | 2. Increasing debt: The debt-equity ratio for the company increased over the years. The debt-equity ratio increased from 0.43 as on March 31,1999 to 1.39 as on March 31, 2001. The financial charge coverage ratio declined from 4.6 to negative 3.26 for the same period. |
| Paam Pharmaceuticals (Delhi) Ltd.   | ICRA Rating Profile and BSE India | 1. Excessive competition: Since PPPDL was primarily engaged in the sale of generic drugs, it faced strong competition from the unorganized sector and numerous other small players in this segment. Furthermore, fall in the prices of some of its main formulations affected the company's operations adversely in 1997-98.  
   2. Cost overrun in the Bhiwadi Project: The Bhiwadi formulations unit that was initially expected to commence operations in April 1995 could begin only in March 1996. This resulted in cost overrun and coupled with the working capital requirements, led to a severe strain on the liquidity position of the company in 1998-97 and 1997-98.  
   3. Asset-liability mismatches: PPDL borrowed substantial short-term funds at high rates of interest. This resulted in a sharp increase in the interest burden during 1997-98, leading to inadequate coverage ratios. Moreover, since the short-term funds were deployed in long-term assets for the Bhiwadi plant, the company faced a severe asset liability tenure mismatch which was further accentuated by the poor profitability from operations. |
| Parasrampuria Synthetics Ltd.       | ICRA Rating Profile           | 1. Demand supply imbalance: The company operated in the synthetic filament yarn industry which passed through a difficult phase due to demand supply imbalance and cheap imports. Most of the units in this industry incurred heavy losses and were shut down. |
| Pasupati Spinning & Weaving Mills Ltd. | ICRA Rating Profile | 1. Depressed polyester viscose (PV) blended yarn margins: The blended yarn segment, which accounted for a major portion of PSWM's operating income, was characterized by over-supply and falling realizations. This resulted in stagnation in the company's operating income and led to a squeeze on its margins.  
   2. Continued project delays: The PV blended yarn and the cotton yarn expansion projects of PSWM, which were expected to be commissioned in 1996-97, were delayed. The project delays were on account of the delay in mobilizing funds.  
   3. Rise in gearing levels following increased borrowings for new projects: The new projects of PSWM were funded primarily through debt as a result of which the debt levels of the company increased steadily over the years. The high debt against poor accrual led to reserves reduced to an increase in PSWM's gearing which stood at 3.16 times as on March 31, 1999. |
| Pennar Aluminium Ltd.                | Asian CERC and ICRA press release | 1. Sluggish demand and severe competition from imports: The performance of PALCO was affected by sluggish demand and sharp reduction in import duties resulting in severe competition from imports.  
   2. High gearing: High gearing and inadequate accruals led to complete erosion of its net worth. |
### Non-availability of fresh funds
The operations of the company’s conductor plant continued to be shut down for non-availability of bank guarantee and letters of credit. With the banks suspending all credit facilities, the company could not procure raw material to run the plant continuously.

### Pennar Profiles Ltd.
- **Source of Information**: Asian CERC and BSE India and ICRA press release
- **Reasons**
  1. Slowdown in the construction industry: Sales off-take was affected by slowdown in construction industry, the principal user of its aluminium extrusion.
  2. Excessive competition: There were significant capacity additions in the extrusion industry resulting in excess supply and a decline in sales realizations.
  3. Lack of presence in local markets: PPL had little presence in the local consumers market and was surviving due to its exports.
  4. Non-availability of finance: With high debts and failing operational performance, the banks suspended all credit facilities. The company could not even procure raw material to run its plant continuously.

### Rama Pulp & Papers Ltd.
- **Source of Information**: http://www.indiainfoline.com and ICRA press release
- **Reasons**
  1. Industrial slowdown: Due to industrial slowdown, there was low demand for packaging paper, RPPL’s principal product. This had an adverse impact on its sales off-take and margins.
  2. High gearing: High gearing and inadequate accruals led to complete erosion of its net worth.

### SB Petroleum (Port Terminals) Ltd.
- No reasons found.

### Simbaoli Sugar Mills Ltd.
- **Source of Information**: ICRA Rating Profile
- **Reasons**
  1. Realizations remained under pressure due to oversupply position despite improved operating performance in the sugar division: Due to supply overhang and steady increase in administered sugarcane prices, there was stagnant realizations in the sugar business.
  2. High gearing and insufficient accruals led to strains on liquidity and default on obligations: SSML’s gearing remained high in the past because of large debt-funded projects and high working capital requirements. The gearing increased to around 2.86 times as on March 31, 2001 as against 2.13 times as on September 30, 2000. High gearing coupled with modest profits from operations resulted in weak coverage indicators with the interest coverage of around 1.1 times in the past years.

### STI Granite India Ltd.
- **Source of Information**: ICRA Rating Profile
- **Reasons**
  1. Bleak industrial scenario: The industry was plagued by an over supply situation, resulting in intense competition. The government’s policy favouring the exporters of rough granite blocks aggravated the situation further. As a result of increasing export of good quality raw blocks, domestic processing units were left with granite blocks of inferior quality.
  2. Low capacity utilization: Due to sluggish demand and high opening stock of polished slabs/tiles (more than 300 days of gross sales), capacity utilization during 1996-97 for the slabs and tiles were only 53% and 19% respectively, down from 70% and 22% respectively in 1995-96. In absolute terms, production of polished slabs and tiles declined by 25% and 14% respectively over the period.
  3. Declining price level: Though SGIL exported its entire production, the depreciation of the rupee did not have any favourable impact on average realization of its products. In fact, stiff international competition forced the price of polished slabs to fall even in rupee terms during 1996-97 by about 13% from that during 1995-96, though the price of tiles showed a marginal increase.
  4. Mounting raw material expenses: SGIL procured nearly the entire requirements of rough granite blocks from outside resulting in higher raw material expenses. Moreover, average raw material yield declined sharply since 1995-96 due to the lack of good quality rough blocks which were exported to overseas processing units. This pushed SGIL’s cost of production further upwards.

Contd.
5. High gearing: The mounting level of working capital needs forced the company to contract high cost short-and long-term debts. Consequently, the gearing (total debt/tangible net worth) of SGIL increased from 2.10 times as on 31st March 1996 to 3.18 times as on 31st March 1997, and interest expenses shot up significantly from 24.3% of OI in 1995-96 to 27.2% of OI in 1996-97.

### Torrent Gujarat Biotech Ltd.

**ICRA Rating Profile**

1. Glut in domestic market led to falling capacity utilization: The Pen-G industry in India was badly affected because of excess supply in the second half of 1990’s. There was an estimated over supply of 25% in India, and 15% worldwide. The low prevailing international prices on account of the glut ruled out export possibilities for Pen-G.

2. Drastic fall in prices because of excess supply: The domestic prices of Pen-G hovered in the range of Rs. 450-500 per billion units (BU) for most of 1997-98. This price level was way below the government fixed price of Rs. 1,025 per BU.

### Unipon India Ltd.

http://www.indiainfoline.com

1. Slowdown in the synthetic filament yarn industry: The synthetic filament yarn industry passed through a difficult phase due to demand supply imbalance and cheap imports.

### Western Orissa Sugar Ltd.

(Erstwhile Western India Sugar & Chemical Industries Ltd.)

http://www.expressindia.com

1. Deterioration in operational performance of various companies of the group: With the Gadgil Western Corporation (GWC) bubble bursting, three companies of the group namely Western India Industries Ltd (WII), Western Paques Ltd (WPL), and Western India Sugar & Chemical Industries Ltd. (WISCL) were put on the chopping block. The employees of group companies were not paid salaries from February 1997.

### ENDNOTES

1. See, for example, Ravishankar (1997); Agarwal (1998); Boley, Dewall and Hoekerd (2000); Andrew (2001); Bhattacharya and Sen (2001); Mallik (2001); Borrrus and Mc Nameee (2002); Mecklai (2002); Subramanian (2002); Viswanathan (2002); Covitz and Harrison (2003); and Reason (2003).

2. For the period 1991-2002, ICRA had completed rating 812 long-term debt issues out of which only 482 ratings were accepted and issued by the issuers. This implies that only 59.35 per cent of the ratings assigned during this period by ICRA were accepted and used by the issuers.

3. The websites that were extensively used for getting information about the rationale for defaults were debtonnet, indiainfoline, expressindia, and sharekhan.

4. The fall in rating takes into account the entire range of rating symbols including ‘+’ and ‘–’ distinctions. A fall by one notch means falling to the immediately following rating symbol.

5. ICRA contests that there was no separate ‘detailed’ rationale published in the Rating Profile since there was nothing to add beyond what was mentioned in the press release.

### REFERENCES


WEBSITES


Suveera Gill is a Senior Lecturer of Accounting and Finance at the University Business School, Panjab University, Chandigarh. She has to her credit seven national-level research projects and nine technical publications in national and international journals. She is also a member of the Society for Capital Market Research and Development, New Delhi. e-mail: suveeragill@hotmail.com

The quality of mercy is not strain’d,
It droppeth as the gentle rain from heaven
Upon the place beneath: it is twice blest;
It blesseth him that gives and him that takes:

William Shakespeare – The Merchant of Venice