

Legal analysis for structured finance transactions

February 2023

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Executive summary

CRISIL Ratings deems legal analysis as a key element in its methodology for rating structured finance transactions. The basic tenet of structured finance is to de-link the credit risk profile of the rated instrument from that of the issuer or originator. This depends on the nature and extent of insulation of the underlying asset along with documentation evidencing the same. In this context, legal analysis plays a critical role in the evaluation of structured finance transactions. In the absence of conclusive judicial precedent or explicit statutory provisions, such transactions are structured within the existing framework of the transfer of property, trust and contract laws in India. Additionally, securitisation transactions where originators or investors are regulated by the Reserve Bank of India (RBI) need to adhere to the applicable regulatory guidelines.

CRISIL Ratings has developed a framework for evaluating legal risks, which is applied for all securitisation transactions. CRISIL Ratings also conducts legal analysis for future flow securitisation transactions, guarantee-backed transactions and commercial mortgage-backed securitisation (CMBS) transactions.

CRISIL Ratings examines three key legal aspects in securitisation transactions. First, the basic condition of true sale, which will establish that the assets transferred to the buyer are bankruptcy remote from the originator. Second, the adequacy of stamp duty as this may affect the enforceability of documents. Third, the nature of internal or external credit enhancement provided for the transaction.

The key element in future flow securitisation is prioritisation of cash flows of the issuer to service the rated debt based on a pre-defined structure. Hence, evaluation of the payment waterfall and escrow arrangement forms the cornerstone of such transactions.

In a guarantee-backed transaction, the guarantee should be unconditional, irrevocable and enforceable. This ensures that the benefit of the credit risk profile of the guarantor is transferred fully to the instrument.

In CMBS transactions, legal analysis primarily focuses on the payment waterfall, escrow mechanism and enforceability of the embedded structural features that empower a debenture trustee to take steps and ensure timely repayment to debt holders.

Scope

This article¹ provides an overview of the CRISIL Ratings framework to evaluate legal risks in:

- Securitisation transactions
- Future flow transactions
- Guarantee-backed transactions
- CMBS

Legal analysis for securitisation transactions

Securitisation legislation and regulation in India

Securitisation transactions in India are primarily carried out through two routes:

- Pass-through certificate issued by a special purpose vehicle (SPV)

¹ The previous version of this article can be accessed here: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/structured-finance/archive/Legal-analysis-in-structured-finance-transactions-sep2021.pdf

- Direct assignment of loans

The RBI has issued guidelines² for securitisation and direct assignment transactions, which stipulate conditions for carrying out such activities in India. One of the basic conditions for securitisation is legitimate sale or 'true sale' of underlying assets, which ensures the assets are not impacted by the bankruptcy of the seller after the sale. A true sale will establish that the rights and duties with respect to the assets are transferred to the buyer and these assets are, therefore, bankruptcy remote from the originator's estate. The RBI has also prescribed certain criteria for a transaction to be deemed a true sale (discussed later in this document). While CRISIL Ratings evaluates all pertinent legal risks in a securitisation transaction, the assessment of the true sale aspect is of paramount importance.

While analysing bankruptcy remoteness, the focus is on certain provisions of the relevant acts and their existing judicial interpretation. All transactions are backed by independent external legal opinions on true sale and the enforceability of the transaction documents by the transaction counsels.

CRISIL Ratings' legal risk evaluation framework

The CRISIL Ratings framework for evaluating legal risks in a securitisation transaction covers risks that could be detrimental to investors and the mitigating factors for such risks. While CRISIL Ratings uses its criteria for evaluating credit, market and counterparty risks, legal risks need to be examined through the documents provided to CRISIL Ratings as part of the transaction.

The three key aspects evaluated by CRISIL Ratings under this framework are:

- True sale
- Stamp duty
- Nature of credit enhancement

True sale

As highlighted earlier, true sale is the building block of a securitisation transaction and the most important aspect in the legal risk evaluation framework. A true sale will establish that the assets transferred to the buyer are bankruptcy remote from the originator's estate. Hence, CRISIL Ratings examines this through the transaction documents.

While the RBI guidelines define true sale as a "sale resulting in immediate legal separation of the seller from the assets sold", there is no statutory definition or judicial interpretation of true sale in India. Hence, inter alia, CRISIL Ratings examines the following:

Extent of recourse to the originator and risk retained by the originator in the assets

A true sale occurs when the seller effectively transfers all risks and rewards pertaining to the asset to the buyer. This would result in the buyer having no recourse to the seller after the sale, except to the extent of credit enhancements (if any) provided by the seller. It is important to consider the extent to which the investor will have recourse to the originator, as this reflects the risk retained in the assets by the originator.

The higher the level of risk retained by the originator, the greater the chances that the courts may not consider the assets as having been transferred from the balance sheet of the originator. There is a possibility that in cases where the originator retains a high level of risk in the assets, the courts may reclassify the securitisation as 'secured borrowing' by the originator. This would vitiate the bankruptcy remoteness of the transaction. Therefore, CRISIL Ratings may regard transactions with unusually high risk retention by the originator as being inconsistent with a true sale.

² These guidelines are applicable to counterparties regulated by the RBI.

If the originators or investors are regulated by the RBI, the transaction should be compliant with its applicable guidelines. Among the various conditions, the originator needs to adhere to the minimum retention requirement. This is primarily designed to ensure that originators have a continuing stake in the performance of the securitised assets to ensure they carry out proper due diligence of the loans to be securitised.

In India, the originator usually continues as the servicer of loans in securitisation structures. CRISIL Ratings believes this does not violate true sale conditions as long as there are no additional liabilities taken on by the originator beyond fulfilling the role of a servicer collecting payments from the borrowers in the pool.

Option and obligation to repurchase assets

As true sale should result in a complete transfer of risks and benefits, and the seller should not be obligated to repurchase assets or support the transaction after the sale of assets. CRISIL Ratings believes any such obligation on the originator is inconsistent with a true sale.

Nevertheless, in transactions where the terms may require the SPV to use cash collections during the revolving period of the transaction to buy fresh assets from the originator (based on the predefined eligibility criteria being met), CRISIL Ratings does not consider such provisions as being inconsistent with the requirements for true sale.

Some transactions in the PTC structure may have a call option wherein the originator retains the option to repurchase fully performing assets towards the end of the securitisation transaction when the residual value of such assets declines to less than 10% of the original pool, for administrative ease. This is also called a clean-up call option and is permitted under the RBI guidelines.

Intention of the parties

As with most legal analysis, the intention of the parties is important to establish a true sale and is often scrutinised by the courts to determine a true sale. Therefore, it is important that the language used in transaction documents clearly conveys the intention of the parties and that the nuances of the transaction do not have the potential to vitiate a true sale. For instance, the price at which the assets are purchased is an important consideration for establishing the intention of the parties. An unfair purchase price can be scrutinised by the courts and could result in vitiation of the true sale nature of the transaction. CRISIL Ratings examines each transaction document to check that the terms of the proposed transaction (as shared by the originator in the term sheet) are appropriately incorporated in the executed documents.

Extent of control retained by the originator over the assets

For a true sale to be established, the originator should have minimal control over the sold assets.

CRISIL Ratings believes a transfer can be established as a true sale only if the transferee has unrestricted rights to the assets. Covenants restricting the transferee's ownership of the assets will be viewed as inconsistent with a true sale by the courts. Hence, CRISIL Ratings will examine such covenants and analyse the level of control that the originator continues to have following the sale.

Appointment of originator as servicer

In India, the originator usually continues as the servicer of the assets in securitisation transactions due to lack of backup servicers. While the appointment of the originator as the servicer is prima facie not considered to be a violation of the true sale criteria, the details of the obligations of the servicer are examined. For instance, if the servicer indemnifies the transferee from payment defaults by the obligors or if the originator takes on servicing of assets without adequate consideration, this could vitiate a true sale. While transactions may not have an adequate

servicer fee³, CRISIL Ratings believes the servicer consideration is factored into the purchase price upfront in most transactions.

Additionally, the transferee could have the right to appoint another servicer if the originator fails to comply with the terms of the servicing agreement. Such a right gives greater control to the transferee.

CRISIL Ratings also bases its analysis of a transaction on an independent legal opinion. For each transaction, we require the originator to obtain a legal opinion from an independent counsel confirming that the transfer of assets is consistent with a true sale.

Stamp duty and registration laws

Stamp duty is an important issue unique to securitisation transactions executed in India. Indian states are empowered to determine their own stamp duty rates, which vary widely among states.

CRISIL Ratings examines the executed documents in each transaction and requires representations and warranties from the originator and an independent legal opinion confirming that the documents adhere to the relevant stamp and registration laws. The reasons for this are:

Consequences of stamp duty evasion

The consequences of evading stamp duty are serious. In terms of the Indian Evidence Act, 1872, documents that are required to be stamped and have not been duly stamped (either unstamped or inadequately stamped) cannot be adduced as evidence in a court of law. This renders the documents unenforceable, unless the deficient stamp duty is paid at the time of enforcement. Additionally, an inadequately stamped document attracts an enormous penalty, sometimes up to 10 times the deficiency in stamp duty paid.

Bearing the cost of stamp duty

The stamp duty payment liability is usually decided by way of contract between the parties to any transaction. In the absence of such an agreement, the general rule is that the person claiming the benefit of the document should bear the stamp duty levied on that document. It is important to note this because the person liable to pay the stamp duty is also liable to pay penalties or fines, if any, with respect to the same.

Differential rates of stamp duty

Stamp duty laws vary across states. Because of the differential stamp duty rates, if a document executed in one state is taken to another, it is liable to be stamped in the second state if the stamp duty there is higher. Therefore, it is essential that the underlying security (if any) for the transferred receivables is located in states with similar or a lower stamp duty than the state in which the transfer document has been executed.

CRISIL Ratings examines the transaction documents to evaluate whether the transaction complies with the relevant stamp duty regulations so that no future liability arises on this account to the investors.

Registration of documents transferring interest in immovable assets

In terms of the Transfer of Property Act, 1882, any document evidencing the transfer of immovable property or interest in immovable property has to be registered with the registrar of land records for the area where the property is located. Documents that transfer legal or beneficial interest should, therefore, be registered to ensure the rights of the investors are not legally impeded.

Typically, in the Indian context, due to high stamp duty rates on conveyance of immovable property, the mortgage security interest continues to be held in the name of the originator. This also enables the originator to exercise all

³ Most agreements quote a minimal fee, which may not be the total consideration for the servicer

enforcement rights available in relation to the mortgage security interest. However, the originator has an obligation to transfer the mortgage security interest as and when requested by the trust.

Nature of credit enhancement

Credit enhancement in a securitisation transaction can be provided in two ways:

- Internal credit enhancement
- External credit enhancement

Internal credit enhancement is provided through various structural features such as excess interest spread, over-collateralisation and subordination. For a detailed understanding of the analysis of internal credit enhancement in securitisation transactions, please refer to the criteria article titled, 'CRISIL Ratings' methodology for ABS transactions.

External credit enhancement is provided through external forms of support such as:

- Cash collateral
- Guarantee/ corporate undertaking

Cash collateral

Credit enhancement, though typically provided by the originator, does not vitiate the true sale nature of the transaction as long as it is bankruptcy remote from the originator. This means that even in the event of bankruptcy of the originator, funds in the cash collateral account should be available to the trustee for paying the investors. Cash collateral can also be provided in the form of a fixed deposit.

Some of the aspects analysed by CRISIL Ratings for evaluating bankruptcy remoteness are:

- Is the cash collateral maintained in a separate account?
- If the account is current, then do the documents expressly state that the money in the account is being held in a trust for the benefit of the trustee?
- If the cash collateral is in the form of a fixed deposit, are the maturity proceeds of the deposit endorsed in favour of the trustee upfront? The originator may, however, be a beneficiary to the residual amounts, if any, in the fixed deposit after payments from the same have been made.

CRISIL Ratings examines the transaction documents that lay down the mode of operation of the cash collateral account and the rights and liabilities of the respective parties with respect to the account. Additionally, CRISIL Ratings requires the originator to furnish an opinion from an independent legal counsel confirming the bankruptcy remoteness of the cash collateral from the originator.

Guarantee/ corporate undertaking

If the credit enhancement is in the form of a guarantee or a corporate undertaking, CRISIL Ratings follows the framework used for evaluating guarantee-backed transactions.

Independent legal opinion

Legal risks in a securitisation transaction are many and need to be evaluated appropriately. While CRISIL Ratings undertakes the analysis of legal risks in a transaction, it also relies on external legal opinion on certain aspects. As a policy, for every transaction, CRISIL Ratings requires the originator to obtain a legal opinion from the transaction counsel⁴ to confirm the following:

⁴ The content of the opinion will, however, vary depending on the facts of a transaction.

- That the transfer of the assets is not in contravention of the underlying loan documents
- That the transfer of the assets to the buyer constitutes a true sale
- That the credit enhancement
 - If in the form of cash, is bankruptcy remote from the credit enhancer/ originator
 - If in the form of a guarantee or corporate undertaking, is enforceable by the trustee and is irrevocable and unconditional
- That the transaction documents are valid and enforceable, and not in contravention of a currently applicable law
- That all transaction documents have been duly executed in accordance with the prevailing stamp duty and registration laws

Legal analysis for future flow transactions

A future flow securitisation transaction essentially involves prioritisation of the issuer's cash flows to service the rated debt based on a pre-defined structure. Hence, a well-defined payment waterfall and a legally sound escrow arrangement form the cornerstones of such transactions. Therefore, CRISIL Ratings' analysis primarily focuses on these two key aspects.

The payment structure that is envisaged under the transaction has to be adequately documented and devoid of ambiguities. Furthermore, the payment waterfall and its mechanism have to be documented and confirmed by all parties to the transaction: the issuer, the trustee and the bank that holds the escrow account. This is typically done through a tripartite agreement. This document incorporates the payment structure and establishes the trustee's rights over the cash flows. CRISIL Ratings also insists that the payment structure be disclosed in the offer document.

In all such cases, the issuer will maintain an escrow account into which all amounts identified as per the transaction are deposited from time to time. The escrow account is central to the transaction and CRISIL Ratings assesses the following aspects of the account:

- Are the cash flows accessible to the trustee/ investors at all times?
- Is the escrow account a no-lien account charged to the trustee?
- Has the issuer declared trust over the account?
- Is the account operated only in accordance with the trustee's instructions? Is this appropriately documented?

The functioning of the future flow mechanism will also depend on the unrestricted right of the investors to the escrowed cash flows. CRISIL Ratings ascertains if the cash flows are subject to prior encumbrances that could interfere with this right. Typically, such encumbrances are mitigated through a consent/ no-objection/ pari passu letter provided by the issuer.

Legal analysis for instruments backed by guarantees

Ratings assigned to instruments backed by guarantees are enhanced based on the type of guarantee (full or partial) and its strength. Therefore, legal analysis of the guarantee is a significant input into the analysis of the credit risk profile of the instrument.

The CRISIL Ratings analytical framework requires the guarantee to be:

- Unconditional
- Irrevocable
- Enforceable
- With a well-defined payment mechanism with clarity on timelines for invocation

Compliance with these parameters ensures that the benefit of the credit risk profile of the guarantor is transferred fully to the instrument. Non-compliance with any parameter will lead to the guarantee not being considered adequate for enhancement. For instance, if the guarantee is revocable under certain pre-specified conditions, there is a likelihood that the repayments on the instrument may not benefit from the guarantee.

In all guaranteed transactions, CRISIL Ratings examines the legal documentation to ensure the following aspects are covered:

- Guarantor's obligations are unconditional and irrevocable and specifically stated in the document
- Guarantor's liability continues even if the issuer is referred under relevant legislations for bankruptcy resolution, or files for winding up, or effects a change in its management
- The guarantor's liability should continue regardless of a change in the trustee
- There should be no ambiguity regarding the quantum of the guarantor's obligation—that is, the document should be clear that the guarantor will be liable for the entire principal as well as interest payments in case of full guarantee. For partial guarantees, the extent of the guarantor's liability, on both interest and principal obligations, should be clearly mentioned
- The terms provide for invocation of guarantee as per pre-defined trigger and payment mechanism to ensure timely payment of obligations

CMBS

CMBS is a financial instrument secured by receivables from commercial real estate. A CMBS instrument is created by pooling one or more commercial mortgages and securitising the lease rentals. In a CMBS transaction, the revenue from the lease rentals is used to service the interest on the debt contracted by the SPV. Typically, the principal component is not repaid through revenue cash flows; it is expected to be repaid by refinancing by the 'indicative maturity date'. If the issuer is unable to refinance the debt, then there are embedded structural features which empower the debenture trustee to take steps and ensure repayment by the final redemption date. This date (after the indicative maturity) is referred to as the legal final maturity date.

Net lease rentals (charges such as maintenance costs, tax deducted at source, service tax, income and property tax are deducted from the gross rentals to calculate the net rentals available to service debt) are paid into a designated escrow account. These lease rentals, along with the escrow account, are hypothecated in favour of the CMBS debt holders wherein the said charge would be an exclusive first ranking charge.

The payment waterfall and escrow account are central to the transaction and, accordingly, CRISIL Ratings focuses on these aspects in its legal analysis. The approach followed is similar to that for ascertaining the efficacy of the payment waterfall and escrow arrangement in a future flow transaction.

The underlying properties are mortgaged in favour of the CMBS debt holders/ investors wherein the said charge would be an exclusive first ranking charge. Alternatively, the developer pledges its entire shareholding in the SPV, which houses the underlying commercial properties, to the debenture trustee. CRISIL Ratings assesses whether the mortgage/ pledge is valid, binding and enforceable in favour of the investors or debenture trustee as per the terms of the transaction documents.

In addition to the above, other elements could be a part of the security package. CRISIL Ratings relies on external legal opinion on certain aspects. As a policy, for every transaction, CRISIL Ratings requires the issuer to obtain legal opinion from the transaction counsel confirming specific aspects of the transaction, including:

- That the transaction is valid as per the terms of the underlying lease deeds and other underlying documents
- That there are no prior encumbrances on the lease rentals or the underlying properties
- That the hypothecation of the escrow account and amounts deposited therein constitutes a valid, binding and enforceable first priority and exclusive security interest in favour of the debt holders
- That the mortgage of the underlying immovable property as security for the redemption of the debt conveys valid, binding and enforceable first priority and exclusive security interest in favour of the debt holders
- That any pledge, assignment or any other security provided would be valid, binding and enforceable in favour of the debt holders
- That the transaction documents are valid and enforceable and not in contravention of any applicable law currently prevailing
- That all transaction documents have been duly executed in accordance with the prevailing stamp duty and registration laws

Conclusion

A strong and well-defined legal structure is an important prerequisite for all securitisation, future flow, guarantee backed or CMBS transactions. Hence, legal analysis conducted by CRISIL Ratings is a critical element in the evaluation of such transactions.

Provisional ratings

Since May 2015, CRISIL Ratings has been assigning 'provisional' ratings for structured obligations, where necessary. This was in compliance with the guidelines from the Securities and Exchange Board of India (SEBI). The provisional nature of such ratings is disclosed by CRISIL Ratings in its communications, including rating letter and rating rationale. SEBI also mandates disclosure of rating that would have been assigned in the absence of the pending steps / documentation. As CRISIL Ratings would not be able to rate the securitization transaction without the pending steps/documentation – as these form the very basis of the ratings - CRISIL Ratings will disclose the fact that no rating would have been assigned in case of absence of the steps/ documentation considered while assigning provisional rating.

Once the relevant documents (as per expectation when the provisional rating was assigned) are in place, the provisional rating will be converted into a final rating as per defined timelines.

For more details, please refer to CRISIL Ratings' Policy on Provisional Ratings, available on www.crisilratings.com

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