Legal analysis in structured finance transactions

September 2018
Criteria contacts

**Somasekhar Vemuri**  
Senior Director – Rating Criteria and Product Development  
Email: somasekhar.vemuri@crisil.com

**Rohit Inamdar**  
Senior Director – Rating structured finance team  
Email: rohit.inamdar@crisil.com

**Ramesh Karunakaran**  
Director – Rating Criteria and Product Development  
Email: ramesh.karunakaran@crisil.com

**Wazeem M A**  
Senior Analyst – Rating Criteria and Product Development  
Email: wazeem.a@crisil.com

In case of any feedback or queries, you may write to us at Criteria.feedback@crisil.com
Executive summary

Legal analysis forms an important element in CRISIL’s methodology for rating structured finance transactions. In general, the basic tenet of structured finance is to de-link the credit profile of the rated instrument from that of the issuer or originator. This will be largely influenced by the nature and extent of insulation of 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 in India are structured within the existing framework of the transfer of property, trust, and contract laws. Additionally, securitisation transactions where originators or investors are regulated by the Reserve Bank of India (RBI) also need to adhere to the applicable regulatory guidelines on these transactions.

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

CRISIL 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’s estate. Secondly, the adequacy of stamp duty since this may affect the enforceability of documents. Thirdly, the nature of internal or external credit enhancement provided for the transaction.

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

In a guarantee-backed transaction, the guarantee should be unconditional, irrevocable and enforceable, among others. Compliance with these key parameters 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 payment waterfall, escrow mechanism and enforceability of the embedded structural features that empowers a debenture trustee to take steps and ensure timely repayment to the debt holders.

Scope

This article provides an overview of CRISIL’s framework which covers the various aspects and the approach used to evaluate legal risks in

- Securitisation transactions
- Future-flow transactions
- Guarantee-backed transactions, and
- CMBS.

---

1 This article is being republished following a periodic review of criteria in September 2018. The previous version of this article, which was published in September 2015, can be accessed here:
A. 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 (PTC) issued by a special purpose vehicle (SPV)
- Direct assignment of loans

The Reserve Bank of India (RBI) has issued guidelines for securitisation and direct assignment transactions which stipulate conditions for carrying out such activity 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 due to bankruptcy of the seller after the sale -- that is, they are bankruptcy remote of the seller. A true sale will establish that the rights and duties with respect to the assets are transferred to the buyer and that these assets are therefore bankruptcy remote from the originator’s estate. The RBI has also prescribed certain criteria to be complied with for a transaction to be deemed a true sale (which are discussed later on in this document). While CRISIL evaluates all pertinent legal risks in a securitisation transaction, the assessment of the true sale aspect is of paramount importance.

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

CRISIL’s legal risk evaluation framework

CRISIL’s framework for evaluating the legal risks in a securitisation transaction covers analysis of risks that could be detrimental to investors and the mitigating factors present in the structure for such risks. While credit, market, and counterparty risks will be evaluated by CRISIL using its criteria for evaluation of such risks, the manifestation of the legal risks needs to be examined through the documents provided to CRISIL as part of the transaction.

The three key aspects evaluated by CRISIL 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 single-most important aspect evaluated under 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 examines whether true sale is established through the transaction documents.

---

2 These guidelines are applicable to counterparties regulated by the RBI and who are party to the transactions.
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 of true sale or a judicial interpretation of it in India. Hence, inter alia, CRISIL 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, since 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 these 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 lead to a vitiation of the condition of bankruptcy remoteness of the transaction. Therefore, if transactions have unusually high levels of risk retention by the originator, CRISIL may regard such transfers as being inconsistent with a true sale.

  If the originators or investors are regulated by the RBI, the transaction should be compliant with the applicable RBI guidelines. Among the various conditions, the originator needs to adhere to the Minimum Retention Requirement (MRR). MRR is primarily designed to ensure that the originators have a continuing stake in the performance of the securitised assets so as to ensure that they carry out proper due diligence of loans to be securitised.

  Securitisation structures in India usually have the originator continuing as the servicer of loans. CRISIL believes that 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 the true sale should result in a complete transfer of risks and benefits, a seller should not be obligated to repurchase assets or support the transaction after the sale of assets. CRISIL believes that any such obligation on the originator to repurchase assets or provide additional assets is inconsistent with a true sale.

  Nevertheless, in those transactions where the terms of the transaction may require the SPV to use cash collections during the revolving period of the transaction to buy fresh assets from the originator, based on predefined eligibility criteria being met. CRISIL 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 also important to establish a true sale. The intention of the parties to a transaction is often scrutinised by the courts in order 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 a transaction do not have the potential to vitiate a true sale. For example, 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 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 assets that are sold. A significant control over the assets by the originator following the sale is viewed unfavourably while establishing true sale.

CRISIL believes that 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. As a result, CRISIL’s framework will examine such covenants and analyse the level of control that the originator continues to have following the sale.

- **Appointment of originator as servicer**

Securitisation transactions in India usually have the originator continuing as the servicer of the assets 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 evaluated. For example, 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 fee, CRISIL believes that in most transactions, the servicer consideration is factored into the purchase price upfront.

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

CRISIL also bases its analysis of a transaction on an independent legal opinion. For each transaction, CRISIL requires 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 and these rates vary widely from state to state.

CRISIL 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 as follows:

- **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 (that is, either unstamped or inadequately stamped) are of no probative force in any court of law. Hence, CRISIL examines the executed documents 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.

---

3 Most agreements quote a minimal fee, which may not be the total consideration for the servicer
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 ten 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 under stamp law is that the person claiming the benefit of a 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 any penalties or fines in respect of the same.

- **Differential rates of stamp duty**

There are variations in stamp duty laws across different states in India. A consequence of the differential stamp duty rates is that if a document executed in one state is taken to another state, the document is liable to be stamped in the second state if the stamp duty in the latter 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 examines the transaction documents to evaluate whether the transaction complies with relevant stamp duty regulations so that no future liability arises on this account to the investors.

- **Registration of documents transferring interest in immoveable assets**

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

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

The credit enhancement in a securitisation transaction can be provided in two ways:

- Internal credit enhancement
- External credit enhancement

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

External credit enhancement is the enhancement provided to a transaction through external forms of support such as:
– Cash collateral
– Guarantee/corporate undertaking

– Cash Collateral

This 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, the 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 that are analysed by CRISIL for evaluating bankruptcy remoteness are:

– Is the cash collateral maintained in a separate account?
– If the account is a current account, then do the documents expressly state that the money lying 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 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 in respect of the account. Additionally, CRISIL requires the originator to furnish a legal opinion from an independent legal counsel confirming the bankruptcy-remoteness of the cash collateral from the originator.

– Guarantee/corporate undertaking

In cases where the credit enhancement is in the form of a guarantee or a corporate undertaking, CRISIL follows the same framework that is used for evaluating guarantee-backed transactions.

Independent legal opinion

The legal risks in a securitisation transaction are many and need to be evaluated appropriately. While CRISIL carries out the analysis of the legal risks in the transaction, it also relies on external legal opinion on certain aspects. As a policy, for every transaction, CRISIL requires the originator to obtain a legal opinion from the transaction counsel confirming the following:

• 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

4 The content of the opinion will however vary depending on the facts of a transaction.
• 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 any applicable law currently prevailing;

• That all transaction documents have been duly executed in accordance with the prevailing stamp duty and registration laws.

B. Legal analysis for future-flow transactions

A future-flow securitisation transaction essentially involves prioritisation of the cash flows of the issuer to meet the rated debt repayments based on pre-defined structure. Hence, a well-defined payment waterfall and a legally sound escrow arrangement form the cornerstones of such transactions. Therefore, CRISIL’s 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 which holds the escrow account. This is typically done through a tripartite agreement between these three parties. This document incorporates the payment structure and establishes the trustee’s rights over the cash flows. CRISIL 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 accordingly CRISIL’s legal analysis focuses on the nature and type of the escrow account. As part of the evaluation, CRISIL assesses the following aspects in this 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 be dependent on the investors’ unrestricted right to the escrowed cash flows. CRISIL ascertains whether the cash flows are subject to any prior encumbrances which could interfere with this right. Typically, such encumbrances are mitigated through a consent/no-objection/pari passu letter provided by the issuer.

C. 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 the strength of the guarantee. Therefore, the legal analysis of the guarantee is a significant input into the analysis of the credit risk profile of the instrument.
CRISIL’s analytical framework requires the guarantee to meet the following key parameters:

- Unconditional
- Irrevocable
- Enforceable
- Presence of 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 one parameter will lead to the guarantee not being considered as adequate for enhancement. For example, 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 examines the legal documentation to ensure that 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.

**D. Commercial mortgage-backed securitisation (CMBS)**

CMBS is a financial instrument secured by receivables from commercial real estate. A CMBS instrument is created by pooling together 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 the revenue cash flows; it is expected to be repaid by refinancing by the ‘indicative maturity date’. If the issuer is not able 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 ‘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 arrive at 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’s legal analysis focuses on these aspects. The approach followed in this analysis is similar to the approach followed in 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’s legal analysis 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, there could other elements which form part of the security package. While CRISIL carries out the analysis of the legal risks in the transaction, it also relies on external legal opinion on certain aspects. As a policy, for every transaction, CRISIL requires the issuer to obtain a legal opinion from the transaction counsel confirming specific aspects of the transaction including, amongst others:

- That the transaction is valid as per the terms of the underlying lease deeds and other underlying documents.
- That there are no prior encumbrances whatsoever 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, the legal analysis conducted by CRISIL is a critical element of such transactions.
E. Provisional ratings

Since 2006, CRISIL had been directly assigning final ratings for structured obligations, based on factors like the credit quality of guarantor, underlying pool of receivables, credit enhancements, etc. as relevant to the transaction; and the presence of legal documents executed to CRISIL’s satisfaction.

With effect from May 2015, CRISIL revised its policy and since then has been assigning ‘provisional’ ratings where necessary. This is in compliance with a May 6, 2015 directive from the Securities and Exchange Board of India (SEBI) for “Standardising the term, rating symbol, and manner of disclosure with regard to conditional/provisional/in principle ratings assigned by CRAs”.

In case completion of certain critical legal documentation is pending at the time of rating assignment, CRISIL will assign provisional ratings to such instruments which will be characterised by a prefix ‘Provisional’ to the rating symbol. This indicates that the rating centrally factors in the completion of certain critical steps/documentation by the issuer for the instrument; without this, the rating would either have been different or not assigned.

The provisional nature of such ratings will be disclosed by CRISIL in its communications, including rating letter and rating rationale. Once the relevant documents (as per expectations when the provisional ratings were assigned) are in place, the provisional ratings will be converted into final ratings as per defined timelines.
About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India’s foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Limited (“CRISIL”). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India (“SEBI”). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business.

We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 1,10,000 MSMEs have been rated by us.

CRISIL Privacy Notice

CRISIL respects your privacy. We may use your contact information, such as your name, address, and email id to fulfill your request and service your account and to provide you with additional information from CRISIL. For further information on CRISIL’s privacy policy please visit www.crisil.com/privacy.