Answers provided

EBA clarifies Article 122a risk retention issues

The European Banking Authority (EBA) has published a set of answers to questions received about Article 122a of the EU's capital requirements directive. In "a huge step forward for the market", the answers build on the CEBS guidelines from December 2010 and clear up many previous uncertainties.

Doug Long, evp business strategy at Principia, explains that the previous guidance left many questions unanswered. "The CEBS issued fairly broad guidelines in December last year. They made it clear that to invest in structured finance, you need to make sure the issuer has met its retention requirements. It listed a good set of operational credit analysis criteria investors must examine to understand the risks they are taking on."

He continues: "That was the framework that the local supervisors have been working from, but ambiguity remained. As they have tried to implement the requirements locally, a lot of questions have arisen. This latest guidance provides more clarification and is firm in reiterating certain elements of the initial guidance to head off potential loop-holes."

Elana Hahn, partner at Morrison & Foerster, is enthusiastic about the answers provided by the EBA. For managed CLOs and ABCP conduits in particular, many issues have now become clearer.

She says: "There is a large section on managed CLOs, which deals specifically with various permutations on fund structures. This is a real breakthrough for the market because people have been discussing potential structures but without knowing exactly what would or would not work. We have run up against a lot of issues and now we have got some answers on them."

The EBA's latest guidelines allow for third-party equity investors to provide the retention requirement for CLOs, albeit with provisos such as being involved in the structuring of the transaction and having no link to the CLO manager. The qualifying retention CLO holder should also be involved in any 'material' changes to the deal over its life. However, manager trading will not have to be vetted day-to-day, so long as eligibility criteria and other tests are complied with.

In addition, funds managed by third parties can play the role of retention interest via the use of originator SPVs, with the retention and holding requirements not extending to the fund's stakeholders.

Another clarification is that CLO managers will no longer be able to capture and monetise gains in equity by selling loans at a profit and reinvesting the money. Instead, the retention must also be

increased commensurately, so that retention requirements are linked to asset values and not values of liabilities.

Hahn believes the increased clarity could help to unlock deal flow. However, she adds: "My only caveat is that there are a few areas where it seems the EBA has provided answers but not bright-line answers. For example, on the question of investor due diligence on the ABCP conduits, their answer is still quite vague."

Hahn continues: "On the one hand, that is positive because it does at least show that the EBA is recognising that there is not necessarily a one-size-fits-all approach and the rule has to be applied on a case-by-case basis. The flip-side of that is that a lot of market participants are really looking for some bright-line tests. It is the uncertainties that are having a bit of a chilling effect on issuance volume."

Increased deal flow would help iron out some of those remaining uncertainties, as it would give regulators a chance to get to grips with some of the practicalities of implementing Article 122a. In that sense, the clarifications could be part of a virtuous circle.

It is also important, however, for investors to develop their own understanding without being too closely spoon fed by regulators. Long notes that the onus at the moment is on not providing a fully prescriptive approach, as individual transactions or exposures will have different characteristics and requirements.

He says: "Investors will need to really analyse their portfolios to quickly understand the granularity of any given deal or new investment. I think the rules have struck an important balance between spelling out what must be done and giving the market enough flexibility to make sound investment decisions that can satisfy the regulation."

Although some uncertainties remain, the EBA has moved the debate on considerably. "There have been a number of comment periods and rewrites of the CEBS guidelines from 2010 and the regulators have clearly worked through many of these issues to come up with quite firm implementation guidelines; the FSA's BIPRU, for example," Long concludes. "These were never intended to be prescriptive per se and there will always be areas open to interpretation. The key is that there is a solid reference point when issuing or investing in structured finance deals and this can help develop a more sustainable market infrastructure."

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