Asset-Backed Alert
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Transaction Doesn't Pass OCC Muster

Banking regulators have rejected a financial institution's request for relief from regulatory capital holding requirements for a transaction backed by unusual assets, including physical property.

The decision was announced in a so-called interpretive letter issued in July by the **Office of the Comptroller of the Currency.**

The institution's name is redacted in the letter posted on the OCC's website. However, securitization pros say it is relevant to any financial institution that might be considering similar transactions.

Banks can obtain relief from regulatory capital requirements by issuing traditional securitizations or synthetic risk-transfer transactions involving a guarantee or credit derivative.

In this case, the institution seeking relief transferred assets including service contracts, intellectual property, software and physical assets such as hardware to an SPV that issued notes.

The OCC concluded that the transaction failed to meet three criteria necessary to qualify for relief. First, the underlying exposures are not primarily financial in nature. Second, the performance of the issued notes does not depend on the performance of the underlying assets. And finally, the regulators concluded that the assets are owned by an operating company.

"The general concept is that banks can segregate assets in an SPV, and, if a deal is structured properly, they get capital relief," said **Carleton Goss,** a partner at law firm **Hunton Andrews** who formerly worked at the OCC. "The OCC is saying that this doesn't work for all types of assets."

The letter asserts that many of the assets held by the SPV, including the intellectual property, software and hardware, are not financial exposures.

The service contracts could be considered a financial exposure. However, the OCC took issue with the fact that their performance is heavily dependent on the institution's ability to continue providing services under the contracts, and not just on the creditworthiness of the customers. And while the transaction is structured so that the SPV could employ an alternate servicer, the OCC said it is uncertain whether another company could meet all the terms of the service contracts, which could affect the customers' willingness to continue making payments.

Either of those factors alone would have been sufficient to disqualify the bank from receiving capital relief for the transaction. But the OCC further concluded that the assets in the transaction are effectively held by an operating company. That's because the SPV's servicer must actively provide a service to its customers to earn their money. In a typical securitization, a servicer simply collects money owed on a debt.

"The economic substance of the transaction represents the transfer of a significant business enterprise to the SPV, and not just the transfer of assets to an entity established to simply invest, reinvest, hold, or trade in financial assets," the letter states. ❖