Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #990
April 2004
12 CFR 3

October 17, 2003

Dear [ ]:

This letter responds to your letter dated May 20, 2003, concerning the capital treatment for merchant processing intangibles (MPIs). [ ] (the Bank) requested that MPIs be included in qualifying intangible assets subject to the same limitations as purchased credit card relationships (PCCRs) for purposes of calculating Tier 1 capital. The OCC has concluded that the current capital treatment of MPIs is appropriate and that the Bank should continue to deduct MPIs from Tier 1 capital and from assets in calculating regulatory capital.

Background

Generally, goodwill and other intangible assets are deducted from Tier 1 capital.[1] Mortgage servicing assets (MSAs), nonmortgage servicing assets (NMSAs), and PCCRs, however, are qualifying intangible assets and, subject to certain limits, need not be deducted from Tier 1 capital. Currently, the limit for all qualifying intangible assets is 100% of Tier 1 capital and NMSAs and PCCRs are subject to a further sublimit of 25% of Tier 1 capital.[2] Qualifying intangible assets are also subject to valuation at least quarterly at the lesser of 90% of the fair value of each intangible asset or 100% of the remaining unamortized book value.[3]

When the OCC amended its capital regulations in 1993, it eliminated a three-part test for determining qualifying intangibles from the regulatory language. The OCC indicated, however, that it would continue to use these criteria as guidance in deciding whether to expand the list of qualifying intangible assets. The three-part test required that:

1) The intangible asset must be able to be separated and sold apart from the bank or from the bulk assets of the bank;

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[1] 12 C.F.R. Part 3, Appendix A Section 2(c)(1)(i) and (ii).
[2] 12 C.F.R. Part 3, Appendix A Section 2(c)(2)(i).
[3] 12 C.F.R. Part 3, Appendix A Section 2(c)(2)(ii).

2) The market value of the intangible asset must be established on an annual basis through an identifiable stream of cash flows, and there must be a high degree of certainty that the asset will hold this market value notwithstanding the future prospects of the bank; and
3) The bank must demonstrate that a market exists which will provide liquidity for the intangible asset.

The *Comptroller's Handbook* defines the business of merchant processing as, "The settlement of electronic payment transactions for merchants. It is a separate and distinct business line from credit card issuing. Merchant processing activity, which is off-balance-sheet, involves gathering sales information from the merchant, collecting funds from the issuing bank, and paying the merchant."[4] Your letter indicates that a merchant processing intangible arises when a buyer pays a premium for a merchant processing business or a merchant contract portfolio. The premium is based on the expected future cash flows generated by the underlying merchant contracts.

In the fall of 2000, the OCC reviewed the appropriate capital treatment for MPIs and determined that MPIs should continue to be deducted from Tier 1 capital. As part of that review, the OCC concluded that MPIs did not meet the requirements of the three-part test described above. Among other factors, a sufficiently liquid market for these assets did not exist.

Discussion

The Bank has proposed that, for risk-based capital purposes, MPIs should be treated in the same manner as PCCRs for the following reasons:

- The merchant processing industry has matured in recent years and the marketability and salability of MPIs are equivalent to that of PCCRs.
- MPIs are valued according to GAAP based on projected cash flows similar to PCCRs.
- The Federal Reserve Board's regulations with respect to MPIs are unclear.
- Deducting MPIs from Tier 1 capital puts banks at a competitive disadvantage with respect to non-bank competitors.

To support the proposal, the Bank provided information documenting sales of businesses and portfolios and discussed the method used to value MPIs. In revisiting the capital treatment for MPIs, the OCC considered the requirements of the three-part test for separability and valuation and sought to determine whether the market for MPIs has become sufficiently liquid that it meets the liquidity requirement for qualifying intangibles.

Separability – Are MPIs able to be sold separately from a bank? The Bank suggests that the number of sales of both businesses and portfolios demonstrates that MPIs are a separately saleable asset. The Bank's data for sales of merchant processing portfolios and businesses for 1994 through early-2003 identified numerous transactions. The Bank also indicates that portfolios where the merchant processing is done under the original bank's name have a higher value.

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[4] *Merchant Processing, Comptroller's Handbook*, December 2001, p. 1.

While the number of transactions suggests that merchant processing assets can be sold separately from a bank, the OCC notes that many portfolios are sold on a "flow" basis; i.e., the seller agrees to generate and sell new accounts to the buyer. The OCC believes that these continuing relationships with the seller suggest that the "separability" provision of the three-part test may not be fully met.

Valuation – Can the market value of MPIs be established through an identifiable stream of cash flows and is there a high degree of certainty that MPIs will hold this market value independently of a bank? The Bank argues that the valuation issues for PCCRs and MPIs are similar and predictable and, in both cases, are based on credit card activity. As evidence of stable valuation, the Bank notes that estimated earnings per share for publicly-traded merchant processors closely track actual earnings per share and that the earnings behavior of "pure play" credit card companies is actually less predictable and more volatile. As further support for stable valuation, the Bank observes that current prices for merchant processing assets range from 2.5-3.5 times net revenue.

Pricing of merchant processing is a fairly standard process based on projected net cash flows, but the OCC's analysis indicates that pricing can vary widely as a multiple of net revenue. Prices vary depending on the types and number of merchants in a portfolio, charge back and loss rates, and attrition rates. Growing portfolios also command a higher price than static portfolios. The OCC is also concerned about the variability of the key underlying assumptions on which the valuation of MPIs is based. There appear to be significant annual revisions in attrition and revenue assumptions.

Marketability/Liquidity – Does a liquid market exist for MPIs? In 2000, the market for merchant processing portfolios was comprised of 4 to 8 buyers of large portfolios and businesses and about 20 buyers of smaller portfolios. On average, there were 4 to 6 large transactions of over $500 million in annual volume per year and at least 12 smaller deals a year. Based on the information the Bank has provided, the market today for MPIs appears to be more active than in 2000. The number of buyers of merchant processing businesses and portfolios increased in 2001 and again in 2002.

While the market is more active, the OCC believes that the saleability of merchant processing portfolios and businesses varies widely depending on the degree of concentration of national merchants or types of merchants, the existence of proprietary processing systems, and other unique characteristics. Based on these considerations, the OCC believes the market for MPIs does not meet the liquidity requirement of the three-part test.

Conclusion

For the reasons cited above, the OCC has determined that the list of qualifying intangible assets should not be expanded. Consequently, MPIs should not be considered as qualifying intangibles in the calculation of Tier 1 capital. This conclusion is based in part on the failure of MPIs to meet the three-part test for separability, valuation, and marketability. We have consulted with staffs of the other U.S. banking agencies and they are in agreement with this policy.

If you have questions or need additional information, please contact Nancy Hunt at (202) 874-5070.

Sincerely,

/s/

Tommy Snow
Director, Capital Policy